Title 26—Internal Revenue

(This book contains part 1, §§1.401 to 1.409)

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY (CONTINUED)

SUBCHAPTER A—INCOME TAX (CONTINUED)

SUPPLEMENTARY PUBLICATIONS: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol and Tobacco Tax Regulations, and Regulations Under Tax Conventions.*

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

NORMAL TAXES AND SURTAXES (CONTINUED)

DEFERRED COMPENSATION, ETC.

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

1.409(p)–1T Prohibited allocation of securities in an S corporation (temporary)

AUTHORITY: 26 U.S.C. 401(m)(9) and 26 U.S.C. 7805.

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Section 1.401(k)–3 is also issued under 26 U.S.C. 401(m)(9).

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Section 1.408A–6 also issued under 26 U.S.C. 408A.

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Section 1.408A–9 also issued under 26 U.S.C. 408A.

Section 1.409(p)–1 is also issued under 26 U.S.C. 409(p)(7).

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. See §§1.72–15, 1.72–16, and 1.402(a)–1(e) for rules regarding the tax treatment of 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; T.D. 9665, 79 FR 26842, May 12, 2014]

§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 or attainment of normal retirement age (subject to paragraph (b)(2) of this section). A plan does not fail to satisfy this paragraph (b)(1)(i) merely because the plan provides, in accordance with section 401(a)(36), that a distribution may be made from the plan to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.

(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(a)–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.

(2) *Normal retirement age*—(i) *General rule*. The normal retirement age under a plan must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(ii) *Age 62 safe harbor*. A normal retirement age under a plan that is age 62 or later is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(iii) *Age 55 to age 62*. In the case of a normal retirement age that is not earlier than age 55 and is earlier than age 62, whether the age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed is based on all of the relevant facts and circumstances.

(iv) *Under age 55*. A normal retirement age that is lower than age 55 is presumed to be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed, unless the Commissioner determines that under the facts and circumstances the normal retirement age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(v) *Age 50 safe harbor for qualified public safety employees*. A normal retirement age under a plan that is age 50 or later is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if substantially all of the participants in the plan are qualified public safety employees (within the meaning of section 72(t)(10)(B)).

(3) *Benefit distribution prior to retirement*. For purposes of paragraph (b)(1)(i) of this section, retirement does not include a mere reduction in the number of hours that an employee works. Accordingly, benefits may not be distributed prior to normal retirement age solely due to a reduction in the number of hours that an employee works.

(4) *Effective date*. Except as otherwise provided in this paragraph (b)(4), paragraphs (b)(2) and (3) of this section are effective May 22, 2007. In the case of a

governmental plan (as defined in section 414(d)), paragraphs (b)(2) and (3) of this section are effective for plan years beginning on or after January 1, 2009. In the case of a plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on May 22, 2007, paragraphs (b)(2) and (3) of this section do not apply before the first plan year that begins after the last of such agreements terminate determined without regard to any extension thereof (or, if earlier, May 24, 2010. See §1.411(d)–4, A–12, for a special transition rule in the case of a plan amendment that increases a plan's normal retirement age pursuant to paragraph (b)(2) of this section.

[T.D. 7748, 46 FR 1695, Jan. 7, 1981, as amended by T.D. 9319, 72 FR 16894, Apr. 5, 2007; T.D. 9325, 72 FR 28606, May 22, 2007]

§ 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.* Notwithstanding paragraph (a) of this section, a plan, or trust forming part of a plan, may provide for the reversion to the employer, upon termination of the plan, of amounts contributed to the plan that exceed the limitations imposed under section 415(c), to the extent set forth in rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

[T.D. 7748, 46 FR 1696, Jan. 7, 1981, as amended by T.D. 9319, 72 FR 16894, Apr. 5, 2007]

§ 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 existing 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.* For rules regarding the information required to be provided with respect to the election to waive a QJSA or a QPSA, see § 1.417(a)(3)–1.

(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, as amended by T.D. 7510, 42 FR 53956, Oct. 4, 1977; T.D. 8219, 53 FR 31841, Aug. 22, 1988; 53 FR 48534, Dec. 1, 1988; T.D. 9099, 68 FR 70144, Dec. 17, 2003]

§ 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. A plan does not fail to satisfy the requirements of this Q&A–16 merely because the amount payable under an optional form of benefit that is subject to the minimum present value requirement of section 417(e)(3) is calculated using the applicable interest rate (and, for periods when required, the applicable mortality table) under section 417(e)(3).

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 incompetnent 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. For rules regarding the explanation of QPSAs and QJSAs required under section 417(a)(3), see §1.417(a)(3)–1. However, the rules of §1.401(a)–20, Q&A–36, as it appeared in 26 CFR part 1 revised April 1, 2003, apply to the explanation of a QJSA under section 417(a)(3) for an annuity starting date prior to February 1, 2006.

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; T.D. 9099, 68 FR 70144, Dec. 17, 2003; T.D. 9256, 71 FR 14802, Mar. 24, 2006]

§ 1.401(a)–21 Rules relating to the use of an electronic medium to provide applicable notices and to make participant elections.

(a) *Introduction*—(1) *In general*—(i) *Permission to use an electronic medium.* This section provides rules relating to the use of an electronic medium to provide applicable notices and to make participant elections as defined in paragraph (e)(1) and (6) of this section with respect to retirement plans, employee benefit arrangements, and individual retirement plans described in paragraph (a)(2) of this section. The rules in this section reflect the provisions of the Electronic Signatures in Global and National Commerce Act, Public Law 106–229 (114 Stat. 464 (2000) (E–SIGN)).

(ii) *Notices and elections required to be in writing or in written form*—(A) *In general.* The rules of this section must be satisfied in order to use an electronic medium to provide an applicable notice or to make a participant election if the notice or election is required to be in writing or in written form under the Internal Revenue Code, Department of Treasury regulations, or other guidance issued by the Commissioner.

(B) *Rules relating to applicable notices.* An applicable notice that is provided using an electronic medium is treated as being provided in writing or in written form if and only if the requirements of paragraph (a)(5) of this section are satisfied and either the consumer consent requirements of paragraph (b) of this section or the requirements for exemption from the consumer consent requirements under paragraph (c) of this section are satisfied. For example, in order to provide a section 402(f) notice electronically, a qualified plan must satisfy either the consumer consent requirements of paragraph (b) of this section or the requirements for exemption under paragraph (c) of this section. If a plan fails to satisfy either of these requirements, the plan must provide the section 402(f) notice using a written paper document in order to satisfy the requirements of section 402(f).

(C) *Rules relating to participant elections.* A participant election that is made using an electronic medium is treated as being provided in writing or in written form if and only if the requirements of paragraphs (a)(5) and (d) of this section are satisfied.

(iii) *Safe harbor method for applicable notices and participant elections that are not required to be in writing or written form.* For an applicable notice or a participant election that is not required to be in writing or in written form, the rules of this section provide a safe harbor method for using an electronic medium to provide the applicable notice or to make the participant election.

(2) *Application of rules*—(i) *Notices, elections, or consents under retirement plans.* The rules of this section apply to any applicable notice or any participant election relating to the following retirement plans: A qualified retirement plan under section 401(a) or 403(a); a section 403(b) plan; a simplified employee pension (SEP) under section 408(k); a simple retirement plan under section 408(p); or an eligible governmental plan under section 457(b).

(ii) *Notices, elections, or consents under other employee benefit arrangements.* The rules of this section also apply to any applicable notice or any participant election relating to the following employee benefit arrangements: An accident and health plan or arrangement under sections 104(a)(3) and 105; a cafeteria plan under section 125; an educational assistance program under section 127; a qualified transportation fringe program under section 132; an Archer MSA under section 220; or a health savings account under section 223.

(iii) *Notices, elections, or consents under individual retirement plans.* The rules of this section also apply to any applicable notice or any participant election relating to individual retirement plans, including a Roth IRA under section 408A; or a deemed IRA under a qualified employer plan described in section 408(q).

(3) *Limitation on application of rules*—(i) *In general.* The rules of this section do not apply to any notice, election, consent, disclosure, or obligation required under the provisions of title I or IV of the Employee Retirement Income Security Act of 1974, as amended (ERISA), over which the Department of Labor or the Pension Benefit Guaranty Corporation has interpretative and enforcement authority. For example, the rules in 29 CFR 2520.104b–1 of the Department of Labor Regulations apply with respect to an employee benefit plan providing disclosure documents, such as a summary plan description or a summary annual report. The rules in this section also do not apply to Internal Revenue Code section 411(a)(3)(B) (relating to suspension of benefits), Internal Revenue Code section 4980B(f)(6)

(relating to an individual's COBRA rights), or any other Internal Revenue Code provision over which Department of Labor or the Pension Benefit Guaranty Corporation has similar interpretative authority.

(ii) *Recordkeeping and other requirements.* The rules in this section only apply with respect to applicable notices and participant elections relating to an individual's rights under a retirement plan, an employee benefit arrangement, or an individual retirement plan. Thus, the rules in this section do not alter the otherwise applicable requirements under the Internal Revenue Code, such as the requirements relating to tax reporting, tax records, or substantiation of expenses. See section 6001 for rules relating to the maintenance of records, statements, and special returns. See also section 101(e) of E–SIGN, which provides that if an electronic record of an applicable notice or a participant election is not maintained in a form that is capable of being retained and accurately reproduced for later reference, then the legal effect, validity, or enforceability of such electronic record may be denied.

(4) *General requirements related to applicable notices and participant elections.* The rules of this section supplement the general requirements related to each applicable notice and participant election. Thus, in addition to satisfying the rules for timing and content, the rules in this section must be satisfied.

(5) *Requirements related to the design of an electronic system used to deliver applicable notices and to make participant elections*—(i) *The electronic system must take into account the content of a notice.* With respect to the content of an applicable notice, the electronic system must be reasonably designed to provide the information in the notice to a recipient in a manner that is no less understandable to the recipient than a written paper document.

(ii) *Identification of the significance of information in the notice.* The electronic system must be designed to alert the recipient, at the time an applicable notice is provided, to the significance of the information in the notice (including identification of the subject matter of the notice), and provide any instructions needed to access the notice, in a manner that is readily understandable.

(b) *Consumer consent requirements*—(1) *Requirements.* With respect to an applicable notice, the consumer consent requirements of this paragraph (b) are satisfied if—

(i) The requirements in paragraphs (b)(2) through (4) of this section are satisfied; and

(ii) In accordance with section 101(c)(6) of E–SIGN, the applicable notice is not provided through the use of oral communication or a recording of an oral communication.

(2) *Consent*—(i) *In general.* The recipient must affirmatively consent to the delivery of the applicable notice using an electronic medium. This consent must be either—

(A) Made electronically in a manner that reasonably demonstrates that the recipient can access the applicable notice in the electronic medium in the form that will be used to provide the notice; or

(B) Made using a written paper document (or using another form not described in paragraph (b)(2)(i)(A) of this section), but only if the recipient confirms the consent electronically in a manner that reasonably demonstrates that the recipient can access the applicable notice in the electronic medium in the form that will be used to provide the notice.

(ii) *Withdrawal of consumer consent.* The consent to receive electronic delivery requirement of this paragraph (b)(2) is not satisfied if the recipient withdraws his or her consent before the applicable notice is delivered.

(3) *Required disclosure statement.* The recipient, prior to consenting under paragraph (b)(2)(i) of this section, must be provided with a clear and conspicuous statement containing the disclosures described in paragraphs (b)(3)(i) through (v) of this section:

(i) *Right to receive paper document*—(A) *In general.* The statement informs the recipient of any right to have the applicable notice be provided using a written paper document or other non-electronic form.

(B) *Post-consent request for paper copy.* The statement informs the recipient how, after having provided consent to receive the applicable notice electronically, the recipient may, upon request, obtain a paper copy of the applicable notice and whether any fee will be charged for such copy.

(ii) *Right to withdraw consumer consent.* The statement informs the recipient of the right to withdraw consent to receive electronic delivery of an applicable notice on a prospective basis at any time and explains the procedures for withdrawing that consent and any conditions, consequences, or fees in the event of the withdrawal.

(iii) *Scope of the consumer consent.* The statement informs the recipient whether the consent to receive electronic delivery of an applicable notice applies only to the particular transaction that gave rise to the applicable notice or to other identified transactions that may be provided or made available during the course of the parties' relationship. For example, the statement may provide that a recipient's consent to receive electronic delivery will apply to all future applicable notices of the recipient relating to the employee benefit arrangement until the recipient is no longer a participant in the employee benefit arrangement (or withdraws the consent).

(iv) *Description of the contact procedures.* The statement describes the procedures to update information needed to contact the recipient electronically.

(v) *Hardware or software requirements.* The statement describes the hardware and software requirements needed to access and retain the applicable notice.

(4) *Post-consent change in hardware or software requirements.* If, after a recipient provides consent to receive electronic delivery, there is a change in the hardware or software requirements needed to access or retain the applicable notice and such change creates a material risk that the recipient will not be able to access or retain the applicable notice in electronic format—

(i) The recipient must receive a statement of—

(A) The revised hardware or software requirements for access to and retention of the applicable notice; and

(B) The right to withdraw consent to receive electronic delivery without the imposition of any fees for the withdrawal and without the imposition of any condition or consequence that was not previously disclosed in paragraph (b)(3) of this section; and

(ii) The recipient must reaffirm consent to receive electronic delivery in accordance with the requirements of paragraph (b)(2) of this section.

(c) *Exemption from consumer consent requirements*—(1) *In general.* This paragraph (c) is satisfied if the conditions in paragraphs (c)(2) and (3) of this section are satisfied. This paragraph (c) constitutes an exemption from the consumer consent requirements of section 101(c) of E–SIGN pursuant to the authority granted in section 104(d)(1) of E–SIGN.

(2) *Effective ability to access.* For purposes of this paragraph (c), the electronic medium used to provide an applicable notice must be a medium that the recipient has the effective ability to access.

(3) *Free paper copy of applicable notice.* At the time the applicable notice is provided, the recipient must be advised that he or she may request and receive the applicable notice in writing on paper at no charge, and, upon request, that applicable notice must be provided to the recipient at no charge.

(d) *Special rules for participant elections*—(1) *In general.* This paragraph (d) is satisfied if the conditions described in the following paragraphs (d)(2) through (6) are satisfied:

(2) *Effective ability to access.* The electronic medium under an electronic system used to make a participant election must be a medium that the person who is eligible to make the election is effectively able to access. If the appropriate individual is not effectively able to access the electronic medium for making the participant election, the participant election will not be treated as made available to that individual. Thus, for example, the participant election will not be treated as made available to that individual for purposes of the rules under section 401(a)(4).

(3) *Authentication.* The electronic system used in making participant elections is reasonably designed to preclude any person other than the appropriate individual from making the election. Whether this condition is satisfied is based on facts and circumstances, including whether the participant election has the potential for a conflict of interest between the individuals involved in the election. See *Examples 3*, *4*, and *5* of paragraph (f) of this section for illustrations of electronic systems that satisfy the authentication requirement of this paragraph (d)(3).

(4) *Opportunity to review.* The electronic system used in making participant elections provides the person making the participant election with a reasonable opportunity to review, confirm, modify, or rescind the terms of the election before the election becomes effective.

(5) *Confirmation of action.* The person making the participant election receives, within a reasonable time, a confirmation of the effect of the election under the terms of the plan or arrangement through either a written paper document or an electronic medium under a system that satisfies the requirements of either paragraph (b) or (c) of this section (as if the confirmation were an applicable notice).

(6) *Participant elections, including spousal consents, that are required to be witnessed by a plan representative or a notary public*—(i) *In general.* In the case of a participant election which is required to be witnessed by a plan representative or a notary public (such as a spousal consent under section 417), the signature of the individual making the participant election is witnessed in the physical presence of a plan representative or a notary public.

(ii) *Electronic notarization permitted.* If the requirements of paragraph (d)(6)(i) of this section are satisfied, an electronic notarization acknowledging a signature (in accordance with section 101(g) of E–SIGN and State law applicable to notary publics) will not be denied legal effect if the signature of the individual is witnessed in the physical presence of a notary public.

(iii) *Delegation to Commissioner.* In guidance published in the Internal Revenue Bulletin, the Commissioner may provide that the use of procedures under an electronic system is deemed to satisfy the physical presence requirement under paragraph (d)(6)(i) of this section, but only if those procedures with respect to the electronic system provide the same safeguards for participant elections as are provided through the physical presence requirement. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(e) *Definitions.* The definitions in this paragraph (e) apply for purposes of this section.

(1) *Applicable notice.* The term *applicable notice* includes any notice, report, statement, or other document required to be provided to a recipient under a retirement plan, employee benefit arrangement, or individual retirement plan as described in paragraph (a)(2) of this section.

(2) *Electronic.* The term *electronic* means technology having electrical, digital, magnetic, wireless, optical, electromagnetic, voice-recording systems, or similar capabilities.

(3) *Electronic medium.* The term *electronic medium* means an electronic method of communication (*e.g.*, Web site, electronic mail, telephonic system, magnetic disk, and CD-ROM).

(4) *Electronic record.* The term *electronic record* means an applicable notice or a participant election that is created, generated, sent, communicated, received, or stored by electronic media.

(5) *Electronic system.* The term *electronic system* means a system designed for creating, generating, sending, receiving, storing, retrieving, displaying, or processing information that makes use of any electronic medium.

(6) *Participant election.* The term *participant election* includes any consent, election, request, agreement, or similar communication made by or from a participant, beneficiary, alternate payee, or an individual entitled to benefits under a retirement plan, employee benefit arrangement, or individual retirement plan as described in paragraph (a)(2) of this section.

(7) *Recipient.* The term *recipient* means a plan participant, beneficiary, employee, alternate payee, or any other person to whom an applicable notice is to be provided.

(f) *Examples.* The following examples illustrate the rules of this section. *Examples 1, 2, 3,* and *6* assume that the requirements of paragraph (a)(4) and (5) of this section are satisfied.

Example 1. (i) *Facts involving using the consumer consent requirements to deliver a section 402(f) notice via e-mail.* Plan A, a qualified plan, permits participants to request benefit distributions from the plan on Plan A's Internet Web site. Under Plan A's system for such transactions, a participant must enter his or her account number, personal identification number (PIN), and his or her e-mail address to which the notice is to be sent. The participant's PIN and account number must match the information in Plan A's records in order for the transaction to proceed. Participant H requests a distribution from Plan A on Plan A's Web site, and, at the time of the request for distribution, a disclosure statement appears on the computer screen that explains that Participant H can consent to receive the section 402(f) notice electronically. The disclosure statement provides information relating to the consent, including how to receive a paper copy of the notice, how to withdraw consent, the hardware and software requirements, and the procedures for accessing the section 402(f) notice, which is in a file format from a specific spreadsheet program. After reviewing the disclosure statement, which satisfies the requirements of paragraph (b)(3) of this section, Participant H consents to receive the section 402(f) notice via e-mail by selecting the consent button at the end of the disclosure statement. As a part of the consent procedure, an e-mail is sent to Participant H's e-mail address in order to demonstrate that Participant H can access the spreadsheet program. In the e-mail, Participant H is prompted to answer a question from the spreadsheet program, which is in an attachment to the e-mail. Once Participant H correctly answers the question, the section 402(f) notice is then delivered to Participant H via e-mail.

(ii) *Conclusion.* In this *Example 1*, Plan A's delivery of the section 402(f) notice to Participant H satisfies the requirements of paragraph (b) of this section.

Example 2. (i) *Facts*—(A) *Facts involving using the alternative method to deliver a section 411(a)(11) notice via e-mail.* Plan B, a qualified plan, permits participants to request benefit distributions from the plan on Plan B's Internet Web site. Under Plan B's system for such transactions, a participant must enter his or her account number and personal identification number (PIN), and his or her e-mail address to which the notice is to be sent. The participant's PIN and account number must match the information in Plan B's records in order for the transaction to proceed. After Participant K, a single employee, requests a distribution from Plan B on Plan B's Internet Web site, the plan administrator provides Participant K with a section 411(a)(11) notice in an attachment to an e-mail. Plan B sends the e-mail with a request for a computer generated notification that the message was received and opened. The e-mail instructs Participant K to read the attachment for important information regarding the request for a distribution. In addition, the e-mail also states that Participant K may request the section 411(a)(11) notice on a written paper document and that, if Participant K requests the notice on a written paper document, it will be provided at no charge. Plan B receives notification indicating that the e-mail was received and opened by Participant K.

(B) *Facts involving making a participant's consent to a distribution.* In order to consent to a distribution, Plan B requires a participant to enter the participant's account number and PIN in order to preclude any person other than the participant from making the election. After the authentication process, Participant K completes a distribution request form on the Web site. After completing the request form, the Web site provides a summary of the information entered on the form and gives Participant K an opportunity to review or modify the distribution request form before the transaction is completed. Within a reasonable period of time after Participant K consents to the distribution, the plan administrator, by e-mail, sends confirmation of the terms (including the form) of the distribution to Participant K and advises Participant K that, upon request, the confirmation may be provided to Participant K on a written paper document at no charge. Plan B retains an electronic copy of the consent to the distribution in a form that is capable of being retained and accurately reproduced for later reference by Participant K.

(ii) *Conclusion.* In this *Example 2*, Plan B's delivery of the section 411(a)(11) notice and the electronic system used to make Participant K's consent to a distribution satisfy the requirements of paragraphs (a), (c), and (d) of this section.

Example 3. (i) *Facts involving the transmission of a spousal consent via electronic notarization.* Plan C, a qualified money purchase pension plan, permits a married participant to request a plan loan through the Plan C's Internet Web site with the notarized consent of the spouse. Under Plan C's system for requesting a plan loan, a participant must enter his or her account number, personal identification number (PIN), and his or her e-mail address. The information entered by the participant must match the information in Plan C's records in order for the transaction to proceed. Participant M, a married participant, is effectively able to access the Web site available to apply for a plan loan. In order to apply for a loan, Plan C requires a participant to enter the participant's account number and PIN in order to preclude any person other than the participant from making the election. Participant M completes the loan application on Plan C's Web site. Within a reasonable period of time after submitting the plan loan application, the plan administrator, by e-mail, sends Participant M the loan application, including all attachments setting forth the terms of the loan agreement and all other required information. In the e-mail, Plan C also notifies Participant M that, upon request, the loan application may be provided to Participant M on a written paper document at no charge. Plan C then instructs Participant M that, in order for the loan application to proceed, Participant M must submit to the plan administrator a notarized spousal consent form. Participant M and M's spouse go to a notary public and the notary witnesses Participant M's spouse signing the spousal consent for the loan agreement on an electronic signature capture pad with adequate security. After witnessing M's spouse signing the spousal consent, the notary public sends an e-mail with an electronic acknowledgement that is attached to or logically associated with the signature of M's spouse to the plan administrator. The electronic acknowledgement is in accordance with section 101(g) of E–SIGN and the relevant State law applicable to notary publics. After the plan receives the e-mail, Plan C sends an e-mail to Participant M, giving M a reasonable period to review and confirm the completed loan application and to determine whether the loan application should be modified or rescinded. In addition, the e-mail to Participant M also provides that M may request the completed loan application on a written paper document and that, if M requests the written paper document, it will be provided at no charge. Plan C retains an electronic copy of the loan agreement, including the spousal consent, in a form that is capable of being retained and accurately reproduced for later reference by all parties.

(ii) *Conclusion*. In this *Example 3*, the transmission of the plan loan agreement satisfies the requirements of paragraphs (a), (c), and (d) of this section. By requiring that the spouse sign the spousal consent on an electronic signature capture pad in the physical presence of a notary public, the electronic system satisfies the requirement that the system be reasonably designed to preclude any person other than the appropriate individual from making the election. Thus, the electronic notarization of spousal consent satisfies the requirements of paragraphs (a) and (d) of this section.

Example 4. (i) *Facts*—(A) *Facts involving using the alternative method of compliance to deliver a section 411(a)(11) notice via an automated telephone system.* A qualified profit-sharing plan (Plan D) permits participants to request distributions through an automated telephone system. Under Plan D's system for such transactions, a participant must enter his or her account number and personal identification number (PIN); this information must match the information in Plan D's records in order for the transaction to proceed. Plan D provides only the following distribution options: single-sum payment; and annual installments over 5, 10, or 20 years. Participant N, a single participant, requests a distribution from Plan D by following the applicable instructions on the automated telephone system. After Participant N has requested the distribution, the automated telephone system recites the section 411(a)(11) notice over the phone. The automated telephone system also advises Participant N that, upon request, the notice may be provided on a written paper document and that, if Participant N so requests, the notice will be provided on a written paper document at no charge.

(B) *Facts involving making a participant's consent to a distribution via an automated telephone system.* In order to consent to a distribution, Plan D requires a participant to enter the participant's account number and PIN in order to preclude any person other than the participant from making the election. Participant N requests a distribution by entering information on the automated telephone system. After completing the request, the automated telephone system provides a oral summary of the information entered and gives Participant N an opportunity to review or modify the distribution request before the transaction is completed. Plan D's automated telephone system confirms the distribution request to Participant N and advises Participant N that, upon request, a confirmation may be provided on a written paper document at no charge. Plan D retains an electronic copy of the consent to the distribution in a form that is capable of being retained and accurately reproduced for later reference by Participant N.

(ii) *Conclusion*. In this *Example 4*, because Plan D has relatively few and simple distribution options, the provision of the section 411(a)(11) notice through the automated telephone system is no less understandable to the participant than a written paper notice for purposes of paragraph (a)(5)(i) of this section. In addition, the automated telephone procedures of Plan D satisfy the applicable requirements of paragraphs (a), (c), and (d) of this section.

Example 5. (i) *Facts*. Same facts as *Example 4* of this paragraph (f), except that, pursuant to Plan D'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 the predetermined instructions from the plan administrator.

(ii) *Conclusion.* As in *Example 4* of this paragraph (f), because Plan D has relatively few and simple distribution options, the provision of the section 411(a)(11) notice through the automated telephone system is no less understandable to the participant than a written paper notice for purposes of paragraph (a)(4) of this section. Further, in this *Example 5*, the customer service telephone procedures of Plan D satisfy the requirements of paragraphs (a), (c), and (d) of this section.

Example 6. (i) *Facts.* Plan E, a qualified plan, permits participants to request distributions by e-mail on the employer's e-mail system. Under this system, a participant must enter his or her account number, personal identification number (PIN), and e-mail address. This information must match that in Plan E's records in order for the transaction to proceed. If a participant requests a distribution 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. Participant Q requests a distribution and receives the section 411(a)(11) notice from the plan administrator by reply e-mail. However, before Participant Q elects a distribution, Q terminates employment. Following termination of employment, Participant Q no longer has access to the employer's e-mail system.

(ii) *Conclusion.* In this *Example 6*, Plan E does not satisfy the participant election requirements under paragraph (d) of this section because Participant Q is not effectively able to access the electronic medium used to make the participant election. Plan E must provide Participant Q with the opportunity to make the participant election through a written paper document or another system that Participant Q is effectively able to access, such as the automated telephone systems described in *Example 4* and *Example 5* of this paragraph (f).

(g) *Effective date.* The rules provided in this section apply to applicable notices provided, and to participant elections made, on or after January 1, 2007. However, a retirement plan, an employee benefit arrangement, or an individual retirement plan that provides an applicable notice or makes a participant election that complies with the requirements set forth in these regulations on or after October 1, 2000, and before January 1, 2007, will not be treated as failing to provide an applicable notice or to make a participant election merely because the notice or election was not in writing or written form.

[T.D. 9294, 71 FR 61883, Oct. 20, 2006]

§ 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)(2)–1 Refund of mistaken employer contributions and withdrawal liability payments to multiemployer plans.

(a) *Introduction*—(1) *In general.* Section 401(a)(2) provides that a contribution or payment of withdrawal liability made to a multiemployer plan due to a mistake of fact or mistake of law can be returned to the employer under certain conditions. This section specifies the conditions under which an employer's contribution or payment may be returned.

(2) *Effective dates.* This section applies to refunds made after July 22, 2002.

(b) *Conditions for return of contribution*—(1) *In general.* In the case of a contribution or a withdrawal liability payment to a multiemployer plan which was made because of a mistake of fact or a mistake of law, the plan will not violate section 401(a)(2) merely because the contribution or payment is returned within six months after the date on which the plan administrator determines that the contribution or payment was the result of a mistake of fact or law. The contribution or payment is considered as returned within the required period if the employer establishes a right to a refund of the amount mistakenly contributed or paid by filing a claim with the plan administrator within six months after the date on which the plan administrator determines that a mistake did occur. For purposes of this section, plan administrator is defined in section 414(g) and the regulations thereunder.

(2) *Applicable conditions*—(i) *In general.* The employer making the contribution or withdrawal liability payment to a multiemployer plan must demonstrate that an excessive contribution or overpayment has been made due to a mistake of fact or law. A mistake of fact or law relating to plan qualification under section 401 or to trust exemption under section 501 is not considered to be a mistake of fact or law which entitles an employer to a refund under this section. For purposes of this section, a multiemployer plan is defined in section 414(f) and the regulations thereunder.

(ii) *Amount to be returned*—(A) *General rule.* The amount to be returned to the employer is the excess of the amount contributed or paid over the amount that would have been contributed or paid had no mistake been made. This amount is the excess contribution or overpayment. Except as provided in paragraph (b)(2)(ii)(B) of this section, interest or earnings attributable to an excess contribution shall not be returned to the employer, and any losses attributable to an excess contribution must reduce the amount returned to the employer. For purposes of the previous sentence, the application of planwide investment experience to the excess contribution would be an acceptable method of calculating losses. A refund of a mistaken contribution must in no event reduce a participant's account balance in a defined contribution plan to an amount less than that amount which would properly have been in that participant's account had no mistake occurred. Thus, to the extent that the refund of an excess contribution would reduce a participant's account balance in a defined contribution plan to an amount less than the amount which would properly be in the participant's account had no mistake occurred, the return of the excess contribution would be prohibited by this section.

(B) *Overpayment of withdrawal liability.* In the case of an overpayment of withdrawal liability established by the plan sponsor under section 4219(c)(2) of ERISA, the plan will not fail to satisfy section 401(a)(2) if, in accordance with

Pension Benefit Guaranty Corporation regulations regarding the overpayments of withdrawal liability (29 CFR 4219.31(d)), the overpayment, with interest, is returned to the employer.

(c) *Amount refunded includible in employer's income.* In general, the amount of the excess contribution or overpayment must be included in gross income by the employer if the excess contribution or overpayment resulted in a tax benefit in a prior year. Any interest credited or paid on the refund of mistaken withdrawal liability payments must also be included in gross income by the employer.

(d) *Application of section 412.* An amount returned under paragraph (b)(2)(ii) of this section is charged to the funding standard account under section 412 in the year in which the amount is returned.

[T.D. 9005, 67 FR 47693, July 22, 2002]

§ 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.

(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.

[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)–2(a)(4)(i), matching contributions that fail to satisfy § 1.401(m)–2(a)(4)(iii), and qualified nonelective contributions treated as elective or matching contributions for certain purposes under §§ 1.401(k)–2(a)(6) and 1.401(m)–2(a)(6), 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, as amended by T.D. 9169, 69 FR 78153, Dec. 29, 2004]

EDITORIAL NOTE: By T.D. 9169, 69 FR 78153, Dec. 29, 2004, the Internal Revenue Service published a document in the FEDERAL REGISTER, attempting to amend paragraph (b)(2)(ii)(B) of §1.401–1(a)(4)–1 by removing ''1.401(k)–1(b)(4)'' and inserting ''1.401(k)–2(a)(5)(i)''. However, because of inaccurate amendatory language, this amendment could not be incorporated.

§ 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

Employee	Years of service	Plan year compensation	Points	Amount of allocation	Allocation rate (percent)
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(c)–1(b)(4) (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.

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§ 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)–6 (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(a)(3) (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(a)(2) (determining the rate using the amount of matching, elective, and after-tax employee contributions determined after any corrections under §§1.401(k)–2(b)(1)(i), 1.401(m)–2(b)(1)(i), 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; T.D. 9169, 69 FR 78153, Dec. 29, 2004]

§ 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
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 ⅓ 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)(ii) 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]

EDITORIAL NOTE: By T.D. 9169, 69 FR 78153, Dec. 29, 2004, the Internal Revenue Service published a document in the FEDERAL REGISTER, attempting to amend paragraph (c)(3)(ii) of §1.401–(a)(4)–9 by removing ''1.401(k)–1(b)(3)(ii) and 1.401(m)–1(b)(3)(ii)'' and inserting ''1.401(k)–1(b)(4)(vi)(B) and 1.401(m)–1(b)(4)(iv)''. However, because of inaccurate amendatory language, this amendment could not be incorporated.

§ 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 preparticipation 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 preparticipation 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)–6 (QNECs) to nonhighly compensated nonexcludable employees who were not eligible employees within the meaning of §1.401(k)–6 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)–5 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)–2(b). 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.

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§ 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).

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§ 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
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)(9)–0 Required minimum distributions; table of contents.

This table of contents lists the regulations relating to required minimum distributions under section 401(a)(9) of the Internal Revenue Code as follows:

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004]

§ 1.401(a)(9)–1 Minimum distribution requirement in general.

Q–1. What plans are subject to the minimum distribution requirement under section 401(a)(9), this section, and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9?

A–1. Under section 401(a)(9), all stock bonus, pension, and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to required minimum distribution rules. See this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 for the distribution rules applicable to these plans. Under section 403(b)(10), annuity contracts or custodial accounts described in section 403(b) are subject to required minimum distribution rules. See § 1.403(b)–6e for the distribution rules applicable to these annuity contracts or custodial accounts. Under section 408(a)(6) and 408(b)(3), individual retirement plans (including, for some purposes, Roth IRAs under section 408A) are subject to required minimum distribution rules. See § 1.408–8 for the distribution rules applicable to individual retirement plans and see § 1.408A–6 for the distribution rules applicable to Roth IRAs under section 408A. Under section 457(d)(2), certain deferred compensation plans for employees of tax exempt organizations or state and local government employees are subject to required minimum distribution rules.

Q–2. Which employee account balances and benefits held under qualified trusts and plans are subject to the distribution rules of section 401(a)(9), this section, and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9?

A–2. (a) *In general.* The distribution rules of section 401(a)(9) apply to all account balances and benefits in existence on or after January 1, 1985. This section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003.

(b) *Beneficiaries.* (1) The distribution rules of this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 apply to account balances and benefits held for the benefit of a beneficiary for calendar years beginning on or after January 1, 2003, even if the employee died prior to January 1, 2003. Thus, in the case of an employee who died prior to January 1, 2003, the designated beneficiary must be redetermined in accordance with the provisions of § 1.401(a)(9)–4 and the applicable distribution period (determined under § 1.401(a)(9)–5 or 1.401(a)(9)–6, whichever is applicable) must be reconstructed for purposes of determining the amount required to be distributed for calendar years beginning on or after January 1, 2003.

(2) A designated beneficiary that is receiving payments under the 5-year rule of section 401(a)(9)(B)(ii), either by affirmative election or default provisions, may, if the plan so provides, switch to using the life expectancy rule of section 401(a)(9)(B)(iii) provided any amounts that would have been required to be distributed under the life expectancy rule of section 401(a)(9)(B)(iii) for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003 or the end of the 5-year period determined under A–2 of § 1.401(a)(9)–3.

(c) *Trust documentation.* If a trust fails to meet the rule of A–5 of § 1.401(a)(9)–4 (permitting the beneficiaries of the trust, and not the trust itself, to be treated as the employee's designated beneficiaries) solely because the trust documentation was not provided to the plan administrator by October 31 of the calendar year following the calendar year in which the employee died, and such documentation is provided to the plan administrator by October 31, 2003, the beneficiaries of the trust will be treated as designated beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(d) *Special rule for governmental plans.* Notwithstanding anything to the contrary in this A–2, a governmental plan (within the meaning of section 414(d)), or an eligible governmental plan described in § 1.457–2(f), is treated as having complied with section 401(a)(9) for all years to which section 401(a)(9) applies to the plan if the plan complies with a reasonable and good faith interpretation of section 401(a)(9).

Q–3. What specific provisions must a plan contain in order to satisfy section 401(a)(9)?

A–3. (a) *Required provisions.* In order to satisfy section 401(a)(9), the plan must include the provisions described in this paragraph reflecting section 401(a)(9). First, the plan must generally set forth the statutory rules of section 401(a)(9), including the incidental death benefit requirement in section 401(a)(9)(G). Second, the plan must provide that distributions will be made in accordance with this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9. The plan document must also provide that the provisions reflecting section 401(a)(9) override any distribution options in the plan inconsistent with section 401(a)(9). The plan also must include any other provisions reflecting section 401(a)(9) that are 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.

(b) *Optional provisions.* The plan may also include written provisions regarding any optional provisions governing plan distributions that do not conflict with section 401(a)(9) and the regulations thereunder.

(c) *Absence of optional provisions.* Plan distributions commencing after an employee's death will be required to be made under the default provision set forth in § 1.401(a)(9)–3 for distributions unless the plan document contains optional provisions that override such default provisions. Thus, if distributions have not commenced to the employee at the time of the employee's death, distributions after the death of an employee are to be made automatically in accordance with the default provisions in A–4(a) of § 1.401(a)(9)–3 unless the plan either specifies in accordance with A–4(b) of § 1.401(a)(9)–3 the method under which distributions will be made or provides for elections by the employee (or beneficiary) in accordance with A–4(c) of § 1.401(a)(9)–3 and such elections are made by the employee or beneficiary.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004; T.D. 9340, 72 FR 41159, July 26, 2007; T.D. 9459, 74 FR 45994, Sept. 8, 2009]

§ 1.401(a)(9)–2 Distributions commencing during an employee's lifetime.

Q–1. In the case of distributions commencing during an employee's lifetime, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)(A)?

A–1. (a) In order to satisfy section 401(a)(9)(A), the entire interest of each employee must be distributed to such employee not later than the required beginning date, or must be distributed, beginning not later than the required beginning date, over the life of the employee or joint lives of the employee and a designated beneficiary or over a period not extending beyond the life expectancy of the employee or the joint life and last survivor expectancy of the employee and the designated beneficiary.

(b) Section 401(a)(9)(G) provides that lifetime distributions must satisfy the incidental death benefit requirements.

(c) The amount required to be distributed for each calendar year in order to satisfy section 401(a)(9)(A) and (G) generally depends on whether a distribution is in the form of distributions under a defined contribution plan or annuity payments under a defined benefit plan or under an annuity contract. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) from an individual account under a defined contribution plan, see § 1.401(a)(9)–5. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) in the case of annuity payments from a defined benefit plan or an annuity contract, see § 1.401(a)(9)–6.

Q–2. For purposes of section 401(a)(9)(C), what does the term *required beginning date* mean?

A–2. (a) Except as provided in paragraph (b) of this A–2 with respect to a 5-percent owner, as defined in paragraph (c) of this A–2, the term *required beginning date* means April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan.

(b) In the case of an employee who is a 5-percent owner, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the employee attains age 70½ .

(c) For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½.

(d) Paragraph (b) of this A–2 does not apply in the case of a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

(e) A plan is permitted to provide that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which an employee attains age 70½ regardless of whether the employee is a 5-percent owner.

Q–3. When does an employee attain age 70½?

A–3. An employee attains age 70½ as of the date six calendar months after the 70th anniversary of the employee's birth. For example, if an employee's date of birth was June 30, 1933, the 70th anniversary of such employee's birth is June 30, 2003. Such employee attains age 70½ on December 30, 2003. Consequently, if the employee is a 5-percent owner or retired, such employee's required beginning date is April 1, 2004. However, if the employee's date of birth was July 1, 1933, the 70th anniversary of such employee's birth would be July 1, 2003. Such employee would then attain age 70½ on January 1, 2004 and such employee's required beginning date would be April 1, 2005.

Q–4. Must distributions made before the employee's required beginning date satisfy section 401(a)(9)?

A–4. Lifetime distributions made before the employee's required beginning date for calendar years before the employee's first distribution calendar year, as defined in A–1(b) of §1.401(a)(9)–5, need not be made in accordance with section 401(a)(9). However, if distributions commence before the employee's required beginning date under a particular distribution option, such as in the form of an annuity, the distribution option fails to satisfy section 401(a)(9) at the time distributions commence if, under terms of the particular distribution option, distributions to be made for the employee's first distribution calendar year or any subsequent distribution calendar year will fail to satisfy section 401(a)(9).

Q–5. If distributions have begun to an employee during the employee's lifetime (in accordance with section 401(a)(9)(A)(ii)), how must distributions be made after an employee's death?

A–5. Section 401(a)(9)(B)(i) provides that if the distribution of the employee's interest has begun in accordance with section 401(a)(9)(A)(ii) and the employee dies before his entire interest has been distributed to him, the remaining portion of such interest must be distributed at least as rapidly as under the distribution method being used under section 401(a)(9)(A)(ii) as of the date of his death. The amount required to be distributed for each distribution calendar year following the calendar year of death generally depends on whether a distribution is in the form of distributions from an individual account under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(B)(i) from an individual account, see §1.401(a)(9)–5. In the case of annuity payments from a defined benefit plan or an annuity contract, see §1.401(a)(9)–6.

Q–6. For purposes of section 401(a)(9)(B), when are distributions considered to have begun to the employee in accordance with section 401(a)(9)(A)(ii)?

A–6. (a) *General rule*. Except as otherwise provided in A–10 of §1.401(a)(9)–6, distributions are not treated as having begun to the employee in accordance with section 401(a)(9)(A)(ii) until the employee's required beginning date, without regard to whether payments have been made before that date. Thus, section 401(a)(9)(B)(i) only applies if an employee dies on or after the employee's required beginning date. For example, if employee A retires in 2003, the calendar year A attains age 65½, and begins receiving installment distributions from a profit-sharing plan over a period not exceeding the joint life and last survivor expectancy of A and A's spouse, benefits are not treated as having begun in accordance with section 401(a)(9)(A)(ii) until April 1, 2009 (the April 1 following the calendar year in which A attains age 70½). Consequently, if A dies before April 1, 2009 (A's required beginning date), distributions after A's death must be made in accordance with section 401(a)(9)(B)(ii) or (iii) and (iv) and §1.401(a)(9)–3, and not section 401(a)(9)(B)(i). This is the case without regard to whether the plan has distributed the minimum distribution for the first distribution calendar year (as defined in A–1(b) of §1.401(a)(9)–5) before A's death.

(b) If a plan provides, in accordance with A–2(e) of this section, that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which an employee attains age 70½, an employee who dies on or after the required beginning date determined under the plan terms is treated as dying after the employee's distributions have begun for purposes of this A–6 even though the employee dies before the April 1 following the calendar year in which the employee retires.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004]

§ 1.401(a)(9)–3 Death before required beginning date.

Q–1. If an employee dies before the employee's required beginning date, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)?

A–1. (a) Except as otherwise provided in A–10 of §1.401(a)(9)–6, if an employee dies before the employee's required beginning date (and, thus, before distributions are treated as having begun in accordance with section 401(a)(9)(A)(ii)), distribution of the employee's entire interest must be made in accordance with one of the methods described in section 401(a)(9)(B)(ii) or (iii) and (iv). One method (the 5-year rule in section 401(a)(9)(B)(ii)) requires that the entire interest of the employee be distributed within 5 years of the employee's death regardless of who or what entity receives the distribution. Another method (the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)) requires that any portion of an employee's interest payable to (or for the benefit of) a designated beneficiary be distributed, commencing within one year of the employee's death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). Section 401(a)(9)(B)(iv) provides special rules where the designated beneficiary is the surviving spouse of the employee, including a special commencement date for distributions under section 401(a)(9)(B)(iii) to the surviving spouse.

(b) See A–4 of this section for the rules for determining which of the methods described in paragraph (a) of this A–1 applies. See A–3 of this section to determine when distributions under the exception to the 5-year rule in section 401(a)(9)(B)(iii) and (iv) must commence. See A–2 of this section to determine when the 5-year period in section 401(a)(9)(B)(ii) ends. For distributions using the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), see §1.401(a)(9)–4 in order to determine the designated beneficiary under section 401(a)(9)(B)(iii) and (iv), see §1.401(a)(9)–5 for the rules for determining the required minimum distribution under a defined contribution plan, and see §1.401(a)(9)–6 for required minimum distributions under defined benefit plans.

Q–2. By when must the employee's entire interest be distributed in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii)?

A–2. In order to satisfy the 5-year rule in section 401(a)(9)(B)(ii), the employee's entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death. For example, if an employee dies on January 1, 2003, the entire interest must be distributed by the end of 2008, in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii).

Q–3. When are distributions required to commence in order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)?

A–3. (a) *Nonspouse beneficiary*. In order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii), if the designated beneficiary is not the employee's surviving spouse, distributions must commence on or before the end of the calendar year immediately following the calendar year in which the employee died. This rule also applies to the distribution of the entire remaining benefit if another individual is a designated beneficiary in addition to the employee's surviving spouse. See A–2 and A–3 of §1.401(a)(9)–8, however, if the employee's benefit is divided into separate accounts.

(b) *Spousal beneficiary*. In order to satisfy the rule in section 401(a)(9)(B)(iii) and (iv), if the sole designated beneficiary is the employee's surviving spouse, distributions must commence on or before the later of—

(1) The end of the calendar year immediately following the calendar year in which the employee died; and

(2) The end of the calendar year in which the employee would have attained age 70½.

Q–4. How is it determined whether the 5-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to a distribution?

A–4. (a) *No plan provision*. If a plan does not adopt an optional provision described in paragraph (b) or (c) of this A–4 specifying the method of distribution after the death of an employee, distribution must be made as follows:

(1) If the employee has a designated beneficiary, as determined under §1.401(a)(9)–4, distributions are to be made in accordance with the life expectancy rule in section 401(a)(9)(B)(iii) and (iv).

(2) If the employee has no designated beneficiary, distributions are to be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

(b) *Optional plan provisions*. A plan may adopt a provision specifying either that the 5-year rule in section 401(a)(9)(B)(ii) will apply to certain distributions after the death of an employee even if the employee has a designated beneficiary or that distribution in every case will be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii). Further, a plan need not have the same method of distribution for the benefits of all employees in order to satisfy section 401(a)(9).

(c) *Elections*. A plan may adopt a provision that permits employees (or beneficiaries) to elect on an individual basis whether the 5-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to distributions after the death of an employee who has a designated beneficiary. Such an election must be made no later than the earlier of the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) (see A–3 of this section for the determination of such calendar year) or the end of the calendar year which contains the fifth anniversary of the date of death of the employee. As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. If a plan provides for the election, the plan may also specify the method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method applies, distribution must be made in accordance with paragraph (a) of this A–4.

Q–5. If the employee's surviving spouse is the employee's sole designated beneficiary and such spouse dies after the employee, but before distributions have begun to the surviving spouse under section 401(a)(9)(B)(iii) and (iv), how is the employee's interest to be distributed?

A–5. Pursuant to section 401(a)(9)(B)(iv)(II), if the surviving spouse is the employee's sole designated beneficiary and dies after the employee, but before distributions to such spouse have begun under section 401(a)(9)(B)(iii) and (iv), the 5-year rule in section 401(a)(9)(B)(ii) and the life expectancy rule in section 401(a)(9)(B)(iii) are to be applied as if the surviving spouse were the employee. In applying this rule, the date of death of the surviving spouse shall be substituted for the date of death of the employee. However, in such case, the rules in section 401(a)(9)(B)(iv) are not available to the surviving spouse of the deceased employee's surviving spouse.

Q–6. For purposes of section 401(a)(9)(B)(iv)(II), when are distributions considered to have begun to the surviving spouse?

A–6. Distributions are considered to have begun to the surviving spouse of an employee, for purposes of section 401(a)(9)(B)(iv)(II), on the date, determined in accordance with A–3 of this section, on which distributions are required to commence to the surviving spouse, even though payments have actually been made before that date. See A–11 of §1.401(a)(9)–6 for a special rule for annuities.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004]

§1.401(a)(9)–4 Determination of the designated beneficiary.

Q–1. Who is a designated beneficiary under section 401(a)(9)(E)?

A–1. A designated beneficiary is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. For example, if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy. The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan. See A–6 of §1.401(a)(9)–8 for rules which apply to qualified domestic relation orders.

Q–2. Must an employee (or the employee's spouse) make an affirmative election specifying a beneficiary for a person to be a designated beneficiary under section 401(a)(9)(E)?

A–2. No, a designated beneficiary is an individual who is designated as a beneficiary under the plan whether or not the designation under the plan was made by the employee. The choice of beneficiary is subject to the requirements of sections 401(a)(11), 414(p), and 417.

Q–3. May a person other than an individual be considered to be a designated beneficiary for purposes of section 401(a)(9)?

A–3. No, only individuals may be designated beneficiaries for purposes of section 401(a)(9). A person that is not an individual, such as the employee's estate, may not be a designated beneficiary. If a person other than an individual is designated as a beneficiary of an employee's benefit, the employee will be treated as having no designated beneficiary for purposes of section 401(a)(9), even if there are also individuals designated as beneficiaries. However, see A–5 of this section for special rules that apply to trusts and A–2 and A–3 of §1.401(a)(9)–8 for rules that apply to separate accounts.

Q–4. When is the designated beneficiary determined?

A–4. (a) *General rule*. In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death. Except as provided in paragraph (b) and §1.401(a)(9)–6, the employee's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death. Consequently, except as provided in §1.401(a)(9)–6, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (e.g., because the person receives the entire benefit to which the person is entitled before that September 30), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death. Accordingly, if a person disclaims entitlement to the employee's benefit, pursuant to a disclaimer that satisfies section 2518 by that September 30 thereby allowing other beneficiaries to receive the benefit in lieu of that person, the disclaiming person is not taken into account in determining the employee's designated beneficiary.

(b) *Surviving spouse.* As provided in A–5 of §1.401(a)(9)–3, if the employee's spouse is the sole designated beneficiary as of September 30 of the calendar year following the calendar year of the employee's death, and the surviving spouse dies after the employee and before the date on which distributions have begun to the surviving spouse under section 401(a)(9)(B)(iii) and (iv), the rule in section 401(a)(9)(B)(iv)(II) will apply. Thus, for example, the relevant designated beneficiary for determining the distribution period after the death of the surviving spouse is the designated beneficiary of the surviving spouse. Similarly, such designated beneficiary will be determined based on the beneficiaries designated as of the date of the surviving spouse's death and who remain beneficiaries as of September 30 of the calendar year following the calendar year of the surviving spouse's death. Further, if, as of that September 30, there is no designated beneficiary under the plan with respect to that surviving spouse, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) and A–2 of §1.401(a)(9)–3.

(c) *Deceased beneficiary.* For purposes of this A–4, an individual who is a beneficiary as of the date of the employee's death and dies prior to September 30 of the calendar year following the calendar year of the employee's death without disclaiming continues to be treated as a beneficiary as of the September 30 of the calendar year following the calendar year of the employee's death in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death, without regard to the identity of the successor beneficiary who is entitled to distributions as the beneficiary of the deceased beneficiary. The same rule applies in the case of distributions to which A–5 of §1.401(a)(9)–3 applies so that, if an individual is designated as a beneficiary of an employee's surviving spouse as of the spouse's date of death and dies prior to September 30 of the year following the year of the surviving spouse's death, that individual will continue to be treated as a designated beneficiary.

Q–5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust with respect to the trust's interest in the employee's benefit be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)?

A–5. (a) If the requirements of paragraph (b) of this A–5 are met with respect to a trust that is named as the beneficiary of an employee under the plan, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met—

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A–1 of this section from the trust instrument.

(4) The documentation described in A–6 of this section has been provided to the plan administrator.

(c) In the case of payments to a trust having more than one beneficiary, see A–7 of §1.401(a)(9)–5 for the rules for determining the designated beneficiary whose life expectancy will be used to determine the distribution period and A–3 of this section for the rules that apply if a person other than an individual is designated as a beneficiary of an employee's benefit. However, the separate account rules under A–2 of §1.401(a)(9)–8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit.

(d) If the beneficiary of the trust named as beneficiary of the employee's interest is another trust, the beneficiaries of the other trust will be treated as being designated as beneficiaries of the first trust, and thus, having been designated by the employee under the plan for purposes of determining the distribution period under section 401(a)(9)(A)(ii), provided that the requirements of paragraph (b) of this A–5 are satisfied with respect to such other trust in addition to the trust named as beneficiary.

Q–6. If a trust is named as a beneficiary of an employee, what documentation must be provided to the plan administrator?

A–6. (a) *Required minimum distributions before death.* If an employee designates a trust as the beneficiary of his or her entire benefit and the employee's spouse is the sole beneficiary of the trust, in order to satisfy the documentation requirements of this A–6 so that the spouse can be treated as the sole designated beneficiary of the employee's benefits (if the other requirements of paragraph (b) of A–5 of this section are satisfied), the employee must either—

(1) Provide to the plan administrator a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each such amendment; or

(2) Provide to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement sufficient to establish that the spouse is the sole beneficiary) for purposes of section 401(a)(9); certify that, to the best of the employee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A–5 of this section are satisfied; agree that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator corrected certifications to the extent that the amendment changes any information previously certified; and agree to provide a copy of the trust instrument to the plan administrator upon demand.

(b) *Required minimum distributions after death.* In order to satisfy the documentation requirement of this A–6 for required minimum distributions after the death of the employee (or spouse in a case to which A–5 of §1.401(a)(9)–3 applies), by October 31 of the calendar year immediately following the calendar year in which the employee died, the trustee of the trust must either—

(1) Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of September 30 of the calendar year following the calendar year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A–5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

(c) *Relief for discrepancy between trust instrument and employee certifications or earlier trust instruments.* (1) If required minimum distributions are determined based on the information provided to the plan administrator in certifications or trust instruments described in paragraph (a) or (b) of this A–6, a plan will not fail to satisfy section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in those certifications or trust instruments previously provided to the plan administrator, but only if the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.

(2) For purposes of determining the amount of the excise tax under section 4974, the required minimum distribution is determined for any year based on the actual terms of the trust in effect during the year.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004]

§ 1.401(a)(9)–5 Required minimum distributions from defined contribution plans.

Q–1. If an employee's benefit is in the form of an individual account under a defined contribution plan, what is the amount required to be distributed for each calendar year?

A–1. (a) *General rule.* If an employee's accrued benefit is in the form of an individual account under a defined contribution plan, the minimum amount required to be distributed for each distribution calendar year, as defined in paragraph (b) of this A–1, is equal to the quotient obtained by dividing the account (determined under A–3 of this section) by the applicable distribution period (determined under A–4 or A–5 of this section, whichever is applicable). However, the required minimum distribution amount will never exceed the entire account balance on the date of the distribution. See A–8 of this section for rules that apply if a portion of the employee's account is not vested. Further, the minimum distribution required to be distributed on or before an employee's required beginning date is always determined under section 401(a)(9)(A)(ii) and this A–1 and not section 401(a)(9)(A)(i).

(b) *Distribution calendar year.* A calendar year for which a minimum distribution is required is a distribution calendar year. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70½, the employee's first distribution calendar year is the year the employee attains age 70½. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee retires, the employee's first distribution calendar year is the calendar year in which the employee retires. In the case of distributions to be made in accordance with the life expectancy rule in §1.401(a)(9)–3 and in section 401(a)(9)(B)(iii) and (iv), the first distribution calendar year is the calendar year containing the date described in A–3(a) or A–3(b) of §1.401(a)(9)–3, whichever is applicable.

(c) *Time for distributions.* The distribution required to be made on or before the employee's required beginning date shall be treated as the distribution required for the employee's first distribution calendar year (as defined in paragraph (b) of this A–1). The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the employee's required beginning date occurs, must be made on or before the end of that distribution calendar year.

(d) *Minimum distribution incidental benefit requirement.* If distributions of an employee's account balance under a defined contribution plan are made in accordance with this section, the minimum distribution incidental benefit requirement of section 401(a)(9)(G) is satisfied. Further, with respect to the retirement benefits provided by that account balance, to the extent the incidental benefit requirement of §1.401–1(b)(1)(i) requires a distribution, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution incidental benefit requirement of section 401(a)(9)(G) and this section.

(e) *Annuity contracts.* Instead of satisfying this A–1, the minimum distribution requirement may be satisfied by the purchase of an annuity contract from an insurance company in accordance with A–4 of §1.401(a)(9)-6 with the employee's entire individual account. If such an annuity is purchased after distributions are required to commence (the required beginning date, in the case of distributions commencing before death, or the date determined under A–3 of §1.401(a)(9)-3, in the case of distributions commencing after death), payments under the annuity contract purchased will satisfy section 401(a)(9) for distribution calendar years after the calendar year of the purchase if payments under the annuity contract are made in accordance with §1.401(a)(9)-6T. In such a case, payments under the annuity contract will be treated as distributions from the individual account for purposes of determining if the individual account satisfies section 401(a)(9) for the calendar year of the purchase. An employee may also purchase an annuity contract with a portion of the employee's account under the rules of A–2(a)(3) of §1.401(a)(9)-8.

Q–2. If an employee's benefit is in the form of an individual account and, in any calendar year, the amount distributed exceeds the minimum required, will credit be given in subsequent calendar years for such excess distribution?

A–2. If, for any distribution calendar year, the amount distributed exceeds the minimum required, no credit will be given in subsequent calendar years for such excess distribution.

Q–3. What is the amount of the account of an employee used for determining the employee's required minimum distribution in the case of an individual account?

A–3. (a) In the case of an individual account, the benefit used in determining the required minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year immediately preceding that distribution calendar year (valuation calendar year) adjusted in accordance with paragraphs (b), (c), and (d) of this A–3.

(b) The account balance is increased by the amount of any contributions or forfeitures allocated to the account balance as of dates in the valuation calendar year after the valuation date. For this purpose, contributions that are allocated to the account balance as of dates in the valuation calendar year after the valuation date, but that are not actually made during the valuation calendar year, are permitted to be excluded.

(c) The account balance is decreased by distributions made in the valuation calendar year after the valuation date.

(d) The account balance does not include the value of any qualifying longevity annuity contract (QLAC), defined in A–17 of §1.401(a)(9)–6, that is held under the plan. This paragraph (d) applies only to contracts purchased on or after July 2, 2014.

(e) If an amount is distributed from a plan and rolled over to another plan (receiving plan), A–2 of §1.401(a)(9)–7 provides additional rules for determining the benefit and required minimum distribution under the receiving plan. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan) in a transfer to which section 414(l) applies, A–3 and A–4 of §1.401(a)(9)–7 provide additional rules for determining the amount of the required minimum distribution and the benefit under both the transferor and transferee plans.

Q–4. For required minimum distributions during an employee's lifetime, what is the applicable distribution period?

A–4. (a) *General rule.* Except as provided in paragraph (b) of this A–4, the applicable distribution period for required minimum distributions for distribution calendar years up to and including the distribution calendar year that includes the employee's date of death is determined using the Uniform Lifetime Table in A–2 of §1.401(a)(9)-9 for the employee's age as of the employee's birthday in the relevant distribution calendar year. If an employee dies on or after the required beginning date, the distribution period applicable for calculating the amount that must be distributed during the distribution calendar year that includes the employee's death is determined as if the employee had lived throughout that year. Thus, a minimum required distribution, determined as if the employee had lived throughout that year, is required for the year of the employee's death and that amount must be distributed to a beneficiary to the extent it has not already been distributed to the employee.

(b) *Spouse is sole beneficiary*—(1) *General rule*. Except as otherwise provided in paragraph (b)(2) of this A–4, if the sole designated beneficiary of an employee is the employee's surviving spouse, for required minimum distributions during the employee's lifetime, the applicable distribution period is the longer of the distribution period determined in accordance with paragraph (a) of this A–4 or the joint life expectancy of the employee and spouse using the employee's and spouse's attained ages as of the employee's and the spouse's birthdays in the distribution calendar year. The spouse is sole designated beneficiary for purposes of determining the applicable distribution period for a distribution calendar year during the employee's lifetime only if the spouse is the sole beneficiary of the employee's entire interest at all times during the distribution calendar year.

(2) *Change in marital status*. If the employee and the employee's spouse are married on January 1 of a distribution calendar year, but do not remain married throughout that year (i.e., the employee or the employee's spouse die or they become divorced during that year), the employee will not fail to have a spouse as the employee's sole beneficiary for that year merely because they are not married throughout that year. If an employee's spouse predeceases the employee, the spouse will not fail to be the employee's sole beneficiary for the distribution calendar year that includes the date of the spouse's death solely because, for the period remaining in that year after the spouse's death, someone other than the spouse is named as beneficiary. However, the change in beneficiary due to the death or divorce of the spouse will be effective for purposes of determining the applicable distribution period under section 401(a)(9) in the distribution calendar year following the distribution calendar year that includes the date of the spouse's death or divorce.

Q–5. For required minimum distributions after an employee's death, what is the applicable distribution period?

A–5. (a) *Death on or after the employee's required beginning date*. If an employee dies after distribution has begun as determined under A–6 of §1.401(a)(9)–2 (generally on or after the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(i), the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is either—

(1) If the employee has a designated beneficiary as of the date determined under A–4 of §1.401(a)(9)–4, the longer of—

(i) The remaining life expectancy of the employee's designated beneficiary determined in accordance with paragraph (c)(1) or (2) of this A–5; and

(ii) The remaining life expectancy of the employee determined in accordance with paragraph (c)(3) of this A–5; or

(2) If the employee does not have a designated beneficiary as of the date determined under A–4 of §1.401(a)(9)–4, the remaining life expectancy of the employee determined in accordance with paragraph (c)(3) of this A–5.

(b) *Death before an employee's required beginning date*. If an employee dies before distribution has begun, as determined under A–5 of §1.401(a)(9)–2 (generally before the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(iii) or (iv) and the life expectancy rule described in A–1 of §1.401(a)(9)–3, the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is determined in accordance with paragraph (c) of this A–5. See A–4 of §1.401(a)(9)–3 to determine when the 5-year rule in section 401(a)(9)(B)(ii) applies (e.g., there is no designated beneficiary or the 5-year rule is elected or specified by plan provision).

(c) *Life expectancy*—(1) *Nonspouse designated beneficiary*. Except as otherwise provided in paragraph (c)(2), the applicable distribution period measured by the beneficiary's remaining life expectancy is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the employee's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year immediately following the calendar year of the employee's death.

(2) *Spouse designated beneficiary.* If the surviving spouse of the employee is the employee's sole beneficiary, the applicable distribution period is measured by the surviving spouse's life expectancy using the surviving spouse's birthday for each distribution calendar year after the calendar year of the employee's death up through the calendar year of the spouse's death. For calendar years after the calendar year of the spouse's death, the applicable distribution period is the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the calendar year of the spouse's death, reduced by one for each calendar year that has elapsed after the calendar year of the spouse's death.

(3) *No designated beneficiary.* If the employee does not have a designated beneficiary, the applicable distribution period measured by the employee's remaining life expectancy is the life expectancy of the employee using the age of the employee as of the employee's birthday in the calendar year of the employee's death. In subsequent calendar years the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year of the employee's death.

Q–6. What life expectancies must be used for purposes of determining required minimum distributions under section 401(a)(9)?

A–6. Life expectancies for purposes of determining required minimum distributions under section 401(a)(9) must be computed using the Single Life Table in A–1 of § 1.401(a)(9)–9 and the Joint and Last Survivor Table in A–3 of § 1.401(a)(9)–9.

Q–7. If an employee has more than one designated beneficiary, which designated beneficiary's life expectancy will be used to determine the applicable distribution period?

A–7. (a) *General rule*—(1) Except as otherwise provided in paragraph (c) of this A–7, if more than one individual is designated as a beneficiary with respect to an employee as of the applicable date for determining the designated beneficiary under A–4 of § 1.401(a)(9)–4, the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period.

(2) See A–3 of § 1.401(a)(9)-4 for rules that apply if a person other than an individual is designated as a beneficiary and see A–2 and A–3 of § 1.401(a)(9)-8 for special rules that apply if an employee's benefit under a plan is divided into separate accounts and the beneficiaries with respect to a separate account differ from the beneficiaries of another separate account.

(b) *Contingent beneficiary.* Except as provided in paragraph (c)(1) of this A–7, if a beneficiary's entitlement to an employee's benefit after the employee's death is a contingent right, such contingent beneficiary is nevertheless considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A–3 of § 1.401(a)(9)-4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A–7.

(c) *Successor beneficiary*—(1) A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A–7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death. Thus, for example, if the first beneficiary has a right to all income with respect to an employee's individual account during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

(2) If the individual beneficiary whose life expectancy is being used to calculate the distribution period dies after September 30 of the calendar year following the calendar year of the employee's death, such beneficiary's remaining life expectancy will be used to determine the distribution period without regard to the life expectancy of the subsequent beneficiary.

(3) This paragraph (c) is illustrated by the following examples:

Example 1. (i) Employer M maintains a defined contribution plan, Plan X. Employee A, an employee of M, died in 2005 at the age of 55, survived by spouse, B, who was 50 years old. Prior to A's death, M had established an account balance for A in Plan X. A's account balance is invested only in productive assets. A named a testamentary trust (Trust P) established under A's will as the beneficiary of all amounts payable from A's account in Plan X after A's death. A copy of the Trust P and a list of the trust beneficiaries were provided to the plan administrator of Plan X by October 31 of the calendar year following the calendar year of A's death. As of the date of A's death, the Trust P was irrevocable and was a valid trust under the laws of the state of A's domicile. A's account balance in Plan X was includible in *A*'s gross estate under §2039.

(ii) Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the Trust P. No other person has a beneficial interest in Trust P. Under the terms of the Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A's account balance in Plan X an amount equal to the income earned on the assets held in A's account in Plan X during the calendar year and to distribute that amount through Trust P to B. Plan X contains no prohibition on withdrawal from A's account of amounts in excess of the annual required minimum distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elects, in order to satisfy section 401(a)(9), to receive annual required minimum distributions using the life expectancy rule in section 401(a)(9)(B)(iii) for distributions over a distribution period equal to B's life expectancy. If B exercises the withdrawal power, the trustee must withdraw from A's account under Plan X the greater of the amount of income earned in the account during the calendar year or the required minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned by A's account in Plan X is required to be distributed to B (along with any other trust income.)

(iii) Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime for the benefit of A's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole designated beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries). Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because B is not the sole designated beneficiary of the testamentary trust's interest in A's account in Plan X, the special rule in 401(a)(9)(B)(iv) is not available and the annual required minimum distributions from the account to Trust M must begin no later than the end of the calendar year immediately following the calendar year of A's death.

Example 2. (i) The facts are the same as *Example 1* except that the testamentary trust instrument provides that all amounts distributed from A's account in Plan X to the trustee while B is alive will be paid directly to B upon receipt by the trustee of Trust P.

(ii) In this case, B is the sole designated beneficiary of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv). No amounts distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary. Therefore, the residuary beneficiaries of Trust P are mere potential successors to B's interest in Plan X. Because B is the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the annual required minimum distributions from A's account to Trust P must begin no later than the end of the calendar year in which A would have attained age 70½, rather than the calendar year immediately following the calendar year of A's death.

Q–8. If a portion of an employee's individual account is not vested as of the employee's required beginning date, how is the determination of the required minimum distribution affected?

A–8. If the employee's benefit is in the form of an individual account, the benefit used to determine the required minimum distribution for any distribution calendar year will be determined in accordance with A–1 of this section without regard to whether or not all of the employee's benefit is vested. If any portion of the employee's benefit is not vested, distributions will be treated as being paid from the vested portion of the benefit first. If, as of the end of a distribution calendar year (or as of the employee's required beginning date, in the case of the employee's first distribution calendar year), the total amount of the employee's vested benefit is less than the required minimum distribution for the calendar year, only the vested portion, if any, of the employee's benefit is required to be distributed by the end of the calendar year (or, if applicable, by the employee's required beginning date). However, the required minimum distribution for the subsequent distribution calendar year must be increased by the sum of amounts not distributed in prior calendar years because the employee's vested benefit was less than the required minimum distribution.

Q–9. Which amounts distributed from an individual account are taken into account in determining whether section 401(a)(9) is satisfied and which amounts are not taken into account in determining whether section 401(a)(9) is satisfied?

A–9. (a) *General rule*. Except as provided in paragraph (b), all amounts distributed from an individual account are distributions that are taken into account in determining whether section 401(a)(9) is satisfied, regardless of whether the amount is includible in income. Thus, for example, amounts that are excluded from income as recovery of investment in the contract under section 72 are taken into account for purposes of determining whether section 401(a)(9) is satisfied for a distribution calendar year. Similarly, amounts excluded from income as net unrealized appreciation on employer securities also are amounts distributed for purposes of determining if section 401(a)(9) is satisfied.

(b) *Exceptions*. The following amounts are not taken into account in determining whether the required minimum amount has been distributed for a calendar year:

(1) Elective deferrals (as defined in section 402(g)(3)) and employee contributions that, pursuant to rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), are returned to the employee (together with the income allocable thereto) in order to comply with the section 415 limitations.

(2) Corrective distributions of excess deferrals as described in § 1.402(g)-1(e)(3), together with the income allocable to these distributions.

(3) Corrective distributions of excess contributions under a qualified cash or deferred arrangement under section 401(k)(8) and excess aggregate contributions under section 401(m)(6), together with the income allocable to these distributions.

(4) Loans that are treated as deemed distributions pursuant to section 72(p).

(5) Dividends described in section 404(k) that are paid on employer securities. (Amounts paid to the plan that, pursuant to section 404(k)(2)(A)(iii)(II), are included in the account balance and subsequently distributed from the account lose their character as dividends.)

(6) The costs of life insurance coverage (P.S. 58 costs).

(7) 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.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004; T.D. 9319, 72 FR 16894, Apr. 5, 2007;T.D. 9673, 79 FR 37639, July 2, 2014]

§ 1.401(a)(9)–6 Required minimum distributions for defined benefit plans and annuity contracts.

Q–1. How must distributions under a defined benefit plan be paid in order to satisfy section 401(a)(9)?

A–1. (a) *General rules.* In order to satisfy section 401(a)(9), except as otherwise provided in this section, distributions of the employee's entire interest under a defined benefit plan must be paid in the form of periodic annuity payments for the employee's life (or the joint lives of the employee and beneficiary) or over a period certain that does not exceed the maximum length of the period certain determined in accordance with A–3 of this section. The interval between payments for the annuity must be uniform over the entire distribution period and must not exceed one year. Once payments have commenced over a period, the period may only be changed in accordance with A–13 of this section. Life (or joint and survivor) annuity payments must satisfy the minimum distribution incidental benefit requirements of A–2 of this section. Except as otherwise provided in this section (such as permitted increases described in A–14 of this section), all payments (whether paid over an employee's life, joint lives, or a period certain) also must be nonincreasing.

(b) *Life annuity with period certain.* The annuity may be a life annuity (or joint and survivor annuity) with a period certain if the life (or lives, if applicable) and period certain each meet the requirements of paragraph (a) of this A–1. For purposes of this section, if distributions are permitted to be made over the lives of the employee and the designated beneficiary, references to a life annuity include a joint and survivor annuity.

(c) *Annuity commencement.* (1) Annuity payments must commence on or before the employee's required beginning date (within the meaning of A–2 of § 1.401(a)(9)–2). The first payment, which must be made on or before the employee's required beginning date, must be the payment which is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Similarly, in the case of distributions commencing after death in accordance with section 401(a)(9)(B)(iii) and (iv), the first payment, which must be made on or before the date determined under A–3(a) or (b) (whichever is applicable) of § 1.401(a)(9)–3, must be the payment which is required for one payment interval. Payment intervals are the periods for which payments are received, *e.g.*, bimonthly, monthly, semi-annually, or annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of annuity payments for payment intervals ending on or after the employee's required beginning date.

(2) This paragraph (c) is illustrated by the following example:

Example. A defined benefit plan (Plan X) provides monthly annuity payments of $500 for the life of unmarried participants with a 10-year period certain. An unmarried, retired participant (A) in Plan X attains age 70½ in 2005. In order to meet the requirements of this paragraph, the first monthly payment of $500 must be made on behalf of A on or before April 1, 2006, and the payments must continue to be made in monthly payments of $500 thereafter for the life and 10-year period certain.

(d) *Single sum distributions.* In the case of a single sum distribution of an employee's entire accrued benefit during a distribution calendar year, the amount that is the required minimum distribution for the distribution calendar year (and thus not eligible for rollover under section 402(c)) is determined using either the rule in paragraph (d)(1) or the rule in paragraph (d)(2) of this A–1.

(1) The portion of the single sum distribution that is a required minimum distribution is determined by treating the single sum distribution as a distribution from an individual account plan and treating the amount of the single sum distribution as the employee's account balance as of the end of the relevant valuation calendar year. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been distributed, the portion of the single sum distribution that represents the required minimum distribution for the employee's first and second distribution calendar years is not eligible for rollover.

(2) The portion of the single sum distribution that is a required minimum

distribution is permitted to be determined by expressing the employee's benefit as an annuity that would satisfy this section with an annuity starting date as of the first day of the distribution calendar year for which the required minimum distribution is being determined, and treating one year of annuity payments as the required minimum distribution for that year, and not eligible for rollover. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been made, the benefit must be expressed as an annuity with an annuity starting date as of the first day of the first distribution calendar year and the payments for the first two distribution calendar years would be treated as required minimum distributions, and not eligible for rollover.

(e) *Death benefits.* The rule in paragraph (a) of this A–1, prohibiting increasing payments under an annuity applies to payments made upon the death of an employee. However, for purposes of this section, an ancillary death benefit described in this paragraph (e) may be disregarded in applying that rule. Such an ancillary death benefit is excluded in determining an employee's entire interest and the rules prohibiting increasing payments do not apply to such an ancillary death benefit. A death benefit with respect to an employee's benefit is an ancillary death benefit for purposes of this A–1 if—

(1) It is not paid as part of the employee's accrued benefit or under any optional form of the employee's benefit; and

(2) The death benefit, together with any other potential payments with respect to the employee's benefit that may be provided to a survivor, satisfy the incidental benefit requirement of § 1.401–1(b)(1)(i).

(f) *Additional guidance.* Additional guidance regarding how distributions under a defined benefit plan must be paid in order to satisfy section 401(a)(9) may be issued 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.

Q–2. How must distributions in the form of a life (or joint and survivor) annuity be made in order to satisfy the minimum distribution incidental benefit (MDIB) requirement of section 401(a)(9)(G) and the distribution component of the incidental benefit requirement of § 1.401–1(b)(1)(i)?

A–2. (a) *Life annuity for employee.* If the employee's benefit is paid in the form of a life annuity for the life of the employee satisfying section 401(a)(9) without regard to the MDIB requirement, the MDIB requirement of section 401(a)(9)(G) will be satisfied.

(b) *Joint and survivor annuity, spouse beneficiary.* If the employee's sole beneficiary, as of the annuity starting date for annuity payments, is the employee's spouse and the distributions satisfy section 401(a)(9) without regard to the MDIB requirement, the distributions to the employee will be deemed to satisfy the MDIB requirement of section 401(a)(9)(G). For example, if an employee's benefit is being distributed in the form of a joint and survivor annuity for the lives of the employee and the employee's spouse and the spouse is the sole beneficiary of the employee, the amount of the periodic payment payable to the spouse would not violate the MDIB requirement if it was 100 percent of the annuity payment payable to the employee, regardless of the difference in the ages between the employee and the employee's spouse.

(c) *Joint and survivor annuity, nonspouse beneficiary*—(1) *Explanation of rule.* If distributions commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee's spouse, the minimum distribution incidental benefit requirement will not be satisfied as of the date distributions commence unless under the distribution option, the annuity payments to be made on and after the employee's required beginning date will satisfy the conditions of this paragraph (c). The periodic annuity payment payable to the survivor must not at any time on and after the employee's required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the table in paragraph (c)(2) of this A–2. The applicable percentage is based on the adjusted employee/beneficiary age difference. The adjusted employee/beneficiary age difference is determined by first calculating the excess of the age of the employee over the age of the beneficiary based on their ages on their birthdays in a calendar year. Then, if the employee is younger than age 70, the age difference determined in the previous sentence is reduced by the number of years that the employee is younger than age 70 on the employee's birthday in the calendar year that contains the annuity starting date. In the case of an annuity that provides for increasing payments, the requirement of this paragraph (c) will not be violated merely because benefit payments to the beneficiary increase, provided the increase is determined in the same manner for the employee and the beneficiary.

(2) *Table.*

Adjusted employee/beneficiary age difference	Applicable percentage
10 years or less	100
11	96
12	93
13	90
14	87
15	84
16	82
17	79
18	77
19	75
20	73
21	72
22	70
23	68
24	67
25	66
26	64
27	63
28	62
29	61
30	60
31	59
32	59
33	58
34	57
35	56
36	56
37	55
38	55
39	54
40	54
41	53
42	53
43	53
44 and greater	52

(3) *Example.* This paragraph (c) is illustrated by the following example:

Example. Distributions commence on January 1, 2003 to an employee (Z), born March 1, 1937, after retirement at age 65. Z's daughter (Y), born February 5, 1967, is Z's beneficiary. The distributions are in the form of a joint and survivor annuity for the lives of Z and Y with payments of $500 a month to Z and upon Z's death of $500 a month to Y, *i.e.*, the projected monthly payment to Y is 100 percent of the monthly amount payable to Z. Accordingly, under A–10 of this section, compliance with the rules of this section is determined as of the annuity starting date. The adjusted employee/beneficiary age difference is calculated by taking the excess of the employee's age over the beneficiary's age and subtracting the number of years the employee is younger than age 70. In this case, Z is 30 years older than Y and is commencing benefit 4 years before attaining age 70 so the adjusted employee-beneficiary age difference is 26 years. Under the table in the paragraph (c)(2) of this A–2, the applicable percentage for a 26-year adjusted employee/beneficiary age difference is 64 percent. As of January 1, 2003 (the annuity starting date) the plan does not satisfy the MDIB requirement because, as of such date, the distribution option provides that, as of Z's required beginning date, the monthly payment to Y upon Z's death will exceed 66 percent of Z's monthly payment.

(d) *Period certain and annuity features.* If a distribution form includes a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain, but in the case of a joint and survivor annuity with a period certain, the amount of the annuity payments payable to the beneficiary must satisfy paragraph (c) of this A–2 after the expiration of the period certain.

(e) *Deemed satisfaction of incidental benefit rule.* Except in the case of distributions with respect to an employee's benefit that include an ancillary death benefit described in paragraph A–1(e) of this section, to the extent the incidental benefit requirement of §1.401–1(b)(1)(i) requires a distribution, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution incidental benefit requirement of this A–2. If the employee's benefits include an ancillary death benefit described in paragraph A–1(e) of this section, the benefits (including the ancillary death benefit) must be distributed in accordance with the incidental benefit requirement described in §1.401–1(b)(1)(i) and the benefits (excluding the ancillary death benefit) must also satisfy the minimum distribution incidental benefit requirement of this A–2.

Q–3. How long is a period certain under a defined benefit plan permitted to extend?

A–3. (a) *Distributions commencing during the employee's life.* The period certain for any annuity distributions commencing during the life of the employee with an annuity starting date on or after the employee's required beginning date generally is not permitted to exceed the applicable distribution period for the employee (determined in accordance with the Uniform Lifetime Table in A–2 of §1.401(a)(9)–9) for the calendar year that contains the annuity starting date. See A–10 of this section for the rule for annuity payments with an annuity starting date before the required beginning date. However, if the employee's sole beneficiary is the employee's spouse, the period certain is permitted to be as long as the joint life and last survivor expectancy of the employee and the employee's spouse, if longer than the applicable distribution period for the employee, provided the period certain is not provided in conjunction with a life annuity under A–1(b) of this section.

(b) *Distributions commencing after the employee's death.* (1) If annuity distributions commence after the death of the employee under the life expectancy rule (under section 401(a)(9)(B)(iii) or (iv)), the period certain for any distributions commencing after death cannot exceed the applicable distribution period determined under A–5(b) of §1.401(a)(9)–5 for the distribution calendar year that contains the annuity starting date.

(2) If the annuity starting date is in a calendar year before the first distribution calendar year, the period certain may not exceed the life expectancy of the designated beneficiary using the beneficiary's age in the year that contains the annuity starting date.

Q–4. Will a plan fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased from an insurance company?

A–4. A plan will not fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased with the employee's benefit by the plan from an insurance company, as long as the payments satisfy the requirements of this section. If the annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment required for one payment interval must be made no later than the end of such payment interval. If the payments actually made under the annuity contract do not meet the requirements of section 401(a)(9), the plan fails to satisfy section 401(a)(9). See also A–14 of this section permitting certain increases under annuity contracts.

Q–5. In the case of annuity distributions under a defined benefit plan, how must additional benefits that accrue after the employee's first distribution calendar year be distributed in order to satisfy section 401(a)(9)?

A–5. (a) In the case of annuity distributions under a defined benefit plan, if any additional benefits accrue in a calendar year after the employee's first distribution calendar year, distribution of the amount that accrues in the calendar year must commence in accordance with A–1 of this section beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues.

(b) A plan will not fail to satisfy section 401(a)(9) merely because there is an administrative delay in the commencement of the distribution of the additional benefits accrued in a calendar year, provided that the actual payment of such amount commences as soon as practicable. However, payment must commence no later than the end of the first calendar year following the calendar year in which the additional benefit accrues, and the total amount paid during such first calendar year must be no less than the total amount that was required to be paid during that year under A–5(a) of this section.

Q–6. If a portion of an employee's benefit is not vested as of December 31 of a distribution calendar year, how is the determination of the required minimum distribution affected?

A–6. In the case of annuity distributions from a defined benefit plan, if any portion of the employee's benefit is not vested as of December 31 of a distribution calendar year, the portion that is not vested as of such date will be treated as not having accrued for purposes of determining the required minimum distribution for that distribution calendar year. When an additional portion of the employee's benefit becomes vested, such portion will be treated as an additional accrual. See A–5 of this section for the rules for distributing benefits which accrue under a defined benefit plan after the employee's first distribution calendar year.

Q–7. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70½, for what period must the employee's accrued benefit under a defined benefit plan be actuarially increased?

A–7. (a) *Actuarial increase starting date*. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70½, in order to satisfy section 401(a)(9)(C)(iii), the employee's accrued benefit under a defined benefit plan must be actuarially increased to take into account any period after age 70½ in which the employee was not receiving any benefits under the plan. The actuarial increase required to satisfy section 401(a)(9)(C)(iii) must be provided for the period starting on the April 1 following the calendar year in which the employee attains age 70½, or January 1, 1997, if later.

(b) *Actuarial increase ending date*. The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9).

(c) *Nonapplication to plan providing same required beginning date for all employees*. If, as permitted under A–2(e) of §1.401(a)(9)–2, a plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70½ (regardless of whether the employee is a 5-percent owner) and the plan makes distributions in an amount sufficient to satisfy section 401(a)(9) using that required beginning date, no actuarial increase is required under section 401(a)(9)(C)(iii).

(d) *Nonapplication to governmental and church plans*. The actuarial increase required under this A–7 does not apply to a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

Q–8. What amount of actuarial increase is required under section 401(a)(9)(C)(iii)?

A–8. In order to satisfy section 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in A–7 of this section) must be no less than: the actuarial equivalent of the employee's retirement benefits that would have been payable as of the date the actuarial increase must commence under paragraph (a) of A–7 of this section if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying section 411.

Q–9. How does the actuarial increase required under section 401(a)(9)(C)(iii) relate to the actuarial increase required under section 411?

A–9. In order for any of an employee's accrued benefit to be nonforfeitable as required under section 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit, the payment of which is deferred past normal retirement age. The only exception to this rule is that generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829). The actuarial increase required under section 401(a)(9)(C)(iii) for the period described in A–7 of this section is generally the same as, and not in addition to, the actuarial increase required for the same period under section 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under section 411, the actuarial increase required under section 401(a)(9)(C)(iii) must be provided even during any period during which an employee's benefit has been suspended in accordance with ERISA section 203(a)(3)(B).

Q–10. What rule applies if distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 of this section?

A–10. (a) *General rule.* If distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 of this section, the annuity starting date will be treated as the required beginning date for purposes of applying the rules of this section and § 1.401(a)(9)–2. Thus, for example, the designated beneficiary distributions will be determined as of the annuity starting date. Similarly, if the employee dies after the annuity starting date but before the required beginning date determined under A–2 of § 1.401(a)(9)–2, after the employee's death, the remaining portion of the employee's interest must continue to be distributed in accordance with this section over the remaining period over which distributions commenced. The rules in § 1.401(a)(9)–3 and section 401(a)(9)(B)(ii) or (iii) and (iv) do not apply.

(b) *Period certain.* If, as of the employee's birthday in the year that contains the annuity starting date, the age of the employee is under 70, the following rule applies in applying the rule in paragraph (a) of A–3 of this section. The applicable distribution period for the employee is the distribution period for age 70, determined in accordance with the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9, plus the excess of 70 over the age of the employee as of the employee's birthday in the year that contains the annuity starting date.

(c) *Adjustment to employee/beneficiary age difference.* See A–2(c)(1) of this section for the determination of the adjusted employee/beneficiary age difference in the case of an employee whose age on the annuity starting date is less than 70.

Q–11. What rule applies if distributions commence to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 of this section.

A–11. If distributions commence to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 of this section, distributions will be considered to have begun on the actual commencement date for purposes of section 401(a)(9)(B)(iv)(II). Consequently, in such case, A–5 of § 1.401(a)(9)–3 and section 401(a)(9)(B)(ii) and (iii) will not apply upon the death of the surviving spouse as though the surviving spouse were the employee. Instead, the annuity distributions must continue to be made, in accordance with the provisions of A–1 of this section, over the remaining period over which distributions commenced.

Q–12. In the case of an annuity contract under an individual account plan that has not yet been annuitized, how is section 401(a)(9) satisfied with respect to the employee's or beneficiary's entire interest under the annuity contract for the period prior to the date annuity payments so commence?

A–12. (a) *General rule.* Prior to the date that an annuity contract under an individual account plan is annuitized, the interest of an employee or beneficiary under that contract is treated as an individual account for purposes of section 401(a)(9). Thus, the required minimum distribution for any year with respect to that interest is determined under § 1.401(a)(9)–5 rather than this section. See A–1(e) of § 1.401(a)(9)–5 for rules relating to the satisfaction of section 401(a)(9) in the year that annuity payments commence, A–3(d) of § 1.401(a)(9)–5 for rules relating to qualifying longevity annuity contracts (QLACs), defined in A–17 of this section, and A–2(a)(3) of § 1.401(a)(9)–8 for rules relating to the purchase of an annuity contract with a portion of an employee's account balance.

(b) *Entire interest.* For purposes of applying the rules in § 1.401(a)(9)–5, the entire interest under the annuity contract as of December 31 of the relevant valuation calendar year is treated as the account balance for the valuation calendar year described in A–3 of § 1.401(a)(9)–5. The entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial present value of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract. However, paragraph (c) of this A–12 describes certain additional benefits that may be disregarded in determining the employee's entire interest under the annuity contract. The actuarial present value of any additional benefits described under this A–12 is to be determined using reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health.

(c) *Exclusions.* (1) The actuarial present value of any additional benefits provided under an annuity contract described in paragraph (b) of this A–12 may be disregarded if the sum of the dollar amount credited to the employee or beneficiary under the contract and the actuarial present value of the additional benefits is no more than 120 percent of the dollar amount credited to the employee or beneficiary under the contract and the contract provides only for the following additional benefits:

(i) Additional benefits that, in the case of a distribution, are reduced by an amount sufficient to ensure that the ratio of such sum to the dollar amount credited does not increase as a result of the distribution, and

(ii) An additional benefit that is the right to receive a final payment upon death that does not exceed the excess of the premiums paid less the amount of prior distributions.

(2) If the only additional benefit provided under the contract is the additional benefit described in paragraph (c)(1)(ii) of this A–12, the additional benefit may be disregarded regardless of its value in relation to the dollar amount credited to the employee or beneficiary under the contract.

(3) The Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) may provide additional guidance on additional benefits that may be disregarded.

(d) *Examples.* The following examples, which use a 5 percent interest rate and the Mortality Table provided in Rev. Rul. 2001–62 (2001–2 C.B. 632), illustrate the application of the rules in this A–12:

Example 1. (i) G is the owner of a variable annuity contract (Contract S) under an individual account plan which has not been annuitized. Contract S provides a death benefit until the end of the calendar year in which the owner attains the age of 84 equal to the greater of the current Contract S notional account value (dollar amount credited to G under the contract) and the largest notional account value at any previous policy anniversary reduced proportionally for subsequent partial distributions (High Water Mark). Contract S provides a death benefit in calendar years after the calendar year in which the owner attains age 84 equal to the current notional account value. Contract S provides that assets within the contract may be invested in a Fixed Account at a guaranteed rate of 2 percent. Contract S provides no other additional benefits.

(ii) At the end of 2008, when G has an attained age of 78 and 9 months the notional account value of Contract S (after the distribution for 2008 of 4.93% of the notional account value as of December 31, 2007) is $550,000, and the High Water Mark, before adjustment for any withdrawals from Contract S in 2008 is $1,000,000. Thus, Contract S will provide additional benefits (*i.e.* the death benefits in excess of the notional account value) through 2014, the year S turns 84. The actuarial present value of these additional benefits at the end of 2008 is determined to be $84,300 (15 percent of the notional account value). In making this determination, the following assumptions are made: on the average, deaths occur mid-year; the investment return on his notional account value is 2 percent per annum; and minimum required distributions (determined without regard to additional benefits under the Contract S) are made at the end of each year. The following table summarizes the actuarial methodology used in determining the actuarial present value of the additional benefit.

Year	Death benefit during year	End-of-year notional account before withdrawal	Average notional account	Withdrawal at end of year	End-of-year notional account after withdrawal
2008	$1,000,000				$550,000
2009	[1] 950,739	[2] $561,000	[3] $555,500	[4] $28,205	532,795
2010	901,983	543,451	538,123	28,492	514,959
2011	853,749	525,258	520,109	28,769	496,490
2012	806,053	506,419	501,454	29,034	477,385
2013	758,916	486,933	482,159	29,287	457,645
2014	712,356	466,798	462,222	29,525	437,273

[1] $1,000,000 death benefit reduced 4.93 percent for withdrawal during 2008.
[2] Notional account value at end of prior year (after distribution) increased by 2 percent return for year.
[3] Average of $550,000 notional account value at end of prior year (after distribution) and $561,000 notional account value at end of current year (before distribution).
[4] December 31, 2008 notional account (before distribution) divided by uniform lifetime table age 79 factor of 19.5.

Year	Survivorship to start of year	Interest discount to end of 2008	Mortality rate during year	Discounted additional benefits within year
2008.				
2009	1.00000	.97590	[5] .04426	17,070
2010	.95574	[6] .92943	.04946	[7] 15,987
2011	[8] .90847	.88517	.05519	14,807
2012	.85833	.84302	.06146	13,546
2013	.80558	.80288	.06788	12,150
2014	.75090	.76464	.07477	10,739
				$84,300

[5] One-quarter age 78 rate plus three-quarters age 79 rate.
[6] Five percent discounted 18 months (1.05+(−1.5)).
[7] Blended age 79/age 80 mortality rate (.04946) multiplied by the $363,860 excess of death benefit over the average notional account value (901,983 less 538,123) multiplied by .95574 probability of survivorship to the start of 2010 multiplied by 18 month interest discount of .92943.
[8] Survivorship to start of preceding year (.95574) multiplied by probability of survivorship during prior year (1–.04946).

(iii) Because Contract S provides that, in the case of a distribution, the value of the additional death benefit (which is the only additional benefit available under the contract) is reduced by an amount that is at least proportional to the reduction in the notional account value and, at age 78 and 9 months, the sum of the notional account value (dollar amount credited to the employee under the contract) and the actuarial present value of the additional death benefit is no more than 120 percent of the notional account value, the exclusion under paragraph (c)(2) of this A–12 is applicable for 2009. Therefore, for purposes of applying the rules in §1.401(a)(9)–5, the entire interest under Contract S may be determined as the notional account value (*i.e.* without regard to the additional death benefit).

Example 2. (i) The facts are the same as in (*Example 1* except that the notional account value is $450,000 at the end of 2008. In this instance, the actuarial present value of the death benefit in excess of the notional account value in 2008 is determined to be $108,669 (24 percent of the notional account value). The following table summarizes the actuarial methodology used in determining the actuarial present value of the additional benefit.

Year	Death benefit during year	End-of-year notional account before withdrawal	Average notional account	Withdrawal at end of year	End-of-year notional account after withdrawal
2008	$1,000,000				$450,000
2009	950,739	$459,000	$454,500	$23,077	435,923
2010	901,983	444,642	440,282	23,311	421,330
2011	853,749	429,757	425,543	23,538	406,219
2012	806,053	414,343	410,281	23,755	390,588
2013	758,916	398,399	394,494	23,962	374,437
2014	712,356	381,926	378,181	24,157	357,768

Year	Survivorship to start of year	Interest discount to end of 2008	Mortality rate during year	Discounted additional benefits within year
2008.				
2009	1.00000	.97590	.04426	$21,432
2010	.95574	.92943	.04946	20,286
2011	.90847	.88517	.05519	19,004
2012	.85833	.84302	.06146	17,601
2013	.80558	.80288	.06788	15,999
2014	.75090	.76464	.07477	14,347
				$108,669

(ii) Because the sum of the notional account balance and the actuarial present value of the additional death benefit is more than 120 percent of the notional account value, the exclusion under paragraph (b)(1) of this A–12 does not apply for 2009. Therefore, for purposes of applying the rules in §1.401(a)(9)–5, the entire interest under Contract S must include the actuarial present value of the additional death benefit.

Q–13: When can an annuity payment period be changed?

A–13. (a) *In general.* An annuity payment period may be changed in accordance with the provisions set forth in paragraph (b) of this A–13 or in association with an annuity payment increase described in A–14 of this section.

(b) *Reannuitization.* If, in a stream of annuity payments that otherwise satisfies section 401(a)(9), the annuity payment period is changed and the annuity payments are modified in association with that change, this modification will not cause the distributions to fail to satisfy section 401(a)(9) provided the conditions set forth in paragraph (c) of this A–13 are satisfied, and either—

(1) The modification occurs at the time that the employee retires or in connection with a plan termination;

(2) The annuity payments prior to modification are annuity payments paid over a period certain without life contingencies; or

(3) The annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and a designated beneficiary, the employee's spouse is the sole designated beneficiary, and the modification occurs in connection with the employee becoming married to such spouse.

(c) *Conditions.* In order to modify a stream of annuity payments in accordance with paragraph (b) of this A–13, the following conditions must be satisfied—

(1) The future payments under the modified stream satisfy section 401(a)(9) and this section (determined by treating the date of the change as a new annuity starting date and the actuarial present value of the remaining payments prior to modification as the entire interest of the participant);

(2) For purposes of sections 415 and 417, the modification is treated as a new annuity starting date;

(3) After taking into account the modification, the annuity stream satisfies section 415 (determined at the original annuity starting date, using the interest rates and mortality tables applicable to such date); and

(4) The end point of the period certain, if any, for any modified payment period is not later than the end point available under section 401(a)(9) to the employee at the original annuity starting date.

(d) *Examples.* For the following examples in this A–13, assume that the Applicable Interest Rate throughout the period from 2005 through 2008 is 5 percent and throughout 2009 is 4 percent, the Applicable Mortality Table throughout the period from 2005 to 2009 is the table provided in Rev. Rul. 2001–62 (2001–C.B. 632) and the section 415 limit in 2005 at age 70 for a straight life annuity is $255,344:

Example 1. (i) A participant (D), who has 10 years of participation in a frozen defined benefit plan (Plan W), attains age 70½ in 2005. D is not retired and elects to receive distributions from Plan W in the form of a straight life (*i.e.* level payment) annuity with annual payments of $240,000 per year beginning in 2005 at a date when D has an attained age of 70. Plan W offers non-retired employees in pay status the opportunity to modify their annuity payments due to an associated change in the payment period at retirement. Plan W treats the date of the change in payment period as a new annuity starting date for the purposes of sections 415 and 417. Thus, for example, the plan provides a new qualified and joint survivor annuity election and obtains spousal consent.

(ii) Plan W determines modifications of annuity payment amounts at retirement such that the present value of future new annuity payment amounts (taking into account the new associated payment period) is actuarially equivalent to the present value of future pre-modification annuity payments (taking into account the pre-modification annuity payment period). Actuarial equivalency for this purpose is determined using the Applicable Interest Rate and the Applicable Mortality Table as of the date of modification.

(iii) D retires in 2009 at the age of 74 and, after receiving four annual payments of $240,000, elects to receive his remaining distributions from Plan W in the form of an immediate final lump sum payment (calculated at 4 percent interest) of $2,399,809.

(iv) Because payment of retirement benefits in the form of an immediate final lump sum payment satisfies (in terms of form) section 401(a)(9), the condition under paragraph (c)(1) of this A–13 is met.

(v) Because Plan W treats a modification of an annuity payment stream at retirement as a new annuity starting date for purposes of sections 415 and 417, the condition under paragraph (c)(2) of this A–13 is met.

(vi) After taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $240,000, $240,000, $240,000, $240,000, and $2,399,809. This benefit stream is actuarially equivalent to a straight life annuity at age 70 of $250,182, an amount less than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the condition under paragraph (c)(3) of this A–13 is met.

(vii) Thus, because a stream of annuity payments in the form of a straight life annuity satisfies section 401(a)(9), and because each of the conditions under paragraph (c) of this A–13 are satisfied, the modification of annuity payments to D described in this example meets the requirements of this A–13.

Example 2. The facts are the same as in *Example 1* except that the straight life annuity payments are paid at a rate of $250,000 per year and after D retires the lump sum payment at age 75 is $2,499,801. Thus, after taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $250,000, $250,000, $250,000, $250,000, and $2,499,801. This benefit stream is actuarially equivalent to a straight life annuity at age 70 of $260,606, an amount greater than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the lump sum payment to D fails to satisfy the condition under paragraph (c)(3) of this A–13. Therefore, the lump sum payment to D fails to meet the requirements of this A–13 and thus fails to satisfy the requirements of section 401(a)(9).

Example 3. (i) A participant (E), who has 10 years of participation in a frozen defined benefit plan (Plan X), attains age 70½ and retires in 2005 at a date when his attained age is 70. E was born in 1935. E elects to receive annual distributions from Plan X in the form of a 27 year period certain annuity (*i.e.*, a 27 year annuity payment period without a life contingency) paid at a rate of $37,000 per year beginning in 2005 with future payments increasing at a rate of 4 percent per year (*i.e.*, the 2006 payment will be $38,480, the 2007 payment will be $40,019 and so on). Plan X offers participants in pay status whose annuity payments are in the form of a term-certain annuity the opportunity to modify their payment period at any time and treats such modifications as a new annuity starting date for the purposes of sections 415 and 417. Thus, for example, the plan provides a new qualified and joint survivor annuity election and obtains spousal consent.

(ii) Plan X determines modifications of annuity payment amounts such that the present value of future new annuity payment amounts (taking into account the new associated payment period) is actuarially equivalent to the present value of future pre-modification annuity payments (taking into account the pre-modification annuity payment period). Actuarial equivalency for this purpose is determined using 5 percent and the Applicable Mortality Table as of the date of modification.

(iii) In 2008, E, after receiving annual payments of $37,000, $38,480, and $40,019, elects to receive his remaining distributions from Plan W in the form of a straight life annuity paid with annual payments of $92,133 per year.

(iv) Because payment of retirement benefits in the form of a straight life annuity satisfies (in terms of form) section 401(a)(9), the condition under paragraph (c)(1) of this A–13 is met.

(v) Because Plan X treats a modification of an annuity payment stream at retirement as a new annuity starting date for purposes of sections 415 and 417, the condition under paragraph (c)(2) of this A–13 is met.

(vi) After taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $37,000, $38,480, $40,019, and a straight life annuity beginning at age 73 of $92,133. This benefit stream is equivalent to a straight life annuity at age 70 of $82,539, an amount less than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the condition under paragraph (c)(3) of this A–13 is met.

(vii) Thus, because a stream of annuity payments in the form of a straight life annuity satisfies section 401(a)(9), and because each of the conditions under paragraph (c) of this A–13 are satisfied, the modification of annuity payments to E described in this example meets the requirements of this A–13.

Q–14. Are annuity payments permitted to increase?

A–14. (a) *General rules.* Except as otherwise provided in this section, all annuity payments (whether paid over an employee's life, joint lives, or a period certain) must be nonincreasing or increase only in accordance with one or more of the following—

(1) With an annual percentage increase that does not exceed the percentage increase in an eligible cost-of-living index as defined in paragraph (b) of this A–14 for a 12-month period ending in the year during which the increase occurs or the prior year;

(2) With a percentage increase that occurs at specified times (*e.g.*, at specified ages) and does not exceed the cumulative total of annual percentage increases in an eligible cost-of-living index as defined in paragraph (b) of this A–14 since the annuity starting date, or if later, the date of the most recent percentage increase. However, in cases providing such a cumulative increase, an actuarial increase may not be provided to reflect the fact that increases were not provided in the interim years;

(3) To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit, but only if there is no longer a survivor benefit because the beneficiary whose life was being used to determine the period described in section 401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee's beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p);

(4) To pay increased benefits that result from a plan amendment;

(5) To allow a beneficiary to convert the survivor portion of a joint and survivor annuity into a single sum distribution upon the employee's death; or

(6) To the extent increases are permitted in accordance with paragraph (c) or (d) of this A–14.

(b) (1) For purposes of this A–14, an eligible cost-of-living index means an index described in paragraphs (b)(2), (b)(3), or (b)(4) of this A–14.

(2) A consumer price index that is based on prices of all items (or all items excluding food and energy) and issued by the Bureau of Labor Statistics, including an index for a specific population (such as urban consumers or urban wage earners and clerical workers) and an index for a geographic area or areas (such as a given metropolitan area or state).

(3) A percentage adjustment based on a cost-of-living index described in paragraph (b)(2) of this A–14, or a fixed percentage if less. In any year when the cost-of-living index is lower than the fixed percentage, the fixed percentage may be treated as an increase in an eligible cost-of-living index, provided it does not exceed the sum of:

(i) The cost-of-living index for that year, and

(ii) The accumulated excess of the annual cost-of-living index from each prior year over the fixed annual percentage used in that year (reduced by any amount previously utilized under this paragraph (b)(3)(ii)).

(4) A percentage adjustment based on the increase in compensation for the position held by the employee at the time of retirement, and provided under either the terms of a governmental plan within the meaning of section 414(d) or under the terms of a nongovernmental plan as in effect on April 17, 2002.

(c) *Additional permitted increases for annuity payments under annuity contracts purchased from insurance companies.* In the case of annuity payments paid from an annuity contract purchased from an insurance company, if the total future expected payments (determined in accordance with paragraph (e)(3) of this A–14) exceed the total value being annuitized (within the meaning of paragraph (e)(1) of this A–14) , the payments under the annuity will not fail to satisfy the nonincreasing payment requirement in A–1(a) of this section merely because the payments are increased in accordance with one or more of the following—

(1) By a constant percentage, applied not less frequently than annually;

(2) To provide a final payment upon the death of the employee that does not exceed the excess of the total value being annuitized (within the meaning of paragraph (e)(1) of this A–14) over the total of payments before the death of the employee;

(3) As a result of dividend payments or other payments that result from actuarial gains (within the meaning of paragraph (e)(2) of this A–14), but only if actuarial gain is measured no less frequently than annually and the resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured); and

(4) An acceleration of payments under the annuity (within the meaning of paragraph (e)(4) of this A–14).

(d) *Additional permitted increases for annuity payments from a qualified trust.* In the case of annuity payments paid under a defined benefit plan qualified under section 401(a) (other than annuity payments under an annuity contract purchased from an insurance company that satisfy paragraph (c) of this section), the payments under the annuity will not fail to satisfy the nonincreasing payment requirement in A–1(a) of this section merely because the payments are increased in accordance with one of the following—

(1) By a constant percentage, applied not less frequently than annually, at a rate that is less than 5 percent per year;

(2) To provide a final payment upon the death of the employee that does not exceed the excess of the actuarial present value of the employee's accrued benefit (within the meaning of section 411(a)(7)) calculated as the annuity starting date using the applicable interest rate and the applicable mortality table under section 417(e) (or, if greater, the total amount of employee contributions) over the total of payments before the death of the employee; or

(3) As a result of dividend payments or other payments that result from actuarial gains (within the meaning of paragraph (e)(2) of this A–14), but only if—

(i) Actuarial gain is measured no less frequently than annually;

(ii) The resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured);

(iii) The actuarial gain taken into account is limited to actuarial gain from investment experience;

(iv) The assumed interest used to calculate such actuarial gains is not less than 3 percent; and

(v) The payments are not increasing by a constant percentage as described in paragraph (d)(1) of this A–14.

(e) *Definitions.* For purposes of this A–14, the following definitions apply—

(1) Total value being annuitized means—

(i) In the case of annuity payments under a section 403(a) annuity plan or under a deferred annuity purchased by a section 401(a) trust, the value of the employee's entire interest (within the meaning of A–12 of this section) being annuitized (valued as of the date annuity payments commence);

(ii) In the case of annuity payments under an immediate annuity contract purchased by a trust for a defined benefit plan qualified under section 401(a), the amount of the premium used to purchase the contract; and

(iii) In the case of a defined contribution plan, the value of the employee's account balance used to purchase an immediate annuity under the contract.

(2) Actuarial gain means the difference between an amount determined using the actuarial assumptions (*i.e.*, investment return, mortality, expense, and other similar assumptions) used to calculate the initial payments before adjustment for any increases and the amount determined under the actual experience with respect to those factors. Actuarial gain also includes differences between the amount determined using actuarial assumptions when an annuity was purchased or commenced and such amount determined using actuarial assumptions used in calculating payments at the time the actuarial gain is determined.

(3) Total future expected payments means the total future payments expected to be made under the annuity contract as of the date of the determination, calculated using the Single Life Table in A–1 of §1.401(a)(9)–9 (or, if applicable, the Joint and Last Survivor Table in A–3 of in §1.401(a)(9)–9) for annuitants who are still alive, without regard to any increases in annuity payments after the date of determination, and taking into account any remaining period certain.

(4) Acceleration of payments means a shortening of the payment period with respect to an annuity or a full or partial commutation of the future annuity payments. An increase in the payment amount will be treated as an acceleration of payments in the annuity only if the total future expected payments under the annuity (including the amount of any payment made as a result of the acceleration) is decreased as a result of the change in payment period.

(f) *Examples.* Paragraph (c) of this A–14 is illustrated by the following examples:

Example 1. Variable annuity. A retired participant (Z1) in defined contribution plan X attains age 70 on March 5, 2005, and thus, attains age 70½ in 2005. Z1 elects to purchase annuity Contract Y1 from Insurance Company W in 2005. Contract Y1 is a single life annuity contract with a 10-year period certain. Contract Y1 provides for an initial annual payment calculated with an assumed interest rate (AIR) of 3 percent. Subsequent payments are determined by multiplying the prior year's payment by a fraction the numerator of which is 1 plus the actual return on the separate account assets underlying Contract Y1 since the preceding payment and the denominator of which is 1 plus the AIR during that period. The value of Z1's account balance in Plan X at the time of purchase is $105,000, and the purchase price of Contract Y1 is $105,000. Contract Y1 provides Z1 with an initial payment of $7,200 at the time of purchase in 2005. The total future expected payments to Z1 under Contract Y1 are $122,400, calculated as the initial payment of $7,200 multiplied by the age 70 life expectancy of 17 provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because the total future expected payments on the purchase date exceed the total value used to purchase Contract Y1 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z1 from Contract Y1 meet the requirements under paragraph (c)(3) of this A–14.

Example 2. Participating annuity. A retired participant (Z2) in defined contribution plan X attains age 70 on May 1, 2005, and thus, attains age 70½ in 2005. Z2 elects to purchase annuity Contract Y2 from Insurance Company W in 2005. Contract Y2 is a participating single life annuity contract with a 10-year period certain. Contract Y2 provides for level annual payments with dividends paid in a lump sum in the year after the year for which the actuarial experience is measured or paid out levelly beginning in the year after the year for which the actuarial gain is measured over the remaining lifetime and period certain, *i.e.*, the period certain ends at the same time as the original period certain. Dividends are determined annually by the Board of Directors of Company W based upon a comparison of actual actuarial experience to expected actuarial experience in the past year. The value of Z2's account balance in

Plan X at the time of purchase is $265,000, and the purchase price of Contract Y2 is $265,000. Contract Y2 provides Z2 with an initial payment of $16,000 in 2005. The total future expected payments to Z2 under Contract Y2 are calculated as the annual initial payment of $16,000 multiplied by the age 70 life expectancy of 17 provided in the Single Life Table in A–1 of §1.401(a)(9)–9 for a total of $272,000. Because the total future expected payments on the purchase date exceeds the total value used to purchase Contract Y2 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z2 from Contract Y2 meet the requirements under paragraph (c)(3) of this A–14.

Example 3. Participating annuity with dividend accumulation. The facts are the same as in *Example 2* except that the annuity provides a dividend accumulation option under which Z2 may defer receipt of the dividends to a time selected by Z2. Because the dividend accumulation option permits dividends to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the dividend accumulation option does not meet the requirements of paragraph (c)(3) of this A–14. Neither does the dividend accumulation option fit within any of the other increases described in paragraph (c) of this A–14. Accordingly, the dividend accumulation option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–14 and thus fail to satisfy the requirements of section 401(a)(9).

Example 4. Participating annuity with dividends used to purchase additional death benefits. The facts are the same as in *Example 2* except that the annuity provides an option under which actuarial gain under the contract is used to provide additional death benefit protection for Z2. Because this option permits payments as a result of actuarial gain to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the option does not meet the requirements of paragraph (c)(3) of this A–14. Neither does the option fit within any of the other increases described in paragraph (c) of this A–14. Accordingly, the addition of the option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–14 and thus fail to satisfy the requirements of section 401(a)(9).

Example 5. Annuity with a fixed percentage increase. A retired participant (Z3) in defined contribution plan X attains age 70½ in 2005. Z3 elects to purchase annuity contract Y3 from Insurance Company W. Contract Y3 is a single life annuity contract with a 20-year period certain (which does not exceed the maximum period certain permitted under A–3(a) of this section) with fixed annual payments increasing 3 percent each year. The value of Z3's account balance in Plan X at the time of purchase is $110,000, and the purchase price of Contract Y3 is $110,000. Contract Y3 provides Z3 with an initial payment of $6,000 at the time of purchase in 2005. The total future expected payments to Z3 under Contract Y3 are $120,000, calculated as the initial annual payment of $6,000 multiplied by the period certain of 20 years. Because the total future expected payments on the purchase date exceed the total value used to purchase Contract Y3 and payments only increase as a constant percentage applied not less frequently than annually, distributions received by Z3 from Contract Y3 meet the requirements under paragraph (c)(1) of this A–14.

Example 6. Annuity with excessive increases. The facts are the same as in *Example 5* except that the initial payment is $5,400 and the annual rate of increase is 4 percent. In this example, the total future expected payments are $108,000, calculated as the initial payment of $5,400 multiplied by the period certain of 20 years. Because the total future expected payments are less than the total value of $110,000 used to purchase Contract Y3, distributions received by Z3 do not meet the requirements under paragraph (c) of this A–14 and thus fail to meet the requirements of section 401(a)(9).

Example 7. Annuity with full commutation feature. (i) A retired participant (Z4) in defined contribution Plan X attains age 78 in 2005. Z4 elects to purchase Contract Y4 from Insurance Company W. Contract Y4 provides for a single life annuity with a 10 year period certain (which does not exceed the maximum period certain permitted under A–3(a) of this section) with annual payments. Contract Y4 provides that Z4 may cancel Contract Y4 at any time before Z4 attains age 84, and receive, on his next payment due date, a final payment in an amount determined by multiplying the initial payment amount by a factor obtained from Table M of Contract Y4 using the Y4's age as of Y4's birthday in the calendar year of the final payment. The value of Z4's account balance in Plan X at the time of purchase is $450,000, and the purchase price of Contract Y4 is $450,000. Contract Y4 provides Z4 with an initial payment in 2005 of $40,000. The factors in Table M are as follows:

Age at final payment	Factor
79	10.5
80	10.0
81	9.5
82	9.0
83	8.5
84	8.0

(ii) The total future expected payments to Z4 under ContractY4 are $456,000, calculated as the initial payment of 40,000 multiplied by the age 78 life expectancy of 11.4 provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because the total future expected payments on the purchase date exceed the total value being annuitized (*i.e.*, the $450,000 used to purchase Contract Y4), the permitted increases set forth in paragraph (c) of this A–14 are available. Furthermore, because the factors in Table M are less than the life expectancy of each of the ages in the Single Life Table provided in A–1 of §1.401(a)(9)–9, the final payment is always less than the total future expected payments. Thus, the final payment is an acceleration of payments within the meaning of paragraph (c)(4) of this A–14.

(iii) As an illustration of the above, if Participant Z4 were to elect to cancel Contract Y4 on the day before he was to attain age 84, his contractual final payment would be $320,000. This amount is determined as $40,000 (the annual payment amount due under Contract Y4) multiplied by 8.0 (the factor in Table M for the next payment due date, age 84). The total future expected payments under Contract Y4 at age 84 before the final payment is $324,000, calculated as the initial payment amount multiplied by 8.1, the age 84 life expectancy provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because $320,000 (the total future expected payments under the annuity contract, including the amount of the final payment) is less than $324,000 (the total future expected payments under the annuity contract, determined before the election), the final payment is an acceleration of payments within the meaning of paragraph (c)(4) of this A–14.

Example 8. Annuity with partial commutation feature. (i) The facts are the same as in *Example 7* except that the annuity provides Z4 may request, at any time before Z4 attains age 84, an ad hoc payment on his next payment due date with future payments reduced by an amount equal to the ad hoc payment divided by the factor obtained from Table M (from *Example* 7) corresponding to Z4's age at the time of the ad hoc payment. Because, at each age, the factors in Table M are less than the corresponding life expectancies in the Single Life Table in A–1 of §1.401(a)(9)–9, total future expected payments under Contract Y4 will decrease after an ad hoc payment. Thus, ad hoc distributions received by Z4 from Contract Y4 will satisfy the requirements under paragraph (c)(4) of this A–4.

(ii) As an illustration of paragraph (i) of this *Example 8*, if Z4 were to request, on the day before he was to attain age 84, an ad hoc payment of $100,000 on his next payment due date, his recalculated annual payment amount would be reduced to $27,500. This amount is determined as $40,000 (the amount of Z4's next annual payment) reduced by $12,500 (his $100,000 ad hoc payment divided by the Table M factor at age 84 of 8.0). Thus, Z4's total future expected payments after the ad hoc payment (and including the ad hoc payment) are equal to $322,750 ($100,000 plus $27,500 multiplied by the Single Life Table value of 8.1). Note that this $322,750 amount is less than the amount of Z4's total future expected payments before the ad hoc payment ($324,000, determined as $40,000 multiplied by 8.1), and the requirements under paragraph (c)(4) of this A–4 are satisfied.

Example 9. Annuity with excessive increases. (i) A retired participant (Z5) in defined contribution plan X attains age 70½ in 2005. Z5 elects to purchase annuity Contract Y5 from Insurance Company W in 2005 with a premium of $1,000,000. Contract Y5 is a single life annuity contract with a 20-year period certain. Contract Y5 provides for an initial payment of $200,000, a second payment one year from the time of purchase of $40,000, and 18 succeeding annual payments each increasing at a constant percentage rate of 4.5 percent from the preceding payment.

(ii) Contract Y5 fails to meet the requirements of section 401(a)(9) because the total future expected payments without regard to any increases in the annuity payment, calculated as $200,000 in year one and $40,000 in each of years two through twenty, is only $960,000 (*i.e.*, an amount that does not exceed the total value used to purchase the annuity).

Q–15: Are there special rules applicable to payments made under a defined benefit plan or annuity contract to a surviving child?

A–15: Yes, pursuant to section 401(a)(9)(F), payments under a defined benefit plan or annuity contract that are made to an employee's child until such child reaches the age of majority (or dies, if earlier) may be treated, for purposes of section 401(a)(9), as if such payments were made to the surviving spouse to the extent they become payable to the surviving spouse upon cessation of the payments to the child. For purposes of the preceding sentence, a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26. In addition, a child who is disabled within the meaning of section 72(m)(7) when the child reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled. Thus, when payments described in this paragraph A–15 become payable to the surviving spouse because the child attains the age of majority, recovers from a disabling illness, dies, or completes a specified course of education, there is not an increase in benefits under A–1 of this section. Likewise, the age of child receiving such payments is not taken into consideration for purposes of the minimum incidental benefit requirement of A–2 of this section.

Q–16: What are the rules for determining required minimum distributions for defined benefit plans and annuity contracts for calendar years 2003, 2004, and 2005?

A–16: A distribution from a defined benefit plan or annuity contract for calendar years 2003, 2004, and 2005 will not fail to satisfy section 401(a)(9) merely because the payments do not satisfy A–1 through A–15 of this section, provided the payments satisfy section 401(a)(9) based on a reasonable and good faith interpretation of the provisions of section 401(a)(9).

Q–17. What is a qualifying longevity annuity contract?

A–17. (a) *Definition of qualifying longevity annuity contract*. A qualifying longevity annuity contract (QLAC) is an annuity contract that is purchased from an insurance company for an employee and that, in accordance with the rules of application of paragraph (d) of this A–17, satisfies each of the following requirements—

(1) Premiums for the contract satisfy the requirements of paragraph (b) of this A–17;

(2) The contract provides that distributions under the contract must commence not later than a specified annuity starting date that is no later than the first day of the month next following the 85th anniversary of the employee's birth;

(3) The contract provides that, after distributions under the contract commence, those distributions must satisfy the requirements of this section (other than the requirement in A–1(c) of this section that annuity payments commence on or before the required beginning date);

(4) The contract does not make available any commutation benefit, cash surrender right, or other similar feature;

(5) No benefits are provided under the contract after the death of the employee other than the benefits described in paragraph (c) of this A–17;

(6) When the contract is issued, the contract (or a rider or endorsement with respect to that contract) states that the contract is intended to be a QLAC; and

(7) The contract is not a variable contract under section 817, an indexed contract, or a similar contract, except to the extent provided by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin and made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402 and on the IRS Web site at *http://www.irs.gov*.

(b) *Limitations on premiums*—(1) *In general*. The premiums paid with respect to the contract on a date satisfy the requirements of this paragraph (b) if they do not exceed the lesser of the dollar limitation in paragraph (b)(2) of this A–17 or the percentage limitation in paragraph (b)(3) of this A–17.

(2) *Dollar limitation*. The dollar limitation is an amount equal to the excess of—

(i) $125,000 (as adjusted under paragraph (d)(2) of this A–17), over

(ii) The sum of—

(A) The premiums paid before that date with respect to the contract, and

(B) The premiums paid on or before that date with respect to any other contract that is intended to be a QLAC and that is purchased for the employee under the plan, or any other plan, annuity, or account described in section 401(a), 403(a), 403(b), or 408 or eligible governmental plan under section 457(b).

(3) *Percentage limitation*. The percentage limitation is an amount equal to the excess of—

(i) 25 percent of the employee's account balance under the plan (including the value of any QLAC held under the plan for the employee) as of that date, determined in accordance with paragraph (d)(1)(iii) of this A–17, over

(ii) The sum of—

(A) The premiums paid before that date with respect to the contract, and

(B) The premiums paid on or before that date with respect to any other contract that is intended to be a QLAC and that is held or was purchased for the employee under the plan.

(c) *Payments after death of the employee*—(1) *Surviving spouse is sole beneficiary*—(i) *Death on or after annuity starting date.* If the employee dies on or after the annuity starting date for the contract and the employee's surviving spouse is the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A–17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse where the periodic annuity payment is not in excess of 100 percent of the periodic annuity payment that is payable to the employee.

(ii) *Death before annuity starting date*—(A) *Amount of annuity.* If the employee dies before the annuity starting date and the employee's surviving spouse is the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A–17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse where the periodic annuity payment is not in excess of 100 percent of the periodic annuity payment that would have been payable to the employee as of the date that benefits to the surviving spouse commence. However, the annuity is permitted to exceed 100 percent of the periodic annuity payment that would have been payable to the employee to the extent necessary to satisfy the requirement to provide a qualified preretirement survivor annuity (as defined under section 417(c)(2) or ERISA section 205(e)(2)) pursuant to section 401(a)(11)(A)(ii) or ERISA section 205(a)(2).

(B) *Commencement date for annuity.* Any life annuity payable to the surviving spouse under paragraph (c)(1)(ii)(A) of this A–17 must commence no later than the date on which the annuity payable to the employee would have commenced under the contract if the employee had not died.

(2) *Surviving spouse is not sole beneficiary*—(i) *Death on or after annuity starting date.* If the employee dies on or after the annuity starting date for the contract and the employee's surviving spouse is not the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A–17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the designated beneficiary where the periodic annuity payment is not in excess of the applicable percentage (determined under paragraph (c)(2)(iii) of this A–17) of the periodic annuity payment that is payable to the employee.

(ii) *Death before annuity starting date*—(A) *Amount of annuity.* If the employee dies before the annuity starting date and the employee's surviving spouse is not the sole beneficiary under the contract then, except as provided in paragraph (c)(4) of this A–17, the only benefit permitted to be paid after the employee's death is a life annuity payable to the designated beneficiary where the periodic annuity payment is not in excess of the applicable percentage (determined under paragraph (c)(2)(iii) of this A–17) of the periodic annuity payment that would have been payable to the employee as of the date that benefits to the designated beneficiary commence under this paragraph (c)(2)(ii).

(B) *Commencement date for annuity.* In any case in which the employee dies before the annuity starting date, any life annuity payable to a designated beneficiary under this paragraph (c)(2)(ii) must commence by the last day of the calendar year immediately following the calendar year of the employee's death.

(iii) *Applicable percentage*—(A) *Contracts without pre-annuity starting date death benefits.* If, as described in paragraph (c)(2)(iv) of this A–17, the contract does not provide for a pre-annuity starting date non-spousal death benefit, the applicable percentage is the percentage described in the table in A–2(c) of this section.

(B) *Contracts with set beneficiary designation.* If the contract provides for a set non-spousal beneficiary designation as described in paragraph (c)(2)(v) (and is not a contract described in paragraph (c)(2)(iv)) of this A–17, the applicable percentage is the percentage described in the table set forth in paragraph (c)(2)(iii)(D) of this A–17. A contract is still considered to provide for a set beneficiary designation even if the surviving spouse becomes the sole beneficiary before the annuity starting date. In such a case, the requirements of paragraph (c)(1) of this A–17 apply and not the requirements of this paragraph (c)(2).

(C) *Contracts providing for return of premium.* If the contract provides for a return of premium as described in paragraph (c)(4) of this A–17, the applicable percentage is 0.

(D) *Applicable percentage table.* The applicable percentage is based on the adjusted employee/beneficiary age difference, determined in the same manner as in A–2(c) of this section.

Adjusted employee/beneficiary age difference	Applicable percentage
2 years or less	100
3	88
4	78
5	70
6	63
7	57
8	52
9	48
10	44
11	41
12	38
13	36
14	34
15	32
16	30
17	28
18	27
19	26
20	25
21	24
22	23
23	22
24	21
25 and greater	20

(iv) *No pre-annuity starting date non-spousal death benefit.* A contract is described in this paragraph (c)(2)(iv) if the contract provides that no benefit is permitted to be paid to a beneficiary other than the employee's surviving spouse after the employee's death—

(A) In any case in which the employee dies before the annuity starting date under the contract; and

(B) In any case in which the employee selects an annuity starting date that is earlier than the specified annuity starting date under the contract and the employee dies less than 90 days after making that election.

(v) *Contracts permitting set non-spousal beneficiary designation.* A contract is described in this paragraph (c)(2)(v) if the contract provides that if the beneficiary under the contract is not the employee's surviving spouse, benefits are payable to the beneficiary only if the beneficiary was irrevocably designated on or before the later of the date of purchase or the employee's required beginning date.

(3) *Calculation of early annuity payments.* For purposes of paragraphs (c)(1)(ii) and (c)(2)(ii) of this A–17, to the extent the contract does not provide an option for the employee to select an annuity starting date that is earlier than the date on which the annuity payable to the employee would have commenced under the contract if the employee had not died, the contract must provide a way to determine the periodic annuity payment that would have been payable if the employee were to have an option to accelerate the payments and the payments had commenced to the employee immediately prior to the date that benefit payments to the surviving spouse or designated beneficiary commence.

(4) *Return of premiums*—(i) *In general.* In lieu of a life annuity payable to a designated beneficiary under paragraph (c)(1) or (2) of this A–17, a QLAC is permitted to provide for a benefit to be paid to a beneficiary after the death of the employee in an amount equal to the excess of—

(A) The premium payments made with respect to the QLAC over

(B) The payments already made under the QLAC.

(ii) *Payments after death of surviving spouse.* If a QLAC is providing a life annuity to a surviving spouse (or will provide a life annuity to a surviving spouse) under paragraph (c)(1) of this A–17, it is also permitted to provide for a benefit paid to a beneficiary after the death of both the employee and the spouse in an amount equal to the excess of—

(A) The premium payments made with respect to the QLAC over

(B) The payments already made under the QLAC.

(iii) *Other rules*—(A) *Timing of return of premium payment following death of employee.* A return of premium payment under this paragraph (c)(4) must be paid no later than the end of the calendar year following the calendar year in which the employee dies. If the employee's death is after the required beginning date, the return of premium payment is treated as a required minimum distribution for the year in which it is paid and is not eligible for rollover.

(B) *Timing of return of premium payment following death of surviving spouse receiving life annuity.* If the return of premium payment is paid after the death of a surviving spouse who is receiving a life annuity (or after the death of a surviving spouse who has not yet commenced receiving a life annuity after the death of the employee), the return of premium payment under this paragraph (c)(4) must be made no later than the end of the calendar year following the calendar year in which the surviving spouse dies. If the surviving spouse's death is after the required beginning date for the surviving spouse, then the return of premium payment is treated as a required minimum distribution for the year in which it is paid and is not eligible for rollover.

(5) *Multiple beneficiaries.* If an employee has more than one designated beneficiary under a QLAC, the rules in A–2(a) of §1.401(a)(9)–8 apply for purposes of paragraphs (c)(1) and (c)(2) of this A–17.

(d) *Rules of application*—(1) *Rules relating to premiums*—(i) *Reliance on representations.* For purposes of the limitation on premiums described in paragraphs (b)(2) and (3) of this A–17, unless the plan administrator has actual knowledge to the contrary, the plan administrator may rely on an employee's representation (made in writing or such other form as may be prescribed by the Commissioner) of the amount of the premiums described in paragraphs (b)(2)(ii)(B) and (b)(3)(ii)(B) of this A–17, but only with respect to premiums that are not paid under a plan, annuity, or contract that is maintained by the employer or an entity that is treated as a single employer with the employer under section 414(b), (c), (m), or (o).

(ii) *Consequences of excess premiums*—(A) *General Rule.* If an annuity contract fails to be a QLAC solely because a premium for the contract exceeds the limits under paragraph (b) of this A–17, then the contract is not a QLAC beginning on the date that premium payment is made unless the excess premium is returned to the non-QLAC portion of the employee's account in accordance with paragraph (d)(1)(ii)(B) of this A–17. If the contract fails to be a QLAC, then the value of the contract may not be disregarded under A–3(d) of §1.401(a)(9)–5 as of the date on which the contract ceases to be a QLAC.

(B) *Correction in year following year of excess.* If the excess premium is returned (either in cash or in the form of a contract that is not intended to be a QLAC) to the non-QLAC portion of the employee's account by the end of the calendar year following the calendar year in which the excess premium was originally paid, then the contract will not be treated as exceeding the limits under paragraph (b) of this A–17 at any time, and the value of the contract will not be included in the employee's account balance under A–3(d) of §1.401(a)(9)–5. If the excess premium (including the fair market value of an annuity contract that is not intended to be a QLAC, if applicable) is returned to the non-QLAC portion of the employee's account after the last valuation date for the calendar year in which the excess premium was originally paid, then the employee's account balance for that calendar year must be increased to reflect that excess premium in the same manner as an employee's account balance is increased under A–2 of §1.401(a)(9)–7 to reflect a rollover received after the last valuation date.

(C) *Return of excess premium not a commutation benefit.* If the excess premium is returned to the non-QLAC portion of the employee's account as described in paragraph (d)(1)(ii)(B) of this A–17, it will not be treated as a violation of the requirement in paragraph (a)(4) of this A–17 that the contract not provide a commutation benefit.

(iii) *Application of 25-percent limit.* For purposes of the 25-percent limit under paragraph (b)(3) of this A–17, an employee's account balance on the date on which premiums for a contract are paid is the account balance as of the last valuation date preceding the date of the premium payment, adjusted as follows. The account balance is increased for contributions allocated to the account during the period that begins after the valuation date and ends before the date the premium is paid and decreased for distributions made from the account during that period.

(2) *Dollar and age limitations subject to adjustments*—(i) *Dollar limitation*. In the case of calendar years beginning on or after January 1, 2015, the $125,000 amount under paragraph (b)(2)(i) of this A–17 will be adjusted at the same time and in the same manner as the limits are adjusted under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2013, and any increase under this paragraph (d)(2)(i) that is not a multiple of $10,000 will be rounded to the next lowest multiple of $10,000.

(ii) *Age limitation*. The maximum age set forth in paragraph (a)(2) of this A–17 may be adjusted to reflect changes in mortality, with any such adjusted age to be prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin and made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402 and on the IRS Web site at *http://www.irs.gov*.

(iii) *Prospective application of adjustments*. If a contract fails to be a QLAC because it does not satisfy the dollar limitation in paragraph (b)(2) of this A–17 or the age limitation in paragraph (a)(2) of this A–17, any subsequent adjustment that is made pursuant to paragraph (d)(2)(i) or paragraph (d)(2)(ii) of this A–17 will not cause the contract to become a QLAC.

(3) *Determination of whether contract is intended to be a QLAC*—(i) *Structural deficiency*. If a contract fails to be a QLAC at any time for a reason other than an excess premium described in paragraph (d)(1)(ii) of this A–17, then as of the date of purchase the contract will not be treated as a QLAC (for purposes of A–3(d) of §1.401(a)(9)–5) or as a contract that is intended to be a QLAC (for purposes of paragraph (b) of this A–17).

(ii) *Roth IRAs*. A contract that is purchased under a Roth IRA is not treated as a contract that is intended to be a QLAC for purposes of applying the dollar and percentage limitation rules in paragraphs (b)(2)(ii)(B) and (b)(3)(ii)(B) of this A–17. See A–14(d) of §1.408A–6. If a QLAC is purchased or held under a plan, annuity, account, or traditional IRA, and that contract is later rolled over or converted to a Roth IRA, the contract is not treated as a contract that is intended to be a QLAC after the date of the rollover or conversion. Thus, premiums paid with respect to the contract will not be taken into account under paragraph (b)(2)(ii)(B) or paragraph (b)(3)(ii)(B) of this A–17 after the date of the rollover or conversion.

(4) *Certain contracts not treated as similar contracts*—(i) *Participating annuity contract*. An annuity contract is not treated as a contract described in paragraph (a)(7) of this A–17 merely because it provides for the payment of dividends described in A–14(c)(3) of §1.401(a)(9)–6.

(ii) *Contracts with cost-of-living adjustments*. An annuity contract is not treated as a contract described in paragraph (a)(7) of this A–17 merely because it provides for a cost-of-living adjustment as described in A–14(b) of §1.401(a)(9)–6.

(5) *Group annuity contract certificates*. The requirement under paragraph (a)(6) of this A–17 that the contract state that it is intended to be a QLAC when issued is satisfied if a certificate is issued under a group annuity contract and the certificate, when issued, states that the employee's interest under the group annuity contract is intended to be a QLAC.

(e) *Effective/applicability date*—(1) *General applicability date*. This A–17 and §1.403(b)–6(e)(9) apply to contracts purchased on or after July 2, 2014 If on or after July 2, 2014 an existing contract is exchanged for a contract that satisfies the requirements of this A–17, the new contract will be treated as purchased on the date of the exchange and the fair market value of the contract that is exchanged for a QLAC will be treated as a premium paid with respect to the QLAC.

(2) *Delayed applicability date for requirement that contract state that it is intended to be QLAC.* An annuity contract purchased before January 1, 2016, will not fail to be a QLAC merely because the contract does not satisfy the requirement of paragraph (a)(6) of this A–17, provided that—

(i) When the contract (or a certificate under a group annuity contract) is issued, the employee is notified that the annuity contract is intended to be a QLAC; and

(ii) The contract is amended (or a rider, endorsement or amendment to the certificate is issued) no later than December 31, 2016, to state that the annuity contract is intended to be a QLAC.

[T.D. 9130, 69 FR 33293, June 15, 2004; 69 FR 68077, Nov. 23, 2004; T.D. 9459, 74 FR 45994, Sept. 8, 2009; T.D. 9673, 79 FR 37639, July 2, 2014; 79 FR 45683, Aug. 6, 2014]

§ 1.401(a)(9)–7 Rollovers and transfers.

Q–1. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan, is the required minimum distribution under the distributing plan affected by the rollover?

A–1. No, if an amount is distributed by one plan and is rolled over to another plan, the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover. See A–1 of § 1.402(c)–2 for the definition of a rollover and A–7 of § 1.402(c)–2 for rules for determining the portion of any distribution that is not eligible for rollover because it is a required minimum distribution.

Q–2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), how are the benefit and the required minimum distribution under the receiving plan affected?

A–2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), the benefit of the employee under the receiving plan is increased by the amount rolled over for purposes of determining the required minimum distribution for the calendar year immediately following the calendar year in which the amount rolled over is distributed. If the amount rolled over is received after the last valuation date in the calendar year under the receiving plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of § 1.401(a)(9)–5, will be increased by the rollover amount valued as of the date of receipt. In addition, if the amount rolled over is received in a different calendar year from the calendar year in which it is distributed, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed.

Q–3. In the case of a transfer of an amount of an employee's benefit from one plan (transferor plan) to another plan (transferee plan), are there any special rules for satisfying section 401(a)(9) or determining the employee's benefit under the transferor plan?

A–3. (a) In the case of a transfer of an amount of an employee's benefit from one plan (transferor plan) to another (transferee plan), the transfer is not treated as a distribution by the transferor plan for purposes of section 401(a)(9). Instead, the benefit of the employee under the transferor plan is decreased by the amount transferred. However, if any portion of an employee's benefit is transferred in a distribution calendar year with respect to that employee, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution with respect to that employee for the calendar year of the transfer using the employee's benefit under the transferor plan before the transfer. Additionally, if any portion of an employee's benefit is transferred in the employee's second distribution calendar year but on or before the employee's required beginning date, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the minimum distribution requirement for the employee's first distribution calendar year based on the employee's benefit under the transferor plan before the transfer. The transferor plan may satisfy the minimum distribution requirement for the calendar year of the transfer (and the prior year if applicable) by segregating the amount which must be distributed from the employee's benefit and not transferring that amount. Such amount may be retained by the transferor plan and must be distributed on or before the date required under section 401(a)(9).

(b) For purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date for the calendar year of the transfer under the transferor plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of §1.401(a)(9)–5, will be decreased by the amount transferred, valued as of the date of the transfer.

Q–4. If an amount of an employee's benefit is transferred from one plan (transferor plan) to another plan (transferee plan), how are the benefit and the required minimum distribution under the transferee plan affected?

A–4. In the case of a transfer from one plan (transferor plan) to another (transferee plan), the benefit of the employee under the transferee plan is increased by the amount transferred in the same manner as if it were a plan receiving a rollover contribution under A–2 of this section.

Q–5. How is a spinoff, merger or consolidation (as defined in §1.414(*l*)–1) treated for purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9)?

A–5. For purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9), a spinoff, a merger, or a consolidation (as defined in §1.414(*l*)–1) will be treated as a transfer of the benefits of the employees involved. Consequently, the benefit and required minimum distribution of each employee involved under the transferor and transferee plans will be determined in accordance with A–3 and A–4 of this section.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002]

§ 1.401(a)(9)–8 Special rules.

Q–1. What distribution rules apply if an employee is a participant in more than one plan?

A–1. If an employee is a participant in more than one plan, the plans in which the employee participates are not permitted to be aggregated for purposes of testing whether the distribution requirements of section 401(a)(9) are met. The distribution of the benefit of the employee under each plan must separately meet the requirements of section 401(a)(9). For this purpose, a plan described in section 414(k) is treated as two separate plans, a defined contribution plan to the extent benefits are based on an individual account and a defined benefit plan with respect to the remaining benefits.

Q–2. If an employee's benefit under a defined contribution plan is divided into separate accounts (or under a defined benefit plan is divided into segregated shares), do the distribution rules in section 401(a)(9) and these regulations apply separately to each separate account?

A–2. (a) *Defined contribution plan.* (1) Except as otherwise provided in this A–2, if an employee's benefit under a defined contribution plan is divided into separate accounts under the plan, the separate accounts will be aggregated for purposes of satisfying the rules in section 401(a)(9). Thus, except as otherwise provided in this A–2, all separate accounts, including a separate account for employee contributions under section 72(d)(2), will be aggregated for purposes of section 401(a)(9).

(2) If the employee's benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). Instead, the rules in section 401(a)(9) separately apply to such separate account under the plan. However, the applicable distribution period for

each such separate account is determined disregarding the other beneficiaries of the employee's benefit only if the separate account is established on a date no later than the last day of the year following the calendar year of the employee's death. For example, if, in the case of a distribution described in section 401(a)(9)(B)(iii) and (iv), the only beneficiary of a separate account under the plan established on a date no later than the end of the year following the calendar year of the employee's death is the employee's surviving spouse, and beneficiaries other than the surviving spouse are designated with respect to the other separate accounts with respect to the employee, distribution of the spouse's separate account under the plan need not commence until the date determined under the first sentence in A–3(b) of §1.401(a)(9)–3, even if distribution of the other separate accounts under the plan must commence at an earlier date. Similarly, in the case of a distribution after the death of an employee to which section 401(a)(9)(B)(i) does not apply, distribution from a separate account of an employee established on a date no later than the end of the year following the year of the employee's death may be made over a beneficiary's life expectancy in accordance with section 401(a)(9)(B)(iii) and (iv) even though distributions from other separate accounts under the plan with different beneficiaries are being made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

(3) A portion of an employee's account balance under a defined contribution plan is permitted to be used to purchase an annuity contract while another portion stays in the account. In that case, the remaining account under the plan must be distributed in accordance with §1.401(a)(9)–5 in order to satisfy section 401(a)(9) and the annuity payments under the annuity contract must satisfy §1.401(a)(9)–6 in order to satisfy section 401(a)(9).

(b) *Defined benefit plan.* The rules of paragraph (a)(2) and (3) of this A–2 also apply to benefits under a defined benefit plan where the benefits under the plan are separated into separate identifiable components which are separately distributed.

Q–3. What are separate accounts for purposes of section 401(a)(9)?

A–3. For purposes of section 401(a)(9), separate accounts in an employee's account are separate portions of an employee's benefit reflecting the separate interests of the employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained. The separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures, for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts. However, once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are only allocated to that account, or investment gain or losses can continue to be allocated among the separate accounts on a pro rata basis. A separate accounting must allocate any post-death distribution to the separate account of the beneficiary receiving that distribution.

Q–4. If a distribution is required to be made to an employee by section 401(a)(9)(A) or is required to be made to a surviving spouse under section 401(a)(9)(B), must the distribution be made even if the employee, or spouse where applicable, fails to consent to a distribution while a benefit is immediately distributable?

A–4. Yes, section 411(a)(11) and section 417(e) (see §§1.411(a)(11)–1(c)(2) and 1.417(e)–1(c)) require employee and spousal consent to certain distributions of plan benefits while such benefits are immediately distributable. If an employee's normal retirement age is later than the employee's required beginning date and, therefore, benefits are still immediately distributable, the plan must, nevertheless, distribute plan benefits to the employee (or where applicable, to the spouse) in a manner that satisfies the requirements of section 401(a)(9). Section 401(a)(9) must be satisfied even though the employee (or spouse, where applicable) fails to consent to the distribution. In such a case, the plan may distribute in the form of a qualified joint and survivor annuity

(QJSA) or in the form of a qualified preretirement survivor annuity (QPSA), as applicable, and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the employee (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417. If, because of section 401(a)(11)(B), the plan is not required to distribute in the form of a QJSA to an employee or a QPSA to a surviving spouse, the plan may distribute the required minimum distribution amount to satisfy section 401(a)(9) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the employee (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417.

Q–5. Who is an employee's spouse or surviving spouse for purposes of section 401(a)(9)?

A–5. Except as otherwise provided in A–6(a) of this section (in the case of distributions of a portion of an employee's benefit payable to a former spouse of an employee pursuant to a qualified domestic relations order), for purposes of section 401(a)(9), an individual is a spouse or surviving spouse of an employee if such individual is treated as the employee's spouse under applicable state law. In the case of distributions after the death of an employee, for purposes of determining whether, under the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), the provisions of section 401(a)(9)(B)(iv) apply, the spouse of the employee is determined as of the date of death of the employee.

Q–6. In order to satisfy section 401(a)(9), are there any special rules which apply to the distribution of all or a portion of an employee's benefit payable to an alternate payee pursuant to a qualified domestic relations order as defined in section 414(p) (QDRO)?

A–6. (a) A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.

(b)(1) If a QDRO provides that an employee's benefit is to be divided and a portion is to be allocated to an alternate payee, such portion will be treated as a separate account (or segregated share) which separately must satisfy the requirements of section 401(a)(9) and may not be aggregated with other separate accounts (or segregated shares) of the employee for purposes of satisfying section 401(a)(9). Except as otherwise provided in paragraph (b)(2) of this A–6, distribution of such separate account allocated to an alternate payee pursuant to a QDRO must be made in accordance with section 401(a)(9). For example, in general, distribution of such account will satisfy section 401(a)(9)(A) if required minimum distributions from such account during the employee's lifetime begin not later than the employee's required beginning date and the required minimum distribution is determined in accordance with §1.401(a)(9)–5 for each distribution calendar year (using an applicable distribution period determined under A–4 of §1.401(a)(9)–5 for the employee in the distribution calendar year either using the Uniform Lifetime Table in A–2 of §1.401(a)(9)–9 or using the joint life expectancy of the employee and a spousal alternate payee in the distribution calendar year if the spousal alternate payee is more than 10 years younger than the employee). The determination of whether distribution from such account after the death of the employee to the alternate payee will be made in accordance with section 401(a)(9)(B)(i) or section 401(a)(9)(B)(ii) or (iii) and (iv) will depend on whether distributions have begun as determined under A–6 of §1.401(a)(9)–2 (which provides, in general, that distributions are not treated as having begun until the employee's required beginning date even though payments may actually have begun before that date). For example, if the alternate payee dies before the employee and distribution of the separate account allocated to the alternate payee pursuant to the QDRO is to be made to the alternate payee's beneficiary, such beneficiary may be treated as a designated beneficiary for purposes of determining the minimum distribution required from such account after the death of the employee if the beneficiary of the alternate payee is an individual and if such beneficiary is a beneficiary under the plan or specified to or in the plan. Specification in or pursuant to the QDRO is treated as specification to the plan.

(2) Distribution of the separate account allocated to an alternate payee pursuant to a QDRO will satisfy the requirements of section 401(a)(9)(A)(ii) if such account is to be distributed, beginning not later than the employee's required beginning date, over the life of the alternate payee (or over a period not extending beyond the life expectancy of the alternate payee). Also, if the plan permits the employee to elect whether distribution upon the death of the employee will be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) pursuant to A–4(c) of §1.401(a)(9)–3, such election is to be made only by the alternate payee for purposes of distributing the separate account allocated to the alternate payee pursuant to the QDRO. If the alternate payee dies after distribution of the separate account allocated to the alternate payee pursuant to a QDRO has begun (determined under A–6 of §1.401(a)(9)–2) but before the employee dies, distribution of the remaining portion of that portion of the benefit allocated to the alternate payee must be made in accordance with the rules in §1.401(a)(9)–5 or 1.401(a)(9)–6 for distributions during the life of the employee. Only after the death of the employee is the amount of the required minimum distribution determined in accordance with the rules of section 401(a)(9)(B).

(c) If a QDRO does not provide that an employee's benefit is to be divided but provides that a portion of an employee's benefit (otherwise payable to the employee) is to be paid to an alternate payee, such portion will not be treated as a separate account (or segregated share) of the employee. Instead, such portion will be aggregated with any amount distributed to the employee and will be treated as having been distributed to the employee for purposes of determining whether section 401(a)(9) has been satisfied with respect to that employee.

Q–7. Will a plan fail to satisfy section 401(a)(9) merely because it fails to distribute an amount otherwise required to be distributed by section 401(a)(9) during the period in which the issue of whether a domestic relations order is a QDRO is being determined?

A–7. A plan will not fail to satisfy section 401(a)(9) merely because it fails to distribute an amount otherwise required to be distributed by section 401(a)(9) during the period in which the issue of whether a domestic relations order is a QDRO is being determined pursuant to section 414(p)(7), provided that the period does not extend beyond the 18-month period described in section 414(p)(7)(E). To the extent that a distribution otherwise required under section 401(a)(9) is not made during this period, any segregated amounts, as defined in section 414(p)(7)(A), will be treated as though the amounts are not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A–8 of §1.401(a)(9)–5 or A–6 of §1.401(a)(9)–6, as applicable.

Q–8. Will a plan fail to satisfy section 401(a)(9) where an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings?

A–8. A plan will not fail to satisfy section 401(a)(9) merely because an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings. To the extent that a distribution otherwise required under section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though such amounts are not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A–8 of § 1.401(a)(9)–5 or A–6 of § 1.401(a)(9)–6, as applicable.

Q–9. Will a plan fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence?

A–9. No, a plan will not fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence. This rule applies without regard to whether the employee is a 5-percent owner with respect to the plan year ending in the calendar year in which distributions commence.

Q–10. Is the distribution of an annuity contract a distribution for purposes of section 401(a)(9)?

A–10. No, the distribution of an annuity contract is not a distribution for purposes of section 401(a)(9).

Q–11. Will a payment by a plan after the death of an employee fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust?

A–11. A payment by a plan after the death of an employee will not fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust. As a result, the estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B). Pursuant to A–3 of § 1.401(a)(9)–4, an estate may not be a designated beneficiary. Thus, pursuant to A–4 of § 1.401(a)(9)–3, distribution to the estate must satisfy the 5-year rule in section 401(a)(9)(B)(iii) if the distribution to the employee had not begun (as defined in A–6 of § 1.401(a)(9)–2) as of the employee's date of death. However, see A–5 and A–6 of § 1.401(a)(9)–4 for provisions under which beneficiaries of a trust with respect to the trust's interest in an employee's benefit are treated as having been designated as beneficiaries of the employee under the plan.

Q–12. Will a plan fail to satisfy section 411(d)(6) if the plan is amended to eliminate the availability of an optional form of benefit to the extent that the optional form does not satisfy section 401(a)(9)?

A–12. No, pursuant to section 411(d)(6)(B), a plan will not fail to satisfy section 411(d)(6) merely because the plan is amended to eliminate the availability of an optional form of benefit to the extent that the optional form does not satisfy section 401(a)(9). (See also A–3 of § 1.401(a)(9)–1, which requires a plan to provide that, notwithstanding any other plan provision, it will not distribute benefits under any option that does not satisfy section 401(a)(9).)

Q–13. Is a plan disqualified merely because it pays benefits under a designation made before January 1, 1984, in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act (TEFRA)?

A–13. No, even though the distribution requirements added by TEFRA were retroactively repealed by the Tax Reform Act of 1984 (TRA of 1984), the transitional election rule in section 242(b) of TEFRA was preserved. Satisfaction of the spousal consent requirements of section 417(a) and (e) (added by the Retirement Equity Act of 1984) will not be considered a revocation of the pre-1984 designation. However, sections 401(a)(11) and 417 must be satisfied with respect to any distribution subject to those sections. The election provided in section 242(b) of TEFRA is hereafter referred to as a section 242(b)(2) election.

Q–14. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), may the transferee plan distribute the amount transferred in accordance with a section 242(b)(2) election made under either the transferor plan or under the transferee plan?

A–14. (a) If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), the amount transferred may be distributed in accordance with a section 242(b)(2) election made under the transferor plan if the employee did not elect to have the amount transferred and if the amount transferred is separately accounted for by the transferee plan. However, only the benefit attributable to the amount transferred, plus earnings thereon, may be distributed in accordance with the section 242(b)(2) election made under the transferor plan. If the employee elected to have the amount transferred, the transfer will be treated as a distribution and rollover of the amount transferred for purposes of this section.

(b) In the case in which an amount is transferred from one plan to another plan, the amount transferred may not be distributed in accordance with a section 242(b)(2) election made under the transferee plan. If a section 242(b)(2) election was made under the transferee plan, the amount transferred must be separately accounted for. If the amount transferred is not separately accounted for under the transferee plan, the section 242(b)(2) election under the transferee plan is revoked and section 401(a)(9) will apply to subsequent distributions by the transferee plan.

(c) A merger, spinoff, or consolidation, as defined in §1.414(l)–1(b), will be treated as a transfer for purposes of the section 242(b)(2) election.

Q–15. If an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), may the receiving plan distribute the amount rolled over in accordance with a section 242(b)(2) election made under either the distributing plan or the receiving plan?

A–15. No, if an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), the receiving plan must distribute the amount rolled over in accordance with section 401(a)(9) whether or not the employee made a section 242(b)(2) election under the distributing plan. Further, if the amount rolled over was not distributed in accordance with the election, the election under the distributing plan is revoked and section 401(a)(9) will apply to all subsequent distributions by the distributing plan. Finally, if the employee made a section 242(b)(2) election under the receiving plan and such election is still in effect, the amount rolled over must be separately accounted for under the receiving plan and distributed in accordance with section 401(a)(9). If amounts rolled over are not separately accounted for, any section 242(b)(2) election under the receiving plan is revoked and section 401(a)(9) will apply to subsequent distributions by the receiving plan.

Q–16. May a section 242(b)(2) election be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations?

A–16. Yes, a section 242(b)(2) election may be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations. However, if the section 242(b)(2) election is revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations and the total amount of the distributions which would have been required to be made prior to the date of the revocation in order to satisfy section 401(a)(9), but for the section 242(b)(2) election, have not been made, the plan must distribute by the end of the calendar year following the calendar year in which the revocation occurs the total amount not yet distributed which was required to have been distributed to satisfy the requirements of section 401(a)(9) and continue distributions in accordance with such requirements.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, 33302, June 15, 2004]

§ 1.401(a)(9)–9 Life expectancy and distribution period tables.

Q–1. What is the life expectancy for an individual for purposes of determining required minimum distributions under section 401(a)(9)?

A–1 The following table, referred to as the Single Life Table, is used for determining the life expectancy of an individual:

SINGLE LIFE TABLE

Age	Life expectancy
0	82.4
1	81.6
2	80.6
3	79.7
4	78.7
5	77.7
6	76.7
7	75.8
8	74.8
9	73.8
10	72.8
11	71.8
12	70.8
13	69.9
14	68.9
15	67.9
16	66.9
17	66.0
18	65.0
19	64.0
20	63.0
21	62.1
22	61.1
23	60.1
24	59.1
25	58.2
26	57.2
27	56.2
28	55.3
29	54.3
30	53.3
31	52.4
32	51.4
33	50.4
34	49.4
35	48.5
36	47.5
37	46.5
38	45.6
39	44.6
40	43.6
41	42.7
42	41.7
43	40.7
44	39.8
45	38.8
46	37.9
47	37.0
48	36.0
49	35.1
50	34.2
51	33.3
52	32.3
53	31.4
54	30.5
55	29.6
56	28.7
57	27.9
58	27.0
59	26.1
60	25.2
61	24.4
62	23.5
63	22.7
64	21.8
65	21.0
66	20.2
67	19.4
68	18.6
69	17.8
70	17.0
71	16.3
72	15.5
73	14.8
74	14.1
75	13.4
76	12.7
77	12.1
78	11.4
79	10.8
80	10.2
81	9.7
82	9.1
83	8.6
84	8.1
85	7.6
86	7.1
87	6.7
88	6.3
89	5.9
90	5.5
91	5.2
92	4.9
93	4.6
94	4.3
95	4.1
96	3.8
97	3.6
98	3.4
99	3.1
100	2.9
101	2.7
102	2.5
103	2.3
104	2.1
105	1.9
106	1.7
107	1.5
108	1.4
109	1.2
110	1.1
111+	1.0

Q–2. What is the applicable distribution period for an individual account for purposes of determining required minimum distributions during an employee's lifetime under section 401(a)(9)?

A–2. *Table for determining distribution period.* The following table, referred to as the Uniform Lifetime Table, is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's spouse is either not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee.

UNIFORM LIFETIME TABLE

Age of employee	Distribution period
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9
76	22.0
77	21.2
78	20.3
79	19.5
80	18.7
81	17.9
82	17.1
83	16.3
84	15.5
85	14.8
86	14.1
87	13.4
88	12.7
89	12.0
90	11.4
91	10.8
92	10.2
93	9.6
94	9.1

UNIFORM LIFETIME TABLE—Continued

Age of employee	Distribution period
95	8.6
96	8.1
97	7.6
98	7.1
99	6.7
100	6.3
101	5.9
102	5.5
103	5.2
104	4.9
105	4.5
106	4.2
107	3.9
108	3.7
109	3.4
110	3.1
111	2.9
112	2.6
113	2.4
114	2.1
115+	1.9

Q–3. What is the joint life and last survivor expectancy of an individual and beneficiary for purposes of determining required minimum distributions under section 401(a)(9)?

A–3. The following table, referred to as the Joint and Last Survivor Table, is used for determining the joint and last survivor life expectancy of two individuals:

JOINT AND LAST SURVIVOR TABLE

Ages	0	1	2	3	4	5	6	7	8	9
0	90.0	89.5	89.0	88.6	88.2	87.8	87.4	87.1	86.8	86.5
1	89.5	89.0	88.5	88.1	87.6	87.2	86.8	86.5	86.1	85.8
2	89.0	88.5	88.0	87.5	87.1	86.6	86.2	85.8	85.5	85.1
3	88.6	88.1	87.5	87.0	86.5	86.1	85.6	85.2	84.8	84.5
4	88.2	87.6	87.1	86.5	86.0	85.5	85.1	84.6	84.2	83.8
5	87.8	87.2	86.6	86.1	85.5	85.0	84.5	84.1	83.6	83.2
6	87.4	86.8	86.2	85.6	85.1	84.5	84.0	83.5	83.1	82.6
7	87.1	86.5	85.8	85.2	84.6	84.1	83.5	83.0	82.5	82.1
8	86.8	86.1	85.5	84.8	84.2	83.6	83.1	82.5	82.0	81.6
9	86.5	85.8	85.1	84.5	83.8	83.2	82.6	82.1	81.6	81.0
10	86.2	85.5	84.8	84.1	83.5	82.8	82.2	81.6	81.1	80.6
11	85.9	85.2	84.5	83.8	83.1	82.5	81.8	81.2	80.7	80.1
12	85.7	84.9	84.2	83.5	82.8	82.1	81.5	80.8	80.2	79.7
13	85.4	84.7	84.0	83.2	82.5	81.8	81.1	80.5	79.9	79.2
14	85.2	84.5	83.7	83.0	82.2	81.5	80.8	80.1	79.5	78.9
15	85.0	84.3	83.5	82.7	82.0	81.2	80.5	79.8	79.1	78.5
16	84.9	84.1	83.3	82.5	81.7	81.0	80.2	79.5	78.8	78.1
17	84.7	83.9	83.1	82.3	81.5	80.7	80.0	79.2	78.5	77.8
18	84.5	83.7	82.9	82.1	81.3	80.5	79.7	79.0	78.2	77.5
19	84.4	83.6	82.7	81.9	81.1	80.3	79.5	78.7	78.0	77.3
20	84.3	83.4	82.6	81.8	80.9	80.1	79.3	78.5	77.7	77.0
21	84.1	83.3	82.4	81.6	80.8	79.9	79.1	78.3	77.5	76.8
22	84.0	83.2	82.3	81.5	80.6	79.8	78.9	78.1	77.3	76.5
23	83.9	83.1	82.2	81.3	80.5	79.6	78.8	77.9	77.1	76.3
24	83.8	83.0	82.1	81.2	80.3	79.5	78.6	77.8	76.9	76.1
25	83.7	82.9	82.0	81.1	80.2	79.3	78.5	77.6	76.8	75.9
26	83.6	82.8	81.9	81.0	80.1	79.2	78.3	77.5	76.6	75.8
27	83.6	82.7	81.8	80.9	80.0	79.1	78.2	77.4	76.5	75.6
28	83.5	82.6	81.7	80.8	79.9	79.0	78.1	77.2	76.4	75.5
29	83.4	82.6	81.6	80.7	79.8	78.9	78.0	77.1	76.2	75.4
30	83.4	82.5	81.6	80.7	79.7	78.8	77.9	77.0	76.1	75.2

JOINT AND LAST SURVIVOR TABLE—Continued

Ages	0	1	2	3	4	5	6	7	8	9
31	83.3	82.4	81.5	80.6	79.7	78.8	77.8	76.9	76.0	75.1
32	83.3	82.4	81.5	80.5	79.6	78.7	77.8	76.8	75.9	75.0
33	83.2	82.3	81.4	80.5	79.5	78.6	77.7	76.8	75.9	74.9
34	83.2	82.3	81.3	80.4	79.5	78.5	77.6	76.7	75.8	74.9
35	83.1	82.2	81.3	80.4	79.4	78.5	77.6	76.6	75.7	74.8
36	83.1	82.2	81.3	80.3	79.4	78.4	77.5	76.6	75.6	74.7
37	83.0	82.2	81.2	80.3	79.3	78.4	77.4	76.5	75.6	74.6
38	83.0	82.1	81.2	80.2	79.3	78.3	77.4	76.4	75.5	74.6
39	83.0	82.1	81.1	80.2	79.2	78.3	77.3	76.4	75.5	74.5
40	82.9	82.1	81.1	80.2	79.2	78.3	77.3	76.4	75.4	74.5
41	82.9	82.0	81.1	80.1	79.2	78.2	77.3	76.3	75.4	74.4
42	82.9	82.0	81.1	80.1	79.1	78.2	77.2	76.3	75.3	74.4
43	82.9	82.0	81.0	80.1	79.1	78.2	77.2	76.2	75.3	74.3
44	82.8	81.9	81.0	80.0	79.1	78.1	77.2	76.2	75.2	74.3
45	82.8	81.9	81.0	80.0	79.1	78.1	77.1	76.2	75.2	74.3
46	82.8	81.9	81.0	80.0	79.0	78.1	77.1	76.1	75.2	74.2
47	82.8	81.9	80.9	80.0	79.0	78.0	77.1	76.1	75.2	74.2
48	82.8	81.9	80.9	80.0	79.0	78.0	77.1	76.1	75.1	74.2
49	82.7	81.8	80.9	79.9	79.0	78.0	77.0	76.1	75.1	74.1
50	82.7	81.8	80.9	79.9	79.0	78.0	77.0	76.0	75.1	74.1
51	82.7	81.8	80.9	79.9	78.9	78.0	77.0	76.0	75.1	74.1
52	82.7	81.8	80.9	79.9	78.9	78.0	77.0	76.0	75.0	74.1
53	82.7	81.8	80.8	79.9	78.9	77.9	77.0	76.0	75.0	74.0
54	82.7	81.8	80.8	79.9	78.9	77.9	76.9	76.0	75.0	74.0
55	82.6	81.8	80.8	79.8	78.9	77.9	76.9	76.0	75.0	74.0
56	82.6	81.7	80.8	79.8	78.9	77.9	76.9	75.9	75.0	74.0
57	82.6	81.7	80.8	79.8	78.9	77.9	76.9	75.9	75.0	74.0
58	82.6	81.7	80.8	79.8	78.8	77.9	76.9	75.9	74.9	74.0
59	82.6	81.7	80.8	79.8	78.8	77.9	76.9	75.9	74.9	74.0
60	82.6	81.7	80.8	79.8	78.8	77.8	76.9	75.9	74.9	73.9
61	82.6	81.7	80.8	79.8	78.8	77.8	76.9	75.9	74.9	73.9
62	82.6	81.7	80.7	79.8	78.8	77.8	76.9	75.9	74.9	73.9
63	82.6	81.7	80.7	79.8	78.8	77.8	76.8	75.9	74.9	73.9
64	82.5	81.7	80.7	79.8	78.8	77.8	76.8	75.9	74.9	73.9
65	82.5	81.7	80.7	79.8	78.8	77.8	76.8	75.8	74.9	73.9
66	82.5	81.7	80.7	79.7	78.8	77.8	76.8	75.8	74.9	73.9
67	82.5	81.7	80.7	79.7	78.8	77.8	76.8	75.8	74.9	73.9
68	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9
69	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9
70	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9
71	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
72	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
73	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
74	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
75	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
76	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
77	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
78	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
79	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
80	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
81	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
82	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
83	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
84	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
85	82.4	81.6	80.6	79.7	78.7	77.7	76.8	75.8	74.8	73.8
86	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
87	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
88	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
89	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
90	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
91	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
92	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
93	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
94	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
95	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
96	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
97	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
98	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
99	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
100	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
101	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
102	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8

JOINT AND LAST SURVIVOR TABLE—Continued

Ages	0	1	2	3	4	5	6	7	8	9
103	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
104	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
105	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
106	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
107	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
108	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
109	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
110	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
111	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
112	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
113	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
114	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
115+	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8

Ages	10	11	12	13	14	15	16	17	18	19
10	80.0	79.6	79.1	78.7	78.2	77.9	77.5	77.2	76.8	76.5
11	79.6	79.0	78.6	78.1	77.7	77.3	76.9	76.5	76.2	75.8
12	79.1	78.6	78.1	77.6	77.1	76.7	76.3	75.9	75.5	75.2
13	78.7	78.1	77.6	77.1	76.6	76.1	75.7	75.3	74.9	74.5
14	78.2	77.7	77.1	76.6	76.1	75.6	75.1	74.7	74.3	73.9
15	77.9	77.3	76.7	76.1	75.6	75.1	74.6	74.1	73.7	73.3
16	77.5	76.9	76.3	75.7	75.1	74.6	74.1	73.6	73.1	72.7
17	77.2	76.5	75.9	75.3	74.7	74.1	73.6	73.1	72.6	72.1
18	76.8	76.2	75.5	74.9	74.3	73.7	73.1	72.6	72.1	71.6
19	76.5	75.8	75.2	74.5	73.9	73.3	72.7	72.1	71.6	71.1
20	76.3	75.5	74.8	74.2	73.5	72.9	72.3	71.7	71.1	70.6
21	76.0	75.3	74.5	73.8	73.2	72.5	71.9	71.3	70.7	70.1
22	75.8	75.0	74.3	73.5	72.9	72.2	71.5	70.9	70.3	69.7
23	75.5	74.8	74.0	73.3	72.6	71.9	71.2	70.5	69.9	69.3
24	75.3	74.5	73.8	73.0	72.3	71.6	70.9	70.2	69.5	68.9
25	75.1	74.3	73.5	72.8	72.0	71.3	70.6	69.9	69.2	68.5
26	75.0	74.1	73.3	72.5	71.8	71.0	70.3	69.6	68.9	68.2
27	74.8	74.0	73.1	72.3	71.6	70.8	70.0	69.3	68.6	67.9
28	74.6	73.8	73.0	72.2	71.3	70.6	69.8	69.0	68.3	67.6
29	74.5	73.6	72.8	72.0	71.2	70.4	69.6	68.8	68.0	67.3
30	74.4	73.5	72.7	71.8	71.0	70.2	69.4	68.6	67.8	67.1
31	74.3	73.4	72.5	71.7	70.8	70.0	69.2	68.4	67.6	66.8
32	74.1	73.3	72.4	71.5	70.7	69.8	69.0	68.2	67.4	66.6
33	74.0	73.2	72.3	71.4	70.5	69.7	68.8	68.0	67.2	66.4
34	73.9	73.0	72.2	71.3	70.4	69.5	68.7	67.8	67.0	66.2
35	73.9	73.0	72.1	71.2	70.3	69.4	68.5	67.7	66.8	66.0
36	73.8	72.9	72.0	71.1	70.2	69.3	68.4	67.6	66.7	65.9
37	73.7	72.8	71.9	71.0	70.1	69.2	68.3	67.4	66.6	65.7
38	73.6	72.7	71.8	70.9	70.0	69.1	68.2	67.3	66.4	65.6
39	73.6	72.7	71.7	70.8	69.9	69.0	68.1	67.2	66.3	65.4
40	73.5	72.6	71.7	70.7	69.8	68.9	68.0	67.1	66.2	65.3
41	73.5	72.5	71.6	70.7	69.7	68.8	67.9	67.0	66.1	65.2
42	73.4	72.5	71.5	70.6	69.7	68.8	67.8	66.9	66.0	65.1
43	73.4	72.4	71.5	70.6	69.6	68.7	67.8	66.8	65.9	65.0
44	73.3	72.4	71.4	70.5	69.6	68.6	67.7	66.8	65.9	64.9
45	73.3	72.3	71.4	70.5	69.5	68.6	67.6	66.7	65.8	64.9
46	73.3	72.3	71.4	70.4	69.5	68.5	67.6	66.6	65.7	64.8
47	73.2	72.3	71.3	70.4	69.4	68.5	67.5	66.6	65.7	64.7
48	73.2	72.2	71.3	70.3	69.4	68.4	67.5	66.5	65.6	64.7
49	73.2	72.2	71.2	70.3	69.3	68.4	67.4	66.5	65.6	64.6
50	73.1	72.2	71.2	70.3	69.3	68.4	67.4	66.5	65.5	64.6
51	73.1	72.2	71.2	70.2	69.3	68.3	67.4	66.4	65.5	64.5
52	73.1	72.1	71.2	70.2	69.2	68.3	67.3	66.4	65.4	64.5
53	73.1	72.1	71.1	70.2	69.2	68.3	67.3	66.3	65.4	64.4
54	73.1	72.1	71.1	70.2	69.2	68.2	67.3	66.3	65.4	64.4
55	73.0	72.1	71.1	70.1	69.2	68.2	67.2	66.3	65.3	64.4
56	73.0	72.1	71.1	70.1	69.1	68.2	67.2	66.3	65.3	64.3
57	73.0	72.0	71.1	70.1	69.1	68.2	67.2	66.2	65.3	64.3

Ages	10	11	12	13	14	15	16	17	18	19
58	73.0	72.0	71.0	70.1	69.1	68.1	67.2	66.2	65.2	64.3
59	73.0	72.0	71.0	70.1	69.1	68.1	67.2	66.2	65.2	64.3
60	73.0	72.0	71.0	70.0	69.1	68.1	67.1	66.2	65.2	64.2
61	73.0	72.0	71.0	70.0	69.1	68.1	67.1	66.2	65.2	64.2
62	72.9	72.0	71.0	70.0	69.0	68.1	67.1	66.1	65.2	64.2
63	72.9	72.0	71.0	70.0	69.0	68.1	67.1	66.1	65.2	64.2
64	72.9	71.9	71.0	70.0	69.0	68.0	67.1	66.1	65.1	64.2
65	72.9	71.9	71.0	70.0	69.0	68.0	67.1	66.1	65.1	64.2
66	72.9	71.9	70.9	70.0	69.0	68.0	67.1	66.1	65.1	64.1
67	72.9	71.9	70.9	70.0	69.0	68.0	67.0	66.1	65.1	64.1
68	72.9	71.9	70.9	70.0	69.0	68.0	67.0	66.1	65.1	64.1
69	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.1	65.1	64.1
70	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
71	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
72	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
73	72.9	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
74	72.9	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
75	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
76	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
77	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
78	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
79	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
80	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
81	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
82	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
83	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
84	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
85	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
86	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
87	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
88	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
89	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
90	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
91	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
92	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
93	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
94	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
95	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
96	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
97	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
98	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
99	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
100	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
101	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
102	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
103	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
104	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
105	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0

106	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
107	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
108	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
109	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
110	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
111	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
112	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
113	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
114	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
115+	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0

Ages	20	21	22	23	24	25	26	27	28	29
20	70.1	69.6	69.1	68.7	68.3	67.9	67.5	67.2	66.9	66.6
21	69.6	69.1	68.6	68.2	67.7	67.3	66.9	66.6	66.2	65.9
22	69.1	68.6	68.1	67.6	67.2	66.7	66.3	65.9	65.6	65.2
23	68.7	68.2	67.9	67.1	66.6	66.2	65.7	65.3	64.9	64.6
24	68.3	67.7	67.2	66.6	66.1	65.6	65.2	64.7	64.3	63.9
25	67.9	67.3	66.7	66.2	65.6	65.1	64.6	64.2	63.7	63.3
26	67.5	66.9	66.3	65.7	65.2	64.6	64.1	63.6	63.2	62.8
27	67.2	66.6	65.9	65.3	64.7	64.2	63.6	63.1	62.7	62.2
28	66.9	66.2	65.6	64.9	64.3	63.7	63.2	62.7	62.1	61.7
29	66.6	65.9	65.2	64.6	63.9	63.3	62.8	62.2	61.7	61.2
30	66.3	65.6	64.9	64.2	63.6	62.9	62.3	61.8	61.2	60.7
31	66.1	65.3	64.6	63.9	63.2	62.6	62.0	61.4	60.8	60.2
32	65.8	65.1	64.3	63.6	62.9	62.2	61.6	61.0	60.4	59.8
33	65.6	64.8	64.1	63.3	62.6	61.9	61.3	60.6	60.0	59.4
34	65.4	64.6	63.8	63.1	62.3	61.6	60.9	60.3	59.6	59.0
35	65.2	64.4	63.6	62.8	62.1	61.4	60.6	59.9	59.3	58.6
36	65.0	64.2	63.4	62.6	61.9	61.1	60.4	59.6	69.0	58.3
37	64.9	64.0	63.2	62.4	61.6	60.9	60.1	59.4	58.7	58.0
38	64.7	63.9	63.0	62.2	61.4	60.6	59.9	59.1	58.4	57.7
39	64.6	63.7	62.9	62.1	61.2	60.4	59.6	58.9	58.1	57.4
40	64.4	63.6	62.7	61.9	61.1	60.2	59.4	58.7	57.9	57.1
41	64.3	63.5	62.6	61.7	60.9	60.1	59.3	58.5	57.7	56.9
42	64.2	63.3	62.5	61.6	60.8	59.9	59.1	58.3	57.5	56.7
43	64.1	63.2	62.4	61.5	60.6	59.8	58.9	58.1	57.3	56.5
44	64.0	63.1	62.2	61.4	60.5	59.6	58.8	57.9	57.1	56.3
45	64.0	63.0	62.2	61.3	60.4	59.5	58.6	57.8	56.9	56.1
46	63.9	63.0	62.1	61.2	60.3	59.4	58.5	57.7	56.8	56.0
47	63.8	62.9	62.0	61.1	60.2	59.3	58.4	57.5	56.7	55.8
48	63.7	62.8	61.9	61.0	60.1	59.2	58.3	57.4	56.5	55.7
49	63.7	62.8	61.8	60.9	60.0	59.1	58.2	57.3	56.4	55.6
50	63.6	62.7	61.8	60.8	59.9	59.0	58.1	57.2	56.3	55.4
51	63.6	62.6	61.7	60.8	59.9	58.9	58.0	57.1	56.2	55.3
52	63.5	62.6	61.7	60.7	59.8	58.9	58.0	57.1	56.1	55.2
53	63.5	62.5	61.6	60.7	59.7	58.8	57.9	57.0	56.1	55.2
54	63.5	62.5	61.6	60.6	59.7	58.8	57.8	56.9	56.0	55.1
55	63.4	62.5	61.5	60.6	59.6	58.7	57.8	56.8	55.9	55.0
56	63.4	62.4	61.5	60.5	59.6	58.7	57.7	56.8	55.9	54.9

Ages	20	21	22	23	24	25	26	27	28	29
57	63.4	62.4	61.5	60.5	59.6	58.6	57.7	56.7	55.8	54.9
58	63.3	62.4	61.4	60.5	59.5	58.6	57.6	56.7	55.8	54.8
59	63.3	62.3	61.4	60.4	59.5	58.5	57.6	56.7	55.7	54.8
60	63.3	62.3	61.4	60.4	59.5	58.5	57.6	56.6	55.7	54.7
61	63.3	62.3	61.3	60.4	59.4	58.5	57.5	56.6	55.6	54.7
62	63.2	62.3	61.3	60.4	59.4	58.4	57.5	56.5	55.6	54.7
63	63.2	62.3	61.3	60.3	59.4	58.4	57.4	56.5	55.6	54.6
64	63.2	62.2	61.3	60.3	59.4	58.4	57.4	56.5	55.5	54.6
65	63.2	62.2	61.3	60.3	59.3	58.4	57.4	56.5	55.5	54.6
66	63.2	62.2	61.2	60.3	59.3	58.4	57.4	56.4	55.5	54.5
67	63.2	62.2	61.2	60.3	59.3	58.3	57.4	56.4	55.5	54.5
68	63.1	62.2	61.2	60.2	59.3	58.3	57.4	56.4	55.4	54.5
69	63.1	62.2	61.2	60.2	59.3	58.3	57.3	56.4	55.4	54.5
70	63.1	62.2	61.2	60.2	59.3	58.3	57.3	56.4	55.4	54.4
71	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.4	55.4	54.4
72	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.3	55.4	54.4
73	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.3	55.4	54.4
74	63.1	62.1	61.2	60.2	59.2	58.2	57.3	56.3	55.4	54.4
75	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
76	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
77	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
78	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
79	63.1	62.1	61.1	60.2	59.2	58.2	57.2	56.3	55.3	54.3
80	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
81	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
82	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
83	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
84	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
85	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
86	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
87	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
88	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
89	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
90	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
91	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
92	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
93	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
94	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
95	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
96	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
97	60.3	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
98	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
99	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
100	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
101	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
102	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
103	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
104	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3

105	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
106	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
107	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
108	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
109	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
110	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
111	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
112	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
113	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
114	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
115+	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3

Ages	30	31	32	33	34	35	36	37	38	39
30	60.2	59.7	59.2	58.8	58.4	58.0	57.6	57.3	57.0	56.7
31	59.7	59.2	58.7	58.2	57.8	57.4	57.0	56.6	56.3	56.0
32	59.2	58.7	58.2	57.7	57.2	56.8	56.4	56.0	55.6	55.3
33	58.8	58.2	57.7	57.2	56.7	56.2	55.8	55.4	55.0	54.7
34	58.4	57.8	57.2	56.7	56.2	55.7	55.3	54.8	54.4	54.0
35	58.0	57.4	56.8	56.2	55.7	55.2	54.7	54.3	53.8	53.4
36	57.6	57.0	56.4	55.8	55.3	54.7	54.2	53.7	53.3	52.8
37	57.3	56.6	56.0	55.4	54.8	54.3	53.7	53.2	52.7	52.3
38	57.0	56.3	55.6	55.0	54.4	53.8	53.3	52.7	52.2	51.7
39	56.7	56.0	55.3	54.7	54.0	53.4	52.8	52.3	51.7	51.2
40	56.4	55.7	55.0	54.3	53.7	53.0	52.4	51.8	51.3	50.8
41	56.1	55.4	54.7	54.0	53.3	52.7	52.0	51.4	50.9	50.3
42	55.9	55.2	54.4	53.7	53.0	52.3	51.7	51.1	50.4	49.9
43	55.7	54.9	54.2	53.4	52.7	52.0	51.3	50.7	50.1	49.5
44	55.5	54.7	53.9	53.2	52.4	51.7	51.0	50.4	49.7	49.1
45	55.3	54.5	53.7	52.9	52.2	51.5	50.7	50.0	49.4	48.7
46	55.1	54.3	53.5	52.7	52.0	51.2	50.5	49.8	49.1	48.4
47	55.0	54.1	53.3	52.5	51.7	51.0	50.2	49.5	48.8	48.1
48	54.8	54.0	53.2	52.3	51.5	50.8	50.0	49.2	48.5	47.8
49	54.7	53.8	53.0	52.2	51.4	50.6	49.8	49.0	48.2	47.5
50	54.6	53.7	52.9	52.0	51.2	50.4	49.6	48.8	48.0	47.3
51	54.5	53.6	52.7	51.9	51.0	50.2	49.4	48.6	47.8	47.0
52	54.4	53.5	52.6	51.7	50.9	50.0	49.2	48.4	47.6	46.8
53	54.3	53.4	52.5	51.6	50.8	49.9	49.1	48.2	47.4	46.6
54	54.2	53.3	52.4	51.5	50.6	49.8	48.9	48.1	47.2	46.4
55	54.1	53.2	52.3	51.4	50.5	49.7	48.8	47.9	47.1	46.3
56	54.0	53.1	52.2	51.3	50.4	49.5	48.7	47.8	47.0	46.1
57	54.0	53.0	52.1	51.2	50.3	49.4	48.6	47.7	46.8	46.0
58	53.9	53.0	52.1	51.2	50.3	49.4	48.5	47.6	46.7	45.8
59	53.8	52.9	52.0	51.1	50.2	49.3	48.4	47.5	46.6	45.7
60	53.8	52.9	51.9	51.0	50.1	49.2	48.3	47.4	46.5	45.6
61	53.8	52.8	51.9	51.0	50.0	49.1	48.2	47.3	46.4	45.5
62	53.7	52.8	51.8	50.9	50.0	49.1	48.1	47.2	46.3	45.4
63	53.7	52.7	51.8	50.9	49.9	49.0	48.1	47.2	46.3	45.3
64	53.6	52.7	51.8	50.8	49.9	48.9	48.0	47.1	46.2	45.3
65	53.6	52.7	51.7	50.8	49.8	48.9	48.0	47.0	46.1	45.2

Ages	30	31	32	33	34	35	36	37	38	39
66	53.6	52.6	51.7	50.7	49.8	48.9	47.9	47.0	46.1	45.1
67	53.6	52.6	51.7	50.7	49.8	48.8	47.9	46.9	46.0	45.1
68	53.5	52.6	51.6	50.7	49.7	48.8	47.8	46.9	46.0	45.0
69	53.5	52.6	51.6	50.6	49.7	48.7	47.8	46.9	45.9	45.0
70	53.5	52.5	51.6	50.6	49.7	48.7	47.8	46.8	45.9	44.9
71	53.5	52.5	51.6	50.6	49.6	48.7	47.7	46.8	45.9	44.9
72	53.5	52.5	51.5	50.6	49.6	48.7	47.7	46.8	45.8	44.9
73	53.4	52.5	51.5	50.6	49.6	48.6	47.7	46.7	45.8	44.8
74	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.8	44.8
75	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.7	44.8
76	53.4	52.4	51.5	50.5	49.6	48.6	47.6	46.7	45.7	44.8
77	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.7	45.7	44.8
78	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
79	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
80	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
81	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
82	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
83	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
84	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
85	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.7
86	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
87	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
88	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
89	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
90	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
91	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
92	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
93	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
94	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
95	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
96	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
97	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
98	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
99	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
100	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
101	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
102	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
103	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
104	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
105	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
106	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
107	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
108	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
109	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
110	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
111	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
112	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
113	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6

114	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
115+	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6

Ages	40	41	42	43	44	45	46	47	48	49
40	50.2	49.8	49.3	48.9	48.5	48.1	47.7	47.4	47.1	46.8
41	49.8	49.3	48.8	48.3	47.9	47.5	47.1	46.7	46.4	46.1
42	49.3	48.8	48.3	47.8	47.3	46.9	46.5	46.1	45.8	45.4
43	48.9	48.3	47.8	47.3	46.8	46.3	45.9	45.5	45.1	44.8
44	48.5	47.9	47.3	46.8	46.3	45.8	45.4	44.9	44.5	44.2
45	48.1	47.5	46.9	46.3	45.8	45.3	44.8	44.4	44.0	43.6
46	47.7	47.1	46.5	45.9	45.4	44.8	44.3	43.9	43.4	43.0
47	47.4	46.7	46.1	45.5	44.9	44.4	43.9	43.4	42.9	42.4
48	47.1	46.4	45.8	45.1	44.5	44.0	43.4	42.9	42.4	41.9
49	46.8	46.1	45.4	44.8	44.2	43.6	43.0	42.4	41.9	41.4
50	46.5	45.8	45.1	44.4	43.8	43.2	42.6	42.0	41.5	40.9
51	46.3	45.5	44.8	44.1	43.5	42.8	42.2	41.6	41.0	40.5
52	46.0	45.3	44.6	43.8	43.2	42.5	41.8	41.2	40.6	40.1
53	45.8	45.1	44.3	43.6	42.9	42.2	41.5	40.9	40.3	39.7
54	45.6	44.8	44.1	43.3	42.6	41.9	41.2	40.5	39.9	39.3
55	45.5	44.7	43.9	43.1	42.4	41.6	40.9	40.2	39.6	38.9
56	45.3	44.5	43.7	42.9	42.1	41.4	40.7	40.0	39.3	38.6
57	45.1	44.3	43.5	42.7	41.9	41.2	40.4	39.7	39.0	38.3
58	45.0	44.2	43.3	42.5	41.7	40.9	40.2	39.4	38.7	38.0
59	44.9	44.0	43.2	42.4	41.5	40.7	40.0	39.2	38.5	37.8
60	44.7	43.9	43.0	42.2	41.4	40.6	39.8	39.0	38.2	37.5
61	44.6	43.8	42.9	42.1	41.2	40.4	39.6	38.8	38.0	37.3
62	44.5	43.7	42.8	41.9	41.1	40.3	39.4	38.6	37.8	37.1
63	44.5	43.6	42.7	41.8	41.0	40.1	39.3	38.5	37.7	36.9
64	44.4	43.5	42.6	41.7	40.8	40.0	39.2	38.3	37.5	36.7
65	44.3	43.4	42.5	41.6	40.7	39.9	39.0	38.2	37.4	36.6
66	44.2	43.3	42.4	41.5	40.6	39.8	38.9	38.1	37.2	36.4
67	44.2	43.3	42.3	41.4	40.6	39.7	38.8	38.0	37.1	36.3
68	44.1	43.2	42.3	41.4	40.5	39.6	38.7	37.9	37.0	36.2
69	44.1	43.1	42.2	41.3	40.4	39.5	38.6	37.8	36.9	36.0
70	44.0	43.1	42.2	41.3	40.3	39.4	38.6	37.7	36.8	35.9
71	44.0	43.0	42.1	41.2	40.3	39.4	38.5	37.6	36.7	35.9
72	43.9	43.0	42.1	41.1	40.2	39.3	38.4	37.5	36.6	35.8
73	43.9	43.0	42.0	41.1	40.2	39.3	38.4	37.5	36.6	35.7
74	43.9	42.9	42.0	41.1	40.1	39.2	38.3	37.4	36.5	35.6
75	43.8	42.9	42.0	41.0	40.1	39.2	38.3	37.4	36.5	35.6
76	43.8	42.9	41.9	41.0	40.1	39.1	38.2	37.3	36.4	35.5
77	43.8	42.9	41.9	41.0	40.0	39.1	38.2	37.3	36.4	35.5
78	43.8	42.8	41.9	40.9	40.0	39.1	38.2	37.2	36.3	35.4
79	43.8	42.8	41.9	40.9	40.0	39.1	38.1	37.2	36.3	35.4
80	43.7	42.8	41.8	40.9	40.0	39.0	38.1	37.2	36.3	35.4
81	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.2	36.2	35.3
82	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.1	36.2	35.3
83	43.7	42.8	41.8	40.9	39.9	39.0	38.0	37.1	36.2	35.3
84	43.7	42.7	41.8	40.8	39.9	39.0	38.0	37.1	36.2	35.3

Ages	40	41	42	43	44	45	46	47	48	49
85	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.2	35.2
86	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.1	35.2
87	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
88	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
89	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
90	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
91	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.2
92	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
93	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
94	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
95	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
96	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
97	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
98	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
99	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
100	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
101	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
102	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
103	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
104	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
105	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
106	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
107	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
108	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
109	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
110	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
111	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
112	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
113	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
114	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
115+	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1

Ages	50	51	52	53	54	55	56	57	58	59
50	40.4	40.0	39.5	39.1	38.7	38.3	38.0	37.6	37.3	37.1
51	40.0	39.5	39.0	38.5	38.1	37.7	37.4	37.0	36.7	36.4
52	39.5	39.0	38.5	38.0	37.6	37.2	36.8	36.4	36.0	35.7
53	39.1	38.5	38.0	37.5	37.1	36.6	36.2	35.8	35.4	35.1
54	38.7	38.1	37.6	37.1	36.6	36.1	35.7	35.2	34.8	34.5
55	38.3	37.7	37.2	36.6	36.1	35.6	35.1	34.7	34.3	33.9
56	38.0	37.4	36.8	36.2	35.7	35.1	34.7	34.2	33.7	33.3
57	37.6	37.0	36.4	35.8	35.2	34.7	34.2	33.7	33.2	32.8
58	37.3	36.7	36.0	35.4	34.8	34.3	33.7	33.2	32.8	32.3
59	37.1	36.4	35.7	35.1	34.5	33.9	33.3	32.8	32.3	31.8
60	36.8	36.1	35.4	34.8	34.1	33.5	32.9	32.4	31.9	31.3
61	36.6	35.8	35.1	34.5	33.8	33.2	32.6	32.0	31.4	30.9
62	36.3	35.6	34.9	34.2	33.5	32.9	32.2	31.6	31.1	30.5
63	36.1	35.4	34.6	33.9	33.2	32.6	31.9	31.3	30.7	30.1

64	35.9	35.2	34.4	33.7	33.0	32.3	31.6	31.0	30.4	29.8
65	35.8	35.0	34.2	33.5	32.7	32.0	31.4	30.7	30.0	29.4
66	35.6	34.8	34.0	33.3	32.5	31.8	31.1	30.4	29.8	29.1
67	35.5	34.7	33.9	33.1	32.3	31.6	30.9	30.2	29.5	28.8
68	35.3	34.5	33.7	32.9	32.1	31.4	30.7	29.9	29.2	28.6
69	35.2	34.4	33.6	32.8	32.0	31.2	30.5	29.7	29.0	28.3
70	35.1	34.3	33.4	32.6	31.8	31.1	30.3	29.5	28.8	28.1
71	35.0	34.2	33.3	32.5	31.7	30.9	30.1	29.4	28.6	27.9
72	34.9	34.1	33.2	32.4	31.6	30.8	30.0	29.2	28.4	27.7
73	34.8	34.0	33.1	32.3	31.5	30.6	29.8	29.1	28.3	27.5
74	34.8	33.9	33.0	32.2	31.4	30.5	29.7	28.9	28.1	27.4
75	34.7	33.8	33.0	32.1	31.3	30.4	29.6	28.8	28.0	27.2
76	34.6	33.8	32.9	32.0	31.2	30.3	29.5	28.7	27.9	27.1
77	34.6	33.7	32.8	32.0	31.1	30.3	29.4	28.6	27.8	27.0
78	34.5	33.6	32.8	31.9	31.0	30.2	29.3	28.5	27.7	26.9
79	34.5	33.6	32.7	31.8	31.0	30.1	29.3	28.4	27.6	26.8
80	34.5	33.6	32.7	31.8	30.9	30.1	29.2	28.4	27.5	26.7
81	34.4	33.5	32.6	31.8	30.9	30.0	29.2	28.3	27.5	26.6
82	34.4	33.5	32.6	31.7	30.8	30.0	29.1	28.3	27.4	26.6
83	34.4	33.5	32.6	31.7	30.8	29.9	29.1	28.2	27.4	26.5
84	34.3	33.4	32.5	31.7	30.8	29.9	29.0	28.2	27.3	26.5
85	34.3	33.4	32.5	31.6	30.7	29.9	29.0	28.1	27.3	26.4
86	34.3	33.4	32.5	31.6	30.7	29.8	29.0	28.1	27.2	26.4
87	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.1	27.2	26.4
88	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.0	27.2	26.3
89	34.3	33.3	32.4	31.5	30.7	29.8	28.9	28.0	27.2	26.3
90	34.2	33.3	32.4	31.5	30.6	29.8	28.9	28.0	27.1	26.3
91	34.2	33.3	32.4	31.5	30.6	29.7	28.9	28.0	27.1	26.3
92	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
93	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
94	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
95	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
96	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
97	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
98	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
99	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
100	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
101	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
102	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
103	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
104	34.2	33.3	32.4	31.4	30.5	29.6	28.8	27.9	27.0	26.1
105	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
106	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
107	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
108	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
109	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
110	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
111	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
112	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
113	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1

Ages	50	51	52	53	54	55	56	57	58	59
114	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
115+	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1

Ages	60	61	62	63	64	65	66	67	68	69
60	30.9	30.4	30.0	29.6	29.2	28.8	28.5	28.2	27.9	27.6
61	30.4	29.9	29.5	29.0	28.6	28.3	27.9	27.6	27.3	27.0
62	30.0	29.5	29.0	28.5	28.1	27.7	27.3	27.0	26.7	26.4
63	29.6	29.0	28.5	28.1	27.6	27.2	26.8	26.4	26.1	25.7
64	29.2	28.6	28.1	27.6	27.1	26.7	26.3	25.9	25.5	25.2
65	28.8	28.3	27.7	27.2	26.7	26.2	25.8	25.4	25.0	24.6
66	28.5	27.9	27.3	26.8	26.3	25.8	25.3	24.9	24.5	24.1
67	28.2	27.6	27.0	26.4	25.9	25.4	24.9	24.4	24.0	23.6
68	27.9	27.3	26.7	26.1	25.5	25.0	24.5	24.0	23.5	23.1
69	27.6	27.0	26.4	25.7	25.2	24.6	24.1	23.6	23.1	22.6
70	27.4	26.7	26.1	25.4	24.8	24.3	23.7	23.2	22.7	22.2
71	27.2	26.5	25.8	25.2	24.5	23.9	23.4	22.8	22.3	21.8
72	27.0	26.3	25.6	24.9	24.3	23.7	23.1	22.5	22.0	21.4
73	26.8	26.1	25.4	24.7	24.0	23.4	22.8	22.2	21.6	21.1
74	26.6	25.9	25.2	24.5	23.8	23.1	22.5	21.9	21.3	20.8
75	26.5	25.7	25.0	24.3	23.6	22.9	22.3	21.6	21.0	20.5
76	26.3	25.6	24.8	24.1	23.4	22.7	22.0	21.4	20.8	20.2
77	26.2	25.4	24.7	23.9	23.2	22.5	21.8	21.2	20.6	19.9
78	26.1	25.3	24.6	23.8	23.1	22.4	21.7	21.0	20.3	19.7
79	26.0	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.5
80	25.9	25.1	24.3	23.6	22.8	22.1	21.3	20.6	20.0	19.3
81	25.8	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.8	19.1
82	25.8	24.9	24.1	23.4	22.6	21.8	21.1	20.4	19.7	19.0
83	25.7	24.9	24.1	23.3	22.5	21.7	21.0	20.2	19.5	18.8
84	25.6	24.8	24.0	23.2	22.4	21.6	20.9	20.1	19.4	18.7
85	25.6	24.8	23.9	23.1	22.3	21.6	20.8	20.1	19.3	18.6
86	25.5	24.7	23.9	23.1	22.3	21.5	20.7	20.0	19.2	18.5
87	25.5	24.7	23.8	23.0	22.2	21.4	20.7	19.9	19.2	18.4
88	25.5	24.6	23.8	23.0	22.2	21.4	20.6	19.8	19.1	18.3
89	25.4	24.6	23.8	22.9	22.1	21.3	20.5	19.8	19.0	18.3
90	25.4	24.6	23.7	22.9	22.1	21.3	20.5	19.7	19.0	18.2
91	25.4	24.5	23.7	22.9	22.1	21.3	20.5	19.7	18.9	18.2
92	25.4	24.5	23.7	22.9	22.0	21.2	20.4	19.6	18.9	18.1
93	25.4	24.5	23.7	22.8	22.0	21.2	20.4	19.6	18.8	18.1
94	25.3	24.5	23.6	22.8	22.0	21.2	20.4	19.6	18.8	18.0
95	25.3	24.5	23.6	22.8	22.0	21.1	20.3	19.6	18.8	18.0
96	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.8	18.0
97	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.7	18.0
98	25.3	24.4	23.6	22.8	21.9	21.1	20.3	19.5	18.7	17.9
99	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
100	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
101	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.7	17.9
102	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.6	17.9

103	25.3	24.4	23.6	22.7	21.9	21.0	20.2	19.4	18.6	17.9
104	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
105	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
106	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
107	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
108	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
109	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
110	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
111	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
112	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
113	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
114	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
115+	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8

Ages	70	71	72	73	74	75	76	77	78	79
70	21.8	21.3	20.9	20.6	20.2	19.9	19.6	19.4	19.1	18.9
71	21.3	20.9	20.5	20.1	19.7	19.4	19.1	18.8	18.5	18.3
72	20.9	20.5	20.0	19.6	19.3	18.9	18.6	18.3	18.0	17.7
73	20.6	20.1	19.6	19.2	18.8	18.4	18.1	17.8	17.5	17.2
74	20.2	19.7	19.3	18.8	18.4	18.0	17.6	17.3	17.0	16.7
75	19.9	19.4	18.9	18.4	18.0	17.6	17.2	16.8	16.5	16.2
76	19.6	19.1	18.6	18.1	17.6	17.2	16.8	16.4	16.0	15.7
77	19.4	18.8	18.3	17.8	17.3	16.8	16.4	16.0	15.6	15.3
78	19.1	18.5	18.0	17.5	17.0	16.5	16.0	15.6	15.2	14.9
79	18.9	18.3	17.7	17.2	16.7	16.2	15.7	15.3	14.9	14.5
80	18.7	18.1	17.5	16.9	16.4	15.9	15.4	15.0	14.5	14.1
81	18.5	17.9	17.3	16.7	16.2	15.6	15.1	14.7	14.2	13.8
82	18.3	17.7	17.1	16.5	15.9	15.4	14.9	14.4	13.9	13.5
83	18.2	17.5	16.9	16.3	15.7	15.2	14.7	14.2	13.7	13.2
84	18.0	17.4	16.7	16.1	15.5	15.0	14.4	13.9	13.4	13.0
85	17.9	17.3	16.6	16.0	15.4	14.8	14.3	13.7	13.2	12.8
86	17.8	17.1	16.5	15.8	15.2	14.6	14.1	13.5	13.0	12.5
87	17.7	17.0	16.4	15.7	15.1	14.5	13.9	13.4	12.9	12.4
88	17.6	16.9	16.3	15.6	15.0	14.4	13.8	13.2	12.7	12.2
89	17.6	16.9	16.2	15.5	14.9	14.3	13.7	13.1	12.6	12.0
90	17.5	16.8	16.1	15.4	14.8	14.2	13.6	13.0	12.4	11.9
91	17.4	16.7	16.0	15.4	14.7	14.1	13.5	12.9	12.3	11.8
92	17.4	16.7	16.0	15.3	14.6	14.0	13.4	12.8	12.2	11.7
93	17.3	16.6	15.9	15.2	14.6	13.9	13.3	12.7	12.1	11.6
94	17.3	16.6	15.9	15.2	14.5	13.9	13.2	12.6	12.0	11.5
95	17.3	16.5	15.8	15.1	14.5	13.8	13.2	12.6	12.0	11.4
96	17.2	16.5	15.8	15.1	14.4	13.8	13.1	12.5	11.9	11.3
97	17.2	16.5	15.8	15.1	14.4	13.7	13.1	12.5	11.9	11.3
98	17.2	16.4	15.7	15.0	14.3	13.7	13.0	12.4	11.8	11.2
99	17.2	16.4	15.7	15.0	14.3	13.6	13.0	12.4	11.8	11.2
100	17.1	16.4	15.7	15.0	14.3	13.6	12.9	12.3	11.7	11.1
101	17.1	16.4	15.6	14.9	14.2	13.6	12.9	12.3	11.7	11.1
102	17.1	16.4	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0
103	17.1	16.3	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0

Ages	70	71	72	73	74	75	76	77	78	79
104	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.6	11.0
105	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.5	10.9
106	17.1	16.3	15.6	14.8	14.1	13.5	12.8	12.2	11.5	10.9
107	17.0	16.3	15.6	14.8	14.1	13.4	12.8	12.1	11.5	10.9
108	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
109	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
110	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.9
111	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
112	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
113	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
114	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
115+	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8

Ages	80	81	82	83	84	85	86	87	88	89
80	13.8	13.4	13.1	12.8	12.6	12.3	12.1	11.9	11.7	11.5
81	13.4	13.1	12.7	12.4	12.2	11.9	11.7	11.4	11.3	11.1
82	13.1	12.7	12.4	12.1	11.8	11.5	11.3	11.0	10.8	10.6
83	12.8	12.4	12.1	11.7	11.4	11.1	10.9	10.6	10.4	10.2
84	12.6	12.2	11.8	11.4	11.1	10.8	10.5	10.3	10.1	9.9
85	12.3	11.9	11.5	11.1	10.8	10.5	10.2	9.9	9.7	9.5
86	12.1	11.7	11.3	10.9	10.5	10.2	9.9	9.6	9.4	9.2
87	11.9	11.4	11.0	10.6	10.3	9.9	9.6	9.4	9.1	8.9
88	11.7	11.3	10.8	10.4	10.1	9.7	9.4	9.1	8.8	8.6
89	11.5	11.1	10.6	10.2	9.9	9.5	9.2	8.9	8.6	8.3
90	11.4	10.9	10.5	10.1	9.7	9.3	9.0	8.6	8.3	8.1
91	11.3	10.8	10.3	9.9	9.5	9.1	8.8	8.4	8.1	7.9
92	11.2	10.7	10.2	9.8	9.3	9.0	8.6	8.3	8.0	7.7
93	11.1	10.6	10.1	9.6	9.2	8.8	8.5	8.1	7.8	7.5
94	11.0	10.5	10.0	9.5	9.1	8.7	8.3	8.0	7.6	7.3
95	10.9	10.4	9.9	9.4	9.0	8.6	8.2	7.8	7.5	7.2
96	10.8	10.3	9.8	9.3	8.9	8.5	8.1	7.7	7.4	7.1
97	10.7	10.2	9.7	9.2	8.8	8.4	8.0	7.6	7.3	6.9
98	10.7	10.1	9.6	9.2	8.7	8.3	7.9	7.5	7.1	6.8
99	10.6	10.1	9.6	9.1	8.6	8.2	7.8	7.4	7.0	6.7
100	10.6	10.0	9.5	9.0	8.5	8.1	7.7	7.3	6.9	6.6
101	10.5	10.0	9.4	9.0	8.5	8.0	7.6	7.2	6.9	6.5
102	10.5	9.9	9.4	8.9	8.4	8.0	7.5	7.1	6.8	6.4
103	10.4	9.9	9.4	8.8	8.4	7.9	7.5	7.1	6.7	6.3
104	10.4	9.8	9.3	8.8	8.3	7.9	7.4	7.0	6.6	6.3
105	10.4	9.8	9.3	8.8	8.3	7.8	7.4	7.0	6.6	6.2
106	10.3	9.8	9.2	8.7	8.2	7.8	7.3	6.9	6.5	6.2
107	10.3	9.8	9.2	8.7	8.2	7.7	7.3	6.9	6.5	6.1
108	10.3	9.7	9.2	8.7	8.2	7.7	7.3	6.8	6.4	6.1
109	10.3	9.7	9.2	8.7	8.2	7.7	7.2	6.8	6.4	6.0
110	10.3	9.7	9.2	8.6	8.1	7.7	7.2	6.8	6.4	6.0
111	10.3	9.7	9.1	8.6	8.1	7.6	7.2	6.8	6.3	6.0
112	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9

113	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9
114	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9
115+	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9

Ages	90	91	92	93	94	95	96	97	98	99
90	7.8	7.6	7.4	7.2	7.1	6.9	6.8	6.6	6.5	6.4
91	7.6	7.4	7.2	7.0	6.8	6.7	6.5	6.4	6.3	6.1
92	7.4	7.2	7.0	6.8	6.6	6.4	6.3	6.1	6.0	5.9
93	7.2	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.6
94	7.1	6.8	6.6	6.4	6.2	6.0	5.9	5.7	5.6	5.4
95	6.9	6.7	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2
96	6.8	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.2	5.0
97	6.6	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9
98	6.5	6.3	6.0	5.8	5.6	5.4	5.2	5.0	4.8	4.7
99	6.4	6.1	5.9	5.6	5.4	5.2	5.0	4.9	4.7	4.5
100	6.3	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5	4.4
101	6.2	5.9	5.6	5.4	5.2	5.0	4.8	4.6	4.4	4.2
102	6.1	5.8	5.5	5.3	5.1	4.8	4.6	4.4	4.3	4.1
103	6.0	5.7	5.4	5.2	5.0	4.7	4.5	4.3	4.1	4.0
104	5.9	5.6	5.4	5.1	4.9	4.6	4.4	4.2	4.0	3.8
105	5.9	5.6	5.3	5.0	4.8	4.5	4.3	4.1	3.9	3.7
106	5.8	5.5	5.2	4.9	4.7	4.5	4.2	4.0	3.8	3.6
107	5.8	5.4	5.1	4.9	4.6	4.4	4.2	3.9	3.7	3.5
108	5.7	5.4	5.1	4.8	4.6	4.3	4.1	3.9	3.7	3.5
109	5.7	5.3	5.0	4.8	4.5	4.3	4.0	3.8	3.6	3.4
110	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.8	3.5	3.3
111	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3
112	5.6	5.3	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2
113	5.6	5.2	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2
114	5.6	5.2	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2
115+	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.6	3.4	3.1

Ages	100	101	102	103	104	105	106	107	108	109
100	4.2	4.1	3.9	3.8	3.7	3.5	3.4	3.3	3.3	3.2
101	4.1	3.9	3.7	3.6	3.5	3.4	3.2	3.1	3.1	3.0
102	3.9	3.7	3.6	3.4	3.3	3.2	3.1	3.0	2.9	2.8
103	3.8	3.6	3.4	3.3	3.2	3.0	2.9	2.8	2.7	2.6
104	3.7	3.5	3.3	3.2	3.0	2.9	2.7	2.6	2.5	2.4
105	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.5	2.4	2.3
106	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.2	2.1
107	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2	2.1	2.0
108	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8
109	3.2	3.0	2.8	2.6	2.4	2.3	2.1	2.0	1.8	1.7
110	3.1	2.9	2.7	2.5	2.3	2.2	2.0	1.9	1.7	1.6
111	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.5
112	3.0	2.8	2.6	2.4	2.2	2.0	1.9	1.7	1.5	1.4
113	3.0	2.8	2.6	2.4	2.2	2.0	1.8	1.6	1.5	1.3

Ages	100	101	102	103	104	105	106	107	108	109
114	3.0	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.4	1.3
115+	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.4	1.2

Ages	110	111	112	113	114	115+
110	1.5	1.4	1.3	1.2	1.1	1.1
111	1.4	1.2	1.1	1.1	1.0	1.0
112	1.3	1.1	1.0	1.0	1.0	1.0
113	1.2	1.1	1.0	1.0	1.0	1.0
114	1.1	1.0	1.0	1.0	1.0	1.0
115+	1.1	1.0	1.0	1.0	1.0	1.0

Q–4. May the tables under this section be changed?

A–4. The Single Life Table, Uniform Lifetime Table and Joint and Last Survivor Table provided in A–1 through A–3 of this section may be changed 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.

[T.D. 8987, 67 FR 18994, Apr. 17, 2002; 67 FR 36676, May 24, 2002]

§ 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)–6, matching contributions (within the meaning of §1.401(m)–5, or employee contributions (within the meaning of §1.401(m)–5 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, as amended by T.D. 9169, 69 FR 78153, Dec. 29, 2004]

EDITORIAL NOTE: By T.D. 9169, 69 FR 78153, Dec. 29, 2004, the Internal Revenue Service published a document in the FEDERAL REGISTER, attempting to amend paragraph (d)(5)(ii) of §1.401–(a)(17)–1 by removing ''1.401(m)–(f)(6)'' and inserting ''1.401(m)–1(a)(3)''. However, because of inaccurate language, this amendment could not be incorporated.

§ 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

[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)–7(b), 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)–7(b) 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; T.D. 9340, 72 FR 41159, July 26, 2007]

§ 1.401(a)(35)–1 Diversification requirements for certain defined contribution plans.

(a) *General rule*—(1) *Diversification requirements*. Section 401(a)(35) imposes diversification requirements on applicable defined contribution plans. A trust that is part of an applicable defined contribution plan is not a qualified trust under section 401(a) unless the plan—

(i) Satisfies the diversification election requirements for elective deferrals and employee contributions set forth in paragraph (b) of this section;

(ii) Satisfies the diversification election requirements for employer nonelective contributions set forth in paragraph (c) of this section;

(iii) Satisfies the investment option requirement set forth in paragraph (d) of this section; and

(iv) Does not apply any restrictions or conditions on investments in employer securities that violate the requirements of paragraph (e) of this section.

(2) *Definitions, effective dates, and transition rules*. The definitions of applicable defined contribution plan, employer security, parent corporation, and publicly traded are set forth in paragraph (f) of this section. Applicability dates and transition rules are set forth in paragraph (g) of this section.

(b) *Diversification requirements for elective deferrals and employee contributions invested in employer securities*—(1) *General rule*. With respect to any individual described in paragraph (b)(2) of this section, if any portion of the individual's account under an applicable defined contribution plan attributable to elective deferrals (as described in section 402(g)(3)(A)), employee contributions, or rollover contributions is invested in employer securities, then the plan satisfies the requirements of this paragraph (b) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to elective deferrals and employee contributions*. An individual is described in this paragraph (b)(2) if the individual is—

(i) A participant;

(ii) An alternate payee who has an account under the plan; or

(iii) A beneficiary of a deceased participant.

(c) *Diversification requirements for employer nonelective contributions invested in employer securities*—(1) *General rule*. With respect to any individual described in paragraph (c)(2) of this section, if a portion of the individual's account under an applicable defined contribution plan attributable to employer nonelective contributions is invested in employer securities, then the plan satisfies the requirements of this paragraph (c) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to employer nonelective contributions.* An individual is described in this paragraph (c)(2) if the individual is—

(i) A participant who has completed at least three years of service;

(ii) An alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service; or

(iii) A beneficiary of a deceased participant.

(3) *Completion of three years of service.* For purposes of paragraph (c)(2) of this section, a participant completes three years of service on the last day of the vesting computation period provided for under the plan that constitutes the completion of the third year of service under section 411(a)(5). However, for a plan that uses the elapsed time method of crediting service for vesting purposes (or a plan that provides for immediate vesting without using a vesting computation period or the elapsed time method of determining vesting), a participant completes three years of service on the day immediately preceding the third anniversary of the participant's date of hire.

(d) *Investment options.* An applicable defined contribution plan must offer not less than three investment options, other than employer securities, to which an individual who has the right to divest under paragraph (b)(1) or (c)(1) of this section may direct the proceeds from the divestment of employer securities. Each of the three investment options must be diversified and have materially different risk and return characteristics. For this purpose, investment options that constitute a broad range of investment alternatives within the meaning of Department of Labor Regulation section 2550.404c–1(b)(3) are treated as being diversified and having materially different risk and return characteristics.

(e) *Restrictions or conditions on investments in employer securities*—(1) *Impermissible restrictions or conditions*—(i) *General rule.* Except as provided in paragraph (e)(2) of this section, an applicable defined contribution plan violates the requirements of this paragraph (e) if the plan imposes restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. A restriction or condition with respect to employer securities means—

(A) A restriction on an individual's right to divest an investment in employer securities that is not imposed on an investment that is not employer securities; or

(B) A benefit that is conditioned on investment in employer securities.

(ii) *Indirect restrictions or conditions*—(A) Except as provided in paragraph (e)(3) of this section, a plan violates the requirements of this paragraph (e) if the plan imposes a restriction or condition described in paragraph (e)(1)(i)(A) or (B) of this section either directly or indirectly.

(B) A plan imposes an indirect restriction on an individual's right to divest an investment in employer securities if, for example, the plan provides that a participant who divests his or her account balance with respect to the investment in employer securities is not permitted for a period of time thereafter to reinvest in employer securities.

(C) A plan does not impose an indirect restriction or condition merely because there are tax consequences that result from an individual's divestment of an investment in employer securities. Thus, the loss of the special treatment for net unrealized appreciation provided under section 402(e)(4) with respect to employer securities is disregarded. Similarly, a plan does not impose an impermissible restriction or condition merely because it provides that an individual may not reinvest divested amounts in the same employer securities account but is permitted to invest such divested amounts in another employer securities account where the only relevant difference between the separate accounts is the section 402(e)(4) cost (or other basis) of the trust in the shares held in each account. (See § 1.402(a)–1(b) for rules regarding section 402(e)(4).)

(2) *Permitted restrictions or conditions*—(i) *In general*. An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes a restriction or a condition set forth in paragraph (e)(2)(ii) or (e)(2)(iii) of this section.

(ii) *Securities laws*. A plan is permitted to impose a restriction or condition on the divestiture of employer securities that is either required in order to ensure compliance with applicable securities laws or is reasonably designed to ensure compliance with applicable securities laws. For example, it is permissible for a plan to limit divestiture rights for participants who are subject to section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78f) to a reasonable period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements because it is reasonably designed to ensure compliance with Rule 10b–5 of the Securities and Exchange Commission.

(iii) *Deferred application of the diversification requirements*—(A) *Becoming an applicable defined contribution plan*. An applicable defined contribution plan is permitted to restrict the application of the diversification requirements of section 401(a)(35) and this section for up to 90 days after the plan becomes an applicable defined contribution plan (for example, a plan becoming an applicable defined contribution plan because the employer securities held under the plan become publicly traded).

(B) *Loss of exception for indirect investments*. In the case where an investment fund described in paragraph (f)(3)(ii)(A) of this section no longer meets the requirement in paragraph (f)(3)(ii)(B) of this section that the investment must be independent of the employer (including the situation where the fund no longer meets the percentage limitation rule in paragraph (f)(3)(ii)(C) of this section), the plan does not fail to satisfy the diversification requirements of section 401(a)(35) and this section merely because it does not offer those rights with respect to that investment fund for up to 90 days after the investment fund ceases to meet those requirements.

(3) *Permitted indirect restrictions or conditions*—(i) *In general*. An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes an indirect restriction or condition set forth in this paragraph (e)(3).

(ii) *Limitation on investment in employer securities*. A plan is permitted to limit the extent to which an individual's account balance can be invested in employer securities, provided the limitation applies without regard to a prior exercise of rights to divest employer securities. For example, a plan does not impose a restriction that violates this paragraph (e) merely because the plan prohibits a participant from investing additional amounts in employer securities if more than 10 percent of that participant's account balance is invested in employer securities.

(iii) *Trading frequency*. A plan is permitted to impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities, provided that the restrictions are designed to limit short-term trading in the employer securities. For example, a plan could provide that a participant may not elect to invest in employer securities if the employee has elected to divest employer securities within a short period of time, such as seven days, prior to the election to invest in employer securities.

(iv) *Fees*. The plan has not provided an indirect benefit that is conditioned on investment in employer securities merely because the plan imposes fees on other investment options that are not imposed on the investment in employer securities. In addition, the plan has not provided a restriction on the right to divest an investment in employer securities merely because the plan imposes a reasonable fee for the divestment of employer securities.

(v) *Stable value or similar fund*. A plan is permitted to allow transfers to be made into or out of a stable value or similar fund more frequently than a fund invested in employer securities for purposes of paragraph (e)(1)(ii) of this section. Thus, a plan that includes a broad range of investment alternatives as described in paragraph (d) of this section, including a stable value or similar fund, does not impose an impermissible restriction under paragraph (e)(1)(ii) of this section merely because it permits transfers into or out of that fund more frequently than other funds under the plan, provided that the plan would otherwise satisfy this paragraph (e) (taking into account any restrictions or conditions imposed with respect to the other investment options under the plan). For purposes of this section, a stable value fund or similar fund means an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity for benefit distributions or transfers to other investment alternatives (such as a product or fund described in Department of Labor Regulation §2550.404c–5(e)(4)(iv)(A) or (v)(A)).

(vi) *Transfers out of a qualified default investment alternative (QDIA).* A plan is permitted to provide for transfers out of a QDIA within the meaning of Department of Labor Regulation section 2550.404c–5(e) more frequently than a fund invested in employer securities.

(vii) *Frozen funds*—(A) *General rule.* A plan is permitted to prohibit any further investment in employer securities. Thus, a plan is not treated as imposing an indirect restriction merely because it provides that an employee that divests an investment in employer securities is not permitted to reinvest in employer securities, but only if the plan does not permit additional contributions or other investments to be invested in employer securities. For this purpose, a plan does not provide for further investment in employer securities merely because dividends paid on employer securities under the plan are reinvested in employer securities.

(B) *Transitional relief for certain leveraged employee stock ownership plans (ESOPs).* An employer stock fund does not fail to be a frozen fund under this paragraph (e)(3)(vii) merely because of the allocation of employer securities that are released as matching contributions from the plan's suspense account that holds employer securities acquired with an exempt loan under section 4975(d)(3). This paragraph (e)(3)(vii)(B) only applies to employer securities that were acquired in a plan year beginning before January 1, 2007, with the proceeds of an exempt loan within the meaning of section 4975(d)(3) which is not refinanced after the end of the last plan year beginning before January 1, 2007.

(4) *Delegation of authority to Commissioner.* The Commissioner may provide for additional permitted restrictions or conditions or permitted indirect restrictions or conditions in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin.

(f) *Definitions*—(1) *Application of definitions.* This paragraph (f) contains definitions that are applicable for purposes of this section.

(2) *Applicable defined contribution plan*—(i) *General rule.* Except as provided in this paragraph (f)(2), an applicable defined contribution plan means any defined contribution plan which holds employer securities that are publicly traded. See paragraph (f)(2)(iv) of this section for a special rule that treats certain plans that hold employer securities that are not publicly traded as applicable defined contribution plans and paragraph (f)(3)(ii) of this section for a special rule that treats certain plans as not holding publicly traded employer securities for purposes of this section.

(ii) *Exception for certain ESOPs.* An employee stock ownership plan (ESOP), as defined in section 4975(e)(7), is not an applicable defined contribution plan if the plan is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers and holds no contributions (or earnings thereunder) that are (or were ever) subject to section 401(k) or 401(m). Thus, an ESOP is an applicable defined contribution plan if the ESOP is a portion of a larger plan (whether or not that larger plan includes contributions that are subject to section 401(k) or 401(m)). For purposes of this paragraph (f)(2)(ii), a plan is not considered to hold amounts ever subject to section 401(k) or 401(m) merely because the plan holds amounts attributable to rollover amounts in a separate account that were previously subject to section 401(k) or 401(m).

(iii) *Exception for one-participant plans.* A one-participant plan, as defined in section 401(a)(35)(E)(iv), is not an applicable defined contribution plan.

(iv) *Certain defined contribution plans treated as holding publicly traded employer securities*—(A) *General rule.* A defined contribution plan holding employer securities that are not publicly traded is treated as an applicable defined contribution plan if any employer maintaining the plan or any member of a controlled group of corporations that includes such employer has issued a class of stock which is publicly traded. For purposes of this paragraph (f)(2)(iv), a controlled group of corporations has the meaning given such term by section 1563(a), except that "50 percent" is substituted for "80 percent" each place it appears.

(B) *Exception for certain plans.* Paragraph (f)(2)(iv)(A) of this section does not apply to a plan if—

(*1*) No employer maintaining the plan (or a parent corporation with respect to such employer) has issued stock that is publicly traded; and

(*2*) No employer maintaining the plan (or parent corporation with respect to such employer) has issued any special class of stock which grants to the holder or issuer particular rights, or bears particular risks for the holder or issuer, with respect to any employer maintaining the plan (or any member of a controlled group of corporations that includes such employer) which has issued any stock that is publicly traded.

(3) *Employer security*—(i) *General rule.* Employer security has the meaning given such term by section 407(d)(1) of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

(ii) *Certain defined contribution plans or investment funds not treated as holding employer securities*—(A) *Exception for certain indirect investments.* Subject to paragraphs (f)(3)(ii)(B) and (C) of this section, a plan (and an investment option described in paragraph (d) of this section) is not treated as holding employer securities for purposes of this section to the extent the employer securities are held indirectly as part of a broader fund that is—

(*1*) A regulated investment company described in section 851(a);

(*2*) A common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or a Federal agency;

(*3*) A pooled investment fund of an insurance company that is qualified to do business in a State;

(*4*) An investment fund managed by an investment manager within the meaning of section 3(38) of ERISA for a multiemployer plan; or

(*5*) Any other investment fund designated by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin.

(B) *Investment must be independent.* The exception set forth in paragraph (f)(3)(ii)(A) of this section applies only if the investment in the employer securities is held in a fund under which—

(*1*) There are stated investment objectives of the fund; and

(*2*) The investment is independent of the employer (or employers) and any affiliate thereof.

(C) *Percentage limitation rule.* For purposes of paragraph (f)(3)(ii)(B)(*2*) of this section, an investment in employer securities in a fund is not considered to be independent of the employer (or employers) and any affiliate thereof if the aggregate value of the employer securities held in the fund is in excess of 10 percent of the total value of all of the fund's investments for the plan year. The determination of whether the value of employer securities exceeds 10 percent of the total value of the fund's investments for the plan year is made as of the end of the preceding plan year. The determination can be based on the information in the latest disclosure of the fund's portfolio holdings that was filed with the Securities and Exchange Commission (SEC) in that preceding plan year.

(4) *Parent corporation.* Parent corporation has the meaning given such term by section 424(e).

(5) *Publicly traded*—(i) *In general.* A security is publicly traded if it is readily tradable on an established securities market.

(ii) *Readily tradable on an established securities market.* For purposes of this paragraph (f)(5), except as provided by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a security is readily tradable on an established securities market if—

(A) The security is traded on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(B) The security is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and the security is deemed by the SEC as having a ''ready market'' under SEC Rule 15c3–1 (17 CFR 240.15c3–1).

(g) *Applicability date and transition rules*—(1) *Statutory effective date*—(i) *General rule.* Except as otherwise provided in this paragraph (g) and section 901(c)(3)(A) and (B) of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780 (2006)) (PPA '06), section 401(a)(35) is effective for plan years beginning after December 31, 2006.

(ii) *Collectively bargained plans*—(A) *Delayed statutory effective date.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006, section 401(a)(35) is effective for plan years beginning after the earlier of—

(*1*) The later of—

(*i*) December 31, 2007; or

(*ii*) The date on which the last such collective bargaining agreement terminates (determined without regard to any extension thereof); or

(*2*) December 31, 2008.

(B) *Treatment of plans with both collectively bargained and non-collectively bargained employees.* If a collective bargaining agreement applies to some, but not all, of the plan participants, the definition of whether the plan is considered a collectively bargained plan for purposes of this paragraph (g)(1)(ii) is made in the same manner as the definition of whether a plan is collectively bargained under section 436(f)(3).

(2) *Regulatory effective/applicability date.* This section is effective and applicable for plan years beginning on or after January 1, 2011.

(3) *Statutory transition rules*—(i) *General rule.* Pursuant to section 401(a)(35)(H), in the case of the portion of an account to which paragraph (c) of this section applies and that consists of employer securities acquired in a plan year beginning before January 1, 2007, the requirements of paragraph (c) of this section only apply to the applicable percentage of such securities.

(ii) *Applicable percentage*—(A) *Phase-in percentage.* For purposes of this paragraph (g)(3), the applicable percentage is determined as follows—

Plan year to which paragraph (c) of this section applies:	The applicable percentage is:
1st	33
2nd	66
3rd and following	100

(B) *Special rule.* For a plan for which the special effective date under section 901(c)(3) of PPA '06 applies, the applicable percentage under this paragraph (g)(3)(ii) is determined without regard to the delayed effective date in section 901(c)(3)(A) and (B) of PPA '06.

(iii) *Nonapplication for participants age 55 with three years of service.* Paragraph (g)(3)(i) of this section does not apply to an individual who is a participant who attained age 55 and had completed at least three years of service (as defined in paragraph (c)(3) of this section) before the first day of the first plan year beginning after December 31, 2005.

(iv) *Separate application by class of securities.* This paragraph (g)(3) applies separately with respect to each class of securities.

[T.D. 9484, 75 FR 27931, May 19, 2010]

§ 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 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§ 1.401(k)–1 through 1.401(k)–6.

LIST OF SECTIONS

LIST OF PARAGRAPHS

§ 1.401(k)–2 ADP Test

(ii) Combination of correction methods.
(iii) Exclusive means of correction.
(2) Corrections through distribution.
(i) General rule.
(ii) Calculation of total amount to be distributed.
(A) Calculate the dollar amount of excess contributions for each HCE.
(B) Determination of the total amount of excess contributions.
(C) Satisfaction of ADP.
(iii) Apportionment of total amount of excess contributions among the HCEs.
(A) Calculate the dollar amount of excess contributions for each HCE.
(B) Limit on amount apportioned to any individual.
(C) Apportionment to additional HCEs.
(iv) Income allocable to excess contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating plan year income.
(D) Plan years before 2008.
(E) Alternative method for allocating plan year and gap period income.
(v) Distribution.
(vi) Tax treatment of corrective distributions.
(A) Corrective distributions for plan years beginning on or after January 1, 2008.
(B) Corrective distributions for plan years beginning before January 1, 2008.
(C) Corrective distributions attributable to designated Roth contributions.
(vii) Other rules.
(A) No employee or spousal consent required.
(B) Treatment of corrective distributions as elective contributions.
(C) No reduction of required minimum distribution.
(D) Partial distributions.
(viii) Examples.
(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) Treatment of recharacterized excess contributions.
(4) Rules applicable to all corrections.
(i) Coordination with distribution of excess deferrals.
(A) Treatment of excess deferrals that reduce excess contributions.
(B) Treatment of excess contributions that reduce excess deferrals.
(ii) Forfeiture of match on distributed excess contributions.
(iii) Permitted forfeiture of QMAC.
(iv) No requirement for recalculation.
(v) Treatment of excess contributions that are catch-up contributions.
(5) Failure to timely 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.
(iii) Special rule for eligible automatic contribution arrangements.
(c) Additional rules for prior year testing method.
(1) Rules for change in testing method.
(i) General rule.
(ii) Situations permitting a change to the prior year testing method.
(2) Calculation of ADP under the prior year testing method for the first plan year.
(i) Plans that are not successor plans.
(ii) First plan year defined.
(iii) Successor plans.
(3) Plans using different testing methods for the ADP and ACP test.
(4) Rules for plan coverage changes.
(i) In general.
(ii) Optional rule for minor plan coverage changes.
(iii) Definitions.
(A) Plan coverage change.
(B) Prior year subgroup.
(C) Weighted average of the ADPs for the prior year subgroups.
(iv) Examples.

§ 1.401(k)–3 Safe harbor requirement

(a) ADP test safe harbor.
(1) Section 401(k)(12) safe harbor.
(2) Section 401(k)(13) safe harbor.
(3) Requirements applicable to safe harbor contributions.
(b) Safe harbor nonelective contribution requirement.
(1) General rule.
(2) Safe harbor compensation defined.
(c) Safe harbor matching contribution requirement.
(1) In general.
(2) Basic matching formula.
(3) Enhanced matching formula.
(4) Limitation on HCE matching contributions.
(5) Use of safe harbor match not precluded by certain plan provisions.
(i) Safe harbor matching contributions on employee contributions.
(ii) Periodic matching contributions.
(6) Permissible restrictions on elective contributions by NHCEs.
(i) General rule.
(ii) Restrictions on election periods.
(iii) Restrictions on amount of elective contributions.
(iv) Restrictions on types of compensation that may be deferred.
(v) Restrictions due to limitations under the Internal Revenue Code.
(7) Examples.
(d) Notice requirement.

[T.D. 9169, 69 FR 78154, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 9 Jan. 3, 2006; T.D. 9324, 72 FR 21109, Apr. 30, 2007; T.D. 9447, 74 FR 8207, Feb. 24, 2009; T.D. 9641, 78 FR 68737, Nov. 15, 2013]

§ 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 paragraphs (a)(2)(ii) and (iii) 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 treating the contributions as taxable income subject to applicable withholding requirements). *See also* section 414(h)(1). A designated Roth contribution, however, is not treated as an after-tax contribution for purposes of this section, §1.401(k)–2 through §1.401(k)–6 and §1.401(m)–1 through §1.401(m)–5. A contribution can be an after-tax employee contribution under the rule of this paragraph (a)(2)(ii) 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 ESOP dividend election.* A cash or deferred arrangement does not include an arrangement under an ESOP under which dividends are either distributed or invested pursuant to an election made by participants or their beneficiaries in accordance with section 404(k)(2)(A)(iii).

(iv) *Treatment of elective contributions as plan assets.* The extent to which elective contributions constitute plan assets for purposes of the prohibited transaction provisions of section 4975 and title I of the Employee Retirement Income Security Act of 1974 (88 Stat. 829), Public Law 93–406, is determined in accordance with regulations and rulings issued by the Department of Labor. *See* 29 CFR 2510.3–102.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any direct or indirect 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.

(ii) *Automatic enrollment.* For purposes of determining whether an election is a cash or deferred election, it is irrelevant whether the default that applies in the absence of an affirmative election is described in paragraph (a)(3)(i)(A) of this section (*i.e.*, the employee receives an amount in cash or some other taxable benefit) or in paragraph (a)(3)(i)(B) of this section (*i.e.*, the employer contributes an amount to a trust or provides an accrual or other benefit under a plan deferring the receipt of compensation).

(iii) *Rules related to timing*—(A) *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.

(B) *Contribution may not precede election.* A contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made.

(C) *Contribution may not precede services*—(*1*) *General rule.* Contributions are made pursuant to a cash or deferred election only if the contributions are made after the employee's performance of service with respect to which the contributions are made (or when the cash or other taxable benefit would be currently available, if earlier).

(*2*) *Exception for bona fide administrative considerations.* The timing of contributions will not be treated as failing to satisfy the requirements of this paragraph (a)(3)(iii)(C) merely because contributions for a pay period are occasionally made before the services with respect to that pay period are performed, provided the contributions are made early in order to accommodate bona fide administrative considerations (for example, the temporary absence of the bookkeeper with responsibility to transmit contributions to the plan) and are not paid early with a principal purpose of accelerating deductions.

(iv) *Current availability defined.* Cash or another taxable benefit 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 benefit 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.

(v) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in section 219(g)(5)(A) (whether or not such other plan or arrangement has terminated), 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 a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans or arrangements of the employer (including plans or arrangements 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 made 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 the case of an irrevocable election made on or before December 23, 1994—

(A) The election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because an employee was previously eligible under another plan of the employer (whether or not such other plan has terminated); and

(B) In the case of a plan in which partners may participate, the election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because the election was made after commencement of employment or after the employee's first becoming eligible under any plan of the employer, provided that the election was made before the first day of the first plan year beginning after December 31, 1988, or, if later, March 31, 1989.

(vi) *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), an employee is treated as having received an amount that is contributed to an exempt trust or plan described in section 401(a) or 403(a) 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).

(vii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

Example 1. (i) 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% 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.

(ii) 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. (i) An employer maintains a profit-sharing plan which provides for discretionary profit sharing contributions and under which each eligible employee may elect to reduce his compensation by up to 10% and to have the employer contribute such amount to the plan. The employer pays each employee every two weeks for services during the immediately preceding two weeks. The employee's election to defer compensation for a payroll period must be made prior to the date the amount would otherwise be paid. The employer contributes to the plan the amount of compensation that each employee elected to defer, at the time it would otherwise be paid to the employee, and does not treat the contribution as an after-tax employee contribution.

(ii) The election is a cash or deferred election and the contributions are elective contributions.

Example 3. (i) The facts are the same as in *Example 2*, except that the employer makes a $10,000 contribution on January 31 of the plan year that is in addition to the contributions that satisfy the employer's obligation to make contributions with respect to cash or deferred elections for prior payroll periods. Employee A makes an election on February 15 to defer $2,000 from compensation that is not currently available and the employer reduces the employee's compensation to reflect the election.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election, because the contribution was made before the election was made. Accordingly, the employer must make an additional contribution of $2,000 in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution may be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 4. (i) The facts are the same as in *Example 3*, except that Employee A had an outstanding election to defer $500 from each payroll period's compensation. The $10,000 additional payment that is contributed early is not made early in order to accommodate bona fide administrative considerations.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election for future payroll periods, because the contribution was made before the earlier of Employee A's performance of services to which the contribution is attributable or when the compensation would be currently available. Furthermore, the exception for early contributions in paragraph (a)(3)(iii)(C)(*2*) of this section does not apply. Accordingly, the employer must make an additional contribution of $500 per payroll period in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution may be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 5. (i) Employer B establishes a money purchase pension plan in 1986. This is the first qualified plan established by Employer B. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 2000, Employer B establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer B permits all employees on the effective date of the profit-sharing plan to make a one-time irrevocable election to have Employer B contribute 5% of compensation on their behalf to the plan and make no other contribution to any other plan of Employer B (including plans not yet established) for the duration of the employee's employment with Employer B, and have their salaries reduced by 5%.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the salaried employees of Employer B who, 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 paragraph (a)(3)(v) of this section 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.

(ii) *Treatment of elective contributions as employer contributions.* Except as otherwise provided in §1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of sections 401(a), 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees.* Except as provided in section 402(g), 402A (effective for taxable years beginning after December 31, 2005), or §1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash 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) *Exclusive means of amounts testing.* Elective contributions (including elective contributions that are designated Roth contributions) under a qualified cash or deferred arrangement satisfy the requirements of section 401(a)(4) with respect to amounts if and only if the amount of elective contributions satisfies the nondiscrimination test of section 401(k) under paragraph (b)(1) of this section. *See* § 1.401(a)(4)–1(b)(2)(ii)(B).

(B) *Testing benefits, rights and features.* A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of section 401(a)(4) with respect to benefits, rights and features in addition to the requirements regarding amounts described in paragraph (a)(4)(iv)(A) of this section. For example, the right to make each level of elective contributions under a cash or deferred arrangement and the right to make designated Roth contributions are rights or features subject to the requirements of section 401(a)(4). *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 HCEs with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4).

(C) *Minimum coverage requirement.* A qualified cash or deferred arrangement is treated as a separate plan that must satisfy the requirements of section 410(b). *See* § 1.410(b)–7(c)(1) for special rules. The determination of whether a cash or deferred arrangement satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. *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 fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section.

(ii) *Treatment of elective contributions as nonelective 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 under such an arrangement 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) *In general.* 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 nondiscrimination tests of sections 401(k), paragraph (b)(1) of this section, section 401(m)(2) and § 1.401(m)–1(b) 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).

(B) *Application of section 401(a)(4) to certain plans.* 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 that automatically satisfies the requirements of section 410(b). *See* §§ 1.401(a)(4)–(c)(5) and 1.410(b)–2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof). *See* sections 401(a)(5) and 410(c)(1)(A).

(v) *Example.* The following example illustrates the application of this paragraph (a)(5):

Example. (i) For the 2006 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement do not satisfy the nondiscrimination test of section 401(k) and paragraph (b) of this section.

(ii) 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 paragraph (a)(5)(ii) of this section. Under paragraph (a)(5)(iii) of this section and under § 1.402(a)–1(d)(1), however, the elective contributions are includible in each employee's gross income.

(6) *Rules applicable to cash or deferred arrangements of self-employed individuals*—(i) *Application of general rules.* Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, 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. Consistent with § 1.402(a)–1(d), the elective contributions under such an arrangement are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement (*i.e.*, the requirements of section 401(k) and this section are satisfied). 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) *Treatment of matching contributions made on behalf of self-employed individuals.* Under section 402(g)(8), matching contributions made on behalf of a self-employed individual are not treated as elective contributions made pursuant to a cash or deferred election, without regard to whether such matching contributions indirectly permit individual partners to vary the amount of contributions made on their behalf.

(iii) *Timing of self-employed individual's cash or deferred election.* For purposes of paragraph (a)(3)(iv) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year and a sole proprietor's compensation is deemed currently available on the last day of the individual's taxable year. Accordingly, a self-employed individual may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship taxable year after the last day of that year. See § 1.401(k)–2(a)(4)(ii) for the rules regarding when these contributions are treated as allocated.

(iv) *Special rule for certain payments to self-employed individuals.* For purposes of sections 401(k) and 401(m), the earned income of a self-employed individual for a taxable year constitutes payment for services during that year. Thus, for example, if a partnership provides for cash advance payments during the taxable year to be made to a partner based on the value of the partner's services prior to the date of payment (and which do not exceed a reasonable estimate of the partner's earned income for the taxable year), a contribution of a portion of these payments to a profit sharing plan in accordance with an election to defer the portion of the advance payments does not fail to be made pursuant to a cash or deferred election within the meaning of paragraph (a)(3)(iii) of this section merely because the contribution is made before the amount of the partner's earned income is finally determined and reported. However, see §1.401(k)–2(a)(4)(ii) for rules on when earned income is treated as received.

(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 cash or deferred arrangement (including any employees taken into account for purposes of section 410(b) pursuant to §1.401(a)(4)–11(g)(3)(vii)(A)) satisfies the requirements of section 410(b) (including the average benefit percentage test, if applicable); and

(ii) The cash or deferred arrangement satisfies—

(A) The ADP test of section 401(k)(3) described in §1.401(k)–2;

(B) The ADP safe harbor provisions of section 401(k)(12) described in §1.401(k)–3; or

(C) The ADP safe harbor provisions of section 401(k)(13) described in §1.401(k)–3; or

(D) The SIMPLE 401(k) provisions of section 401(k)(11) described in §1.401(k)–4.

(2) *Automatic satisfaction by certain plans.* Notwithstanding paragraph (b)(1) of this section, a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof) shall be treated as meeting the requirements of this paragraph (b).

(3) *Anti-abuse provisions.* This section and §§1.401(k)–2 through 1.401(k)–6 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring*—(i) *In general.* This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans and cash or deferred arrangements for purposes of this section, and §§1.401(k)–2 through 1.401(k)–6.

(ii) *Aggregation of cash or deferred arrangements within a plan.* Except as otherwise specifically provided in this paragraph (b)(4), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement and a plan must apply a single test under paragraph (b)(1)(ii) of this section with respect to all such arrangements within the plan. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, all contributions under both cash or deferred arrangements must be treated as made under a single cash or deferred arrangement subject to a single test, even if they have significantly different features, such as different limits on elective contributions.

(iii) *Aggregation of plans*—(A) *In general.* For purposes of this section and §§1.401(k)–2 through 1.401(k)–6, 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), as modified by paragraph (b)(4)(v) 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 sections 401(k) and (m).

(B) *Plans with inconsistent ADP testing methods.* Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all cash or deferred arrangements under a plan. Thus, in applying the permissive aggregation rules of § 1.410(b)–7(d), an employer may not aggregate plans (within the meaning of § 1.410(b)–7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of § 1.410(b)–7(b)) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of § 1.410(b)–7(b)) using the ADP safe harbor provisions of section 401(k)(12) and another plan that is using the ADP test of section 401(k)(3).

(iv) *Disaggregation of plans and separate testing*—(A) *In general.* If a cash or deferred arrangement is included in a plan (within the meaning of § 1.410(b)–7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the cash or deferred arrangement must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a cash or deferred arrangement are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(k), unless the employer is applying the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) with respect to the plan. Similarly, if a cash or deferred arrangement under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the arrangement must be treated as two separate arrangements, one comprising all eligible employees who have met the age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the age and service requirements under section 410(a)(1), unless the plan is using the rule in § 1.401(k)–2(a)(1)(iii)(A).

(B) *Restructuring prohibited.* 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).

(v) *Modifications to section 410(b) rules*—(A) *Certain disaggregation rules not applicable.* The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in § 1.410(b)–7(c)(1) and ESOP and non-ESOP portions of a plan set forth in § 1.410(b)–7(c)(2) shall not apply for purposes of this section and §§ 1.401(k)–2 through 1.401(k)–6. Accordingly, notwithstanding § 1.410(b)–7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of section 414(l), as described in § 1.410(b)–7(b)) are permitted to be aggregated for these purposes.

(B) *Permissive aggregation of collective bargaining units.* Notwithstanding the general rule under section 410(b) and § 1.410(b)–7(c) that 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 the collective bargaining unit is treated as comprising separate plans, an employer can treat two or more separate collective bargaining units as a single collective bargaining unit for purposes of this section and §§ 1.401(k)–2 through 1.401(k)–6, 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 (*e.g.*, 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.* Notwithstanding §1.410(b)–7(c)(4)(ii)(C), 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 (b)(4)(v)(B) of this section (including the permissive 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 that 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 noncollectively bargaining unit employees who benefit under the plan are employed by one or more employers.

(vi) *Examples.* The following examples illustrate the application of this paragraph (b)(4):

Example 1. (i) Employer A maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. For purposes of applying section 410(b), Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(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).

(ii) Under these facts, the requirements of this section and §§1.401(k)–2 through 1.401(k)–6 must be applied on an employer-wide rather than a qualified separate line of business basis.

Example 2. (i) Employer B maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer B are eligible to participate. For purposes of applying section 410(b), the plan treats the cash or deferred arrangement as two separate plans, one for the employees who have completed the minimum age and service eligibility conditions under section 410(a)(1) and the other for employees who have not completed the conditions. The plan provides that it will satisfy the section 401(k) safe harbor requirement of §1.401(k)–3 with respect to the employees who have met the minimum age and service conditions and that it will meet the ADP test requirements of §1.401(k)–2 with respect to the employees who have not met the minimum age and service conditions.

(ii) Under these facts, the cash or deferred arrangement must be disaggregated on a consistent basis with the disaggregation of Plan W. Thus, the requirements of §1.401(k)–2 must be applied by comparing the ADP for eligible HCEs who have not completed the minimum age and service conditions with the ADP for eligible NHCEs for the applicable year who have not completed the minimum age and service conditions.

Example 3. (i) Employer C maintains Plan X, a stock-bonus plan including an ESOP. The plan also includes a cash or deferred arrangement for participants in the ESOP and non-ESOP portions of the plan.

(ii) Pursuant to paragraph (b)(4)(v)(A) of this section the ESOP and non-ESOP portions of the stock-bonus plan are a single cash or deferred arrangement for purposes of this section and §§1.401(k)–2 through 1.401(k)–6. However, as provided in paragraph (a)(4)(iv)(C) of this section, the ESOP and non-ESOP portions of the plan are still treated as separate plans for purposes of satisfying the requirements of section 410(b).

(c) *Nonforfeitability requirements*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (c) only if the amount attributable to an employee's elective contributions are immediately nonforfeitable, within the meaning of paragraph (c)(2) of this section, are disregarded for purposes of applying section 411(a)(2) to other contributions or benefits, and the contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Definition of immediately nonforfeitable.* An amount is immediately nonforfeitable if it 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. An amount that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(3) *Example.* The following example illustrates the application of this paragraph (c):

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. All employees participating in the plan have a nonforfeitable right to a percentage of their account balance derived from all contributions (including elective contributions) 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) The cash or deferred arrangement does not satisfy paragraph (c) of this section because elective contributions are not immediately nonforfeitable. Thus, the cash or deferred arrangement is a nonqualified cash or deferred arrangement.

(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 additional requirements of paragraphs (d)(2) through (5) of this section (to the extent applicable)—

(i) The employee's death, disability, or severance from employment;

(ii) In the case of a profit-sharing, stock bonus or rural cooperative plan, the employee's attainment of age 59½, or the employee's hardship; or

(iii) The termination of the plan.

(2) *Rules applicable to distributions upon severance from employment.* An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee.

(3) *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 if and 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.

(ii) *Limit on maximum distributable amount*—(A) *General rule.* A distribution on account of hardship must be limited to the maximum distributable amount. The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions. Thus, the maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered under paragraph (d)(3)(ii)(B) of this section.

(B) *Grandfathered amounts.* If the plan so provides, the maximum distributable amount may be increased for amounts 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 in the case of a collectively bargained plan, the earlier of—

(*1*) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986 terminates (determined without regard to any extension thereof after February 28, 1986); or

(*2*) January 1, 1991 and consisting of—

(*i*) Income allocable to elective contributions;

(*ii*) Qualified nonelective contributions and allocable income; and

(*iii*) Qualified matching contributions and allocable income.

(iii) *Immediate and heavy financial need*—(A) *In general*. Whether an employee has an immediate and heavy financial need is to be determined based on all the 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) *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 (or necessary to obtain) medical care that would be deductible under section 213(d) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);

(*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 up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2) and (d)(1)(B));

(*4*) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

(*5*) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(d)(1)(B)); or

(*6*) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

(iv) *Distribution necessary to satisfy financial need*—(A) *Distribution may not exceed amount of need*. A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need. For this purpose, the amount required to satisfy the 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.

(B) *No alternative means available*. A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all the relevant facts and circumstances. For purposes of this paragraph (d)(3)(iv), 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 (or comparable State law) is not treated as a resource of the employee.

(C) *Employer reliance on employee representation*. For purposes of paragraph (d)(3)(iv)(B) of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's representation (made in writing or such other form as may be prescribed by the Commissioner), 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;

(*4*) By other currently available distributions (including distribution of ESOP dividends under section 404(k)) and nontaxable (at the time of the loan) loans, under plans maintained by the employer or by any other employer; or

(*5*) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) *Employee need not take counterproductive actions.* For purposes of this paragraph (d)(3)(iv), a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) of this section 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.

(E) *Distribution deemed necessary to satisfy immediate and heavy financial need.* A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied—

(*1*) The employee has obtained all other currently available distributions (including distribution of ESOP dividends under section 404(k), but not hardship distributions) and nontaxable (at the time of the loan) loans, under the plan and all other plans maintained by the employer; and

(*2*) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) *Definition of other plans.* For purposes of paragraph (d)(3)(iv)(C)(*4*) and (E)(*1*) of this section, the phrase *plans maintained by the employer* means all qualified and nonqualified plans of deferred compensation maintained by the employer, including 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 or a health or welfare benefit plan (including one that is part of a cafeteria plan). In addition, for purposes of paragraph (d)(3)(iv)(E)(*2*) of this section, the phrase *plans maintained by the employer* also includes a stock option, stock purchase, or similar plan maintained by the employer. See §1.401(k)–6 for the continued treatment of suspended employees as eligible employees.

(v) *Commissioner may expand standards.* The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (*see* §601.601(d)(2) of this chapter), expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.

(4) *Rules applicable to distributions upon plan termination*—(i) *No alternative defined contribution plan.* A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains an alternative defined contribution plan. For purposes of the preceding sentence, the definition of the term ''employer'' contained in §1.401(k)–6 is applied as of the date of plan termination, and a plan is an alternative defined contribution plan only if it is a defined contribution plan that 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. However, if at all times

during the 24-month period beginning 12 months before the date of plan termination, fewer than 2% 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 an alternative defined contribution plan. In addition, a defined contribution plan is not treated as an alternative defined contribution plan if it is an employee stock ownership plan as defined in section 4975(e)(7) or 409(a), a simplified employee pension as defined in section 408(k), a SIMPLE IRA plan as defined in section 408(p), a plan or contract that satisfies the requirements of section 403(b), or a plan that is described in section 457(b) or (f).

(ii) *Lump sum requirement for certain distributions.* A distribution may be made under paragraph (d)(1)(iii) of this section only if it is a lump sum distribution. The term lump sum distribution has the meaning provided in section 402(e)(4)(D) (without regard to section 402(e)(4)(D)(i)(I), (II), (III) and (IV)). In addition, a lump sum distribution includes a distribution of an annuity contract from a trust that is part of a plan described in section 401(a) and which is exempt from tax under section 501(a) or an annuity plan described in 403(a).

(5) *Rules applicable to all distributions*—(i) *Exclusive distribution rules.* 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). Pursuant to section 401(k)(8), the prohibition on distributions set forth in this section does not apply to a distribution of excess contributions under §1.401(k)–2(b).

(ii) *Deemed distributions.* The cost of life insurance (determined under section 72) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph (d). 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 paragraph (d) generally continue to apply to amounts attributable to elective contributions (including QNECs and qualified matching contributions taken into account for the ADP test under §1.401(k)–2(a)(6)) 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). In addition, a cash or deferred arrangement fails to satisfy the limitations of this paragraph (d) if it transfers amounts to a plan that does not provide that the transferred amounts may not be distributed before the times specified in this paragraph (d). The transferor plan does not fail to comply with the preceding sentence if it reasonably concludes that the transferee plan provides that the transferred amounts may not be distributed before the times specified in this paragraph (d). What constitutes a basis for a reasonable conclusion is determined under standards comparable to those under the rules related to acceptance of rollover distributions. See §1.401(a)(31)–1, A–14. The limitations of this paragraph (d) 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 this paragraph (d) also do not apply to amounts that have been paid in a direct rollover to the plan after being distributed by another plan.

(6) *Examples*. The following examples illustrate the application of this paragraph (d):

Example 1. Employer M maintains Plan V, 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 cash or deferred arrangement is a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. (i) Employer N maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement. Plan W provides for distributions upon a participant's severance from employment, death or disability. All employees of Employer N and its wholly owned subsidiary, Employer O, are eligible to participate in Plan W. Employer N agrees to sell all issued and outstanding shares of Employer O to an unrelated entity, Employer T, effective on December 31, 2006. Following the transaction, Employer O will be a wholly owned subsidiary of Employer T. Additionally, individuals who are employed by Employer O on the effective date of the sale continue to be employed by Employer O following the sale. Following the transaction, all employees of Employer O will cease to participate in Plan W and will become eligible to participate in the cash or deferred arrangement maintained by Employer T, Plan X. No assets will be transferred from Plan W to Plan X, except in the case of a direct rollover within the meaning of section 401(a)(31).

(ii) Employer O ceases to be a member of Employer N's controlled group as a result of the sale. Therefore, employees of Employer O who participated in Plan W will have a severance from employment and are eligible to receive a distribution from Plan W.

Example 3. (i) Employer Q maintains Plan Y, a profit-sharing plan that includes a cash or deferred arrangement. Plan Y, the only plan maintained by Employer Q, does not provide for loans. However, Plan Y provides that elective contributions under the arrangement may be distributed to an eligible employee on account of hardship using the deemed immediate and heavy financial need provisions of paragraph (d)(3)(iii)(B) of this section and provisions regarding distributions necessary to satisfy financial need of paragraphs (d)(3)(iv)(A) through (D) of this section. Employee A is an eligible employee in Plan Y with an account balance of $50,000 attributable to elective contributions made by Employee A. The total amount of elective contributions made by Employee A, who has not previously received a distribution from Plan Y, is $20,000. Employee A requests a $15,000 hardship distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent. At the time of the distribution request, the sole asset of Employee A (that is reasonably available to Employee A within the meaning of paragraph (d)(3)(iv)(B) of this section) is a savings account with an available balance of $10,000.

(ii) 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. Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependent is deemed to be on account of an immediate and heavy financial need of Employee A.

(iii) A distribution is treated as necessary to satisfy Employee A's immediate and heavy financial need to the extent the need may not be relieved from other resources reasonably available to Employee A. Under paragraph (d)(3)(iv)(B) of this section, Employee A's $10,000 savings account is a resource that is reasonably available to the employee and must be taken into account in determining the amount necessary to satisfy Employee A's immediate and heavy financial need. Thus, Employee A may receive a distribution of only $5,000 of his elective contributions on account of this hardship, plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 4. (i) The facts are the same as in *Example 3*. Employee B, another employee of Employer Q has an account balance of $25,000, attributable to Employee B's elective contributions. The total amount of elective contributions made by Employee B, who has not previously received a distribution from Plan Y, is $15,000. Employee B requests a $10,000 distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his child. Employee B makes a written representation (with respect to which Employer Q has no actual knowledge to the contrary) that the need cannot reasonably be relieved:

(A) Through reimbursement or compensation by insurance or otherwise;

(B) By liquidation of the employee's assets;

(C) By cessation of elective contributions or employee contributions under the plan;

(D) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or

(E) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee B's child is deemed to be on account of an Employee B's immediate and heavy financial need. In addition, because Employer Q can rely on Employee B's written representation, the distribution is considered necessary to satisfy Employee B's immediate and heavy financial need. Therefore, Employee B may receive a $10,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 5. (i) The facts are the same as in *Example 3*, except Plan Y provides for hardship distributions using the safe harbor rule of paragraph (d)(3)(iv)(E) of this section. Accordingly, Plan Y provides for a 6 month suspension of an eligible employee's elective contributions and employee contributions to the plan after the receipt of a hardship distribution by such eligible employee.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependent is deemed to be on account of an Employee A's immediate and heavy financial need. In addition, because Employee A is not eligible for any other distribution or loan from Plan Y and Plan Y suspends Employee A's elective contributions and employee contributions following receipt of the hardship distribution, the distribution will be deemed necessary to satisfy Employee A's immediate and heavy financial need (and Employee A is not required to first liquidate his savings account). Therefore, Employee A may receive a $15,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 6. Employer R maintains a pre-ERISA money purchase pension plan that includes a cash or deferred arrangement that is not a rural cooperative plan. 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 permissible distribution event only in a profit-sharing, stock bonus or rural cooperative plan. Since elective contributions under the arrangement may be distributed before a permissible 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 money purchase 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 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. However, except as expressly permitted under section 401(m), 410(b)(2)(A)(ii) or 416(c)(2)(A), elective contributions and matching contributions taken into account under §1.401(k)–2(a) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the contributions are made) satisfy the requirements of section 401(a).

(2) *Election requirements*—(i) *Cash must be available*. 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, but

would be treated as a matching contribution. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(ii) *Frequency of elections.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

(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 contributions and withdrawals are attributed to the separate accounts and gains, losses, 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. The separate accounting requirement of this paragraph (e)(3)(i) applies at the time the elective contribution is contributed to the plan and continues to apply until the contribution is distributed under the plan.

(ii) *Satisfaction of 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 qualified cash or deferred arrangement (and, if applicable, under another plan to which QNECs and QMACs are made) are subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments*—(i) *General rule.* A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted after May 6, 1986, by a State or local government or political subdivision thereof, or any agency or instrumentality thereof (a governmental unit). 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.

(ii) *Rural cooperative plans and Indian tribal governments.* This paragraph (e)(4) does not apply to a rural cooperative plan or to a plan of an employer which is an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State or tribal law which is owned in whole or in part by any of the entities in this paragraph (e)(4)(ii).

(iii) *Adoption after May 6, 1986.* A cash or deferred arrangement is treated as adopted after May 6, 1986, with respect to all employees of any employer that adopts the arrangement after such date.

(iv) *Adoption before May 7, 1986.* 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. If an employer adopted an arrangement prior to such date, all employees of the employer may participate in the arrangement.

(5) *One-year eligibility requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service with the employer maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to section 410(a)(1)(B)(i)) to be eligible to make a cash or deferred election under the arrangement.

(6) *Other benefits not contingent upon elective contributions*—(i) *General rule.* 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—

(A) Any matching contribution (as defined in §1.401(m)–1(a)(2)) made by reason of such an election;

(B) Any benefit, right or feature (such as a plan loan) that requires, or results in, an amount to be withheld from an employee's pay (*e.g.* to pay for the benefit or to repay the loan), to the extent the cash or deferred arrangement restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes);

(C) Any reduction in the employer's top-heavy contributions under section 416(c)(2) because of matching contributions that resulted from the elective contributions; or

(D) 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.* For purposes of this paragraph (e)(6), other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective 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, bonuses or other cash remuneration (other than the amount that would be contributed under 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. Additionally, 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.* Any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 (88 Stat. 829), Public Law 93–406, that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent. 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.

(iv) *Nonqualified deferred compensation.* Except as otherwise provided in paragraph (e)(6)(iii) of this section, participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) 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.

(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 following examples illustrate the application of this paragraph (e)(6):

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% 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% 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 this paragraph (e)(6).

(7) *Plan provision requirement.* A plan that includes a cash or deferred arrangement satisfies this paragraph (e) only if it provides that the nondiscrimination requirements of section 401(k) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1)(ii) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3), as described in paragraph (b)(1)(ii)(A) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(k)(12), as described in paragraph (b)(1)(ii)(B) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. In addition, a plan that uses the safe harbor method of section 401(k)(13), as described in paragraph (b)(1)(ii)(C) of this section, must specify the default percentages that apply for the plan year and whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution, and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (e)(7), a plan may incorporate by reference the provisions of section 401(k)(3) and §1.401(k)–2 if that is the nondiscrimination test being applied. The Commissioner may, in guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), specify the options that will apply under the plan if the nondiscrimination test is incorporated by reference in accordance with the preceding sentence.

(8) *Section 415 compensation required.* With respect to compensation that is paid (or would have been paid but for a cash or deferred election) in plan years beginning on or after July 1, 2007, a cash or deferred arrangement satisfies this paragraph (e) only if cash or deferred elections can only be made with respect to amounts that are compensation within the meaning of section 415(c)(3) and §1.415(c)–2. Thus, for example, the arrangement is not a qualified cash or deferred arrangement if an eligible employee who is not in qualified military service (as that term is defined in section 414(u)) and who is not permanently and totally disabled (as defined in section 22(e)(3)) can make a cash or deferred election with respect to an amount paid after severance from employment, unless the amount is paid by the later of 2½ months after severance from employment or the end of the year that includes the date of severance from employment and is described in §1.415(c)–2(e)(3)(ii) or (iii).

(f) *Special rules for designated Roth contributions*—(1) *In general.* The term designated Roth contribution means an elective contribution under a qualified cash or deferred arrangement that, to the extent permitted under the plan, is—

(i) Designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan;

(ii) Treated by the employer as not excludible from the employee's gross income (in accordance with paragraph (f)(2) of this section);

(iii) Maintained by the plan in a separate account (in accordance with paragraph (f)(3) of this section).

(2) *Inclusion treatment.* An elective contribution is generally treated as not excludible from gross income if it is treated as includible in gross income by the employer (e.g., by treating the contribution as wages subject to applicable income tax withholding). However, in the case of a self-employed individual, an elective contribution is treated as not excludible from gross income only if the individual does not claim a deduction for such amount. If an elective contribution would not have been includible in gross income if the amount had been paid directly to the employee (rather than being subject to a cash or deferral election), the elective contribution is nevertheless permitted to be a designated Roth contribution, provided the employee is entitled to treat the amount as an investment in the contract pursuant to section 72(f)(2).

(3) *Separate accounting required.* Under the separate accounting requirement of this paragraph (f)(3), contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account maintained for the employee and the plan must maintain a record of the employee's investment in the contract (that is, designated Roth contributions that have not been distributed) with respect to the employee's designated Roth account. In addition, gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan. However, forfeitures may not be allocated to the designated Roth account and no contributions other than designated Roth contributions and rollover contributions described in section 402A(c)(3)(B) may be allocated to such account. The separate accounting requirement applies at the time the designated Roth contribution is contributed to the plan and must continue to apply until the designated Roth account is completely distributed. A–13 of §1.402A–1 for additional requirements for separate accounting.

(4) *Designated Roth contributions must satisfy rules applicable to elective contributions*—(i) *In general.* A designated Roth contribution must satisfy the requirements applicable to elective contributions made under a qualified cash or deferred arrangement. Thus, for example, a designated Roth contribution must satisfy the requirements of paragraphs (c) and (d) of this section and is treated as an employer contribution for purposes of sections 401(a), 401(k), 402, 404, 409, 411, 412, 415, 416 and 417. In addition, the designated Roth contributions are treated as elective contributions for purposes of the ADP test. Similarly, the designated Roth account under the plan is subject to the rules of section 401(a)(9)(A) and (B) in the same manner as an account that contains pre-tax elective contributions.

(ii) *Special rules for direct rollovers.* A direct rollover from a designated Roth account under a qualified cash or deferred arrangement may only be made to another designated Roth account under an applicable retirement plan described in section 402A(e)(1) or to a Roth IRA described in section 408A, and only to the extent the rollover is permitted under the rules of section 402(c). Moreover, a participant's designated Roth account and the participant's other accounts under a plan are treated as accounts held under two separate plans (within the meaning of section 414(l)) for purposes of applying the automatic rollover rules for mandatory distributions under section 401(a)(31)(B)(i)(I) and the special rules in A–9 through A–11 of §1.401(a)(31)–1.

(5) *Rules regarding designated Roth contribution elections*—(i) *Frequency of elections.* The rules under paragraph (e)(2)(ii) of this section regarding frequency of elections apply in the same manner to both pre-tax elective contributions and designated Roth contributions. Thus, an employee must have an effective opportunity to make (or change) an election to make designated Roth contributions at least once during each plan year.

(ii) *Default elections*—(A) In the case of a plan that provides for both pre-tax elective contributions and designated Roth contributions and in which, under paragraph (a)(3)(ii) of this section, the default in the absence of an affirmative election is to make a contribution under the cash or deferred arrangement, the plan terms must provide the extent to which the default contributions are pre-tax elective contributions and the extent to which the default contributions are designated Roth contributions.

(B) If the default contributions under the plan are designated Roth contributions, then an employee who has not made an affirmative election is deemed to have irrevocably designated the contributions (in accordance with section 402A(c)(1)(B)) as designated Roth contributions.

(6) *Effective date.* Section 402A and the provisions of this section 1.401(k)–1(f) apply to taxable years beginning after December 31, 2005.

(g) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (g), this section and §§1.401(k)–2 through 1.401(k)–6 apply to plan years that begin on or after January 1, 2006.

(2) *Early implementation permitted.* A plan is permitted to apply the rules of this section and §§1.401(k)–2 through 1.401(k)–6 to any plan year that ends after December 29, 2004, provided the plan applies all the rules of this section and §§1.401(k)–2 through 1.401(k)–6 and all the rules of §§1.401(m)–1 through 1.401(m)–5, to the extent applicable, for that plan year and all subsequent plan years.

(3) *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 in effect on the date described in paragraph (g)(1) of this section, the provisions of this section and §§1.401(k)–2 through 1.401(k)–6 apply to the later of the first plan year beginning after the termination of the last such agreement or the first plan year described in paragraph (g)(1) of this section.

(4) *Applicability of prior regulations.* For any plan year before a plan applies this section and §§1.401(k)–2 through 1.401(k)–6 (either the first plan year beginning on or after January 1, 2006, or such earlier year, as provided in paragraph (g)(2) of this section), §1.401(k)–1 (as it appeared in the April 1, 2004 edition of 26 CFR part 1) applies to the plan to the extent that section, as it so appears, reflects the statutory provisions of section 401(k) as in effect for the relevant year.

[T.D. 9169, 69 FR 78154, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 9 Jan. 3, 2006; T.D. 9319, 72 FR 16894, Apr. 5, 2007; T.D. 9324, 72 FR 21109, Apr. 30, 2007; T.D. 9447, 74 FR 8207, Feb. 24, 2009]

§ 1.401(k)–2 ADP test.

(a) *Actual deferral percentage (ADP) test*—(1) *In general*—(i) *ADP test formula.* A cash or deferred arrangement satisfies the ADP test for a plan year only if—

(A) The ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ADP for the eligible HCEs for the plan year over the ADP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees.* If, for the applicable year for determining the ADP of the NHCEs for a plan year, there are no eligible NHCEs (*i.e.*, all of the eligible employees under the cash or deferred arrangement for the applicable year are HCEs), the arrangement is deemed to satisfy the ADP test for the plan year.

(iii) *Special rule for early participation.* If a cash or deferred arrangement provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the cash or deferred arrangement meets the requirements of section 410(b)(1), then in determining whether the arrangement meets the requirements under paragraph (a)(1) of this section, either—

(A) Pursuant to section 401(k)(3)(F), the ADP test is performed under the plan (determined without regard to disaggregation under §1.410(b)–7(c)(3)), using the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(k)–1(b)(4), the plan is disaggregated into separate plans and the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ADP*—(i) *General rule.* The ADP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ADRs of the eligible employees in that group for that year. The ADP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method.* The ADP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ADP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ADP test is being performed. Under the prior year testing method, the ADP for the eligible NHCEs is determined using the ADRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ADP test is being calculated. Under the current year testing method, the applicable year for determining the ADP for the eligible NHCEs is the same plan year as the plan year for which the ADP test is being performed. Under either method, the ADP for eligible HCEs is the average of the ADRs of the eligible HCEs for the plan year for which the ADP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ADR*—(i) *General rule.* The ADR of an eligible employee for a plan year or applicable year is the sum of the employee's elective contributions taken into account with respect to such employee for the year, determined under the rules of paragraphs (a)(4) and (5) of this section, and the qualified nonelective contributions and qualified matching contributions taken into account with respect to such employee under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ADR is calculated to the nearest hundredth of a percentage point. If no elective contributions, qualified nonelective contributions, or qualified matching contributions are taken into account under this section with respect to an eligible employee for the year, the ADR of the employee is zero.

(ii) *ADR of HCEs eligible under more than one arrangement*—(A) *General rule.* Pursuant to section 401(k)(3)(A), the ADR of an HCE who is an eligible employee in more than one cash or deferred arrangement of the same employer is calculated by treating all contributions with respect to such HCE under any such arrangement as being made under the cash or deferred arrangement being tested. Thus, the ADR for such an HCE is calculated by accumulating all contributions under any cash or deferred arrangement (other than a cash or deferred arrangement described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the cash or deferred arrangement under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ADR for the plan year of that plan for an HCE who participates in multiple cash or deferred arrangements of the same employer is the sum of all contributions during such 12-month period that would be taken into account with respect to the HCE under all such arrangements in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(k)–3.

(B) *Plans not permitted to be aggregated.* Cash or deferred arrangements under plans that are not permitted to be aggregated under §1.401(k)–1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(k)–1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)–7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

Example 1. (i) Employee A, an HCE with compensation of $120,000, is eligible to make elective contributions under Plan S and Plan T, two profit-sharing plans maintained by Employer H with calendar year plan years, each of which includes a cash or deferred arrangement. During the current plan year, Employee A makes elective contributions of $6,000 to Plan S and $4,000 to Plan T.

(ii) Under each plan, the ADR for Employee A is determined by dividing Employee A's total elective contributions under both arrangements by Employee A's compensation taken into account under the plan for the year. Therefore, Employee A's ADR under each plan is 8.33% ($10,000/$120,000).

Example 2. (i) The facts are the same as in *Example 1*, except that Plan T defines compensation (for deferral and testing purposes) to exclude all bonuses paid to an employee. Plan S defines compensation (for deferral and testing purposes) to include bonuses paid to an employee. During the current year, Employee A's compensation included a $10,000 bonus. Therefore, Employee A's compensation under Plan T is $110,000 and Employee A's compensation under Plan S is $120,000.

(ii) Employee A's ADR under Plan T is 9.09% ($10,000/$110,000) and under Plan S, Employee A's ADR is 8.33% ($10,000/$120,000).

Example 3. (i) Employer J sponsors two profit-sharing plans, Plan U and Plan V, each of which includes a cash or deferred arrangement. Plan U's plan year begins on July 1 and ends on June 30. Plan V has a calendar year plan year. Compensation under both plans is limited to the participant's compensation during the period of participation. Employee B is an HCE who participates in both plans. Employee B's monthly compensation and elective contributions to each plan for the 2005 and 2006 calendar years are as follows:

Calendar year	Monthly compensation	Monthly elective contribution to Plan U	Monthly elective contribution to Plan V
2005	$10,000	$500	$400
2006	11,500	700	550

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and Plan V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($900 × 6) + ($1,250 × 6)) / (($10,000 × 6) + ($11,500 × 6)), or 10%.

(iii) Under Plan V, Employee B's ADR for the plan year ended December 31, 2005, is equal to total elective contributions under Plan U and V for the plan year ending December 31, 2005, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan V for the plan year ending December 31, 2005, is ($10,800/$120,000), or 9%.

Example 4. (i) The facts are the same as *Example 3*, except that Employee B first becomes eligible to participate in Plan U on January 1, 2006.

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($400 × 6) + ($1,250 × 6)) / (($10,000 × 6) + ($11,500 × 6)), or 7.67%.

(4) *Elective contributions taken into account under the ADP test*—(i) *General rule.* An elective contribution is taken into account in determining the ADR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied—

(A) The elective contribution is allocated to the eligible employee's account under the plan as of a date within that year. For purposes of this rule, an elective contribution is considered allocated as of a date within a year only if—

(*1*) The allocation is not contingent on 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 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 year but for the employee's election to defer under the arrangement; or

(*2*) Is attributable to services performed by the employee in the year and, but for the employee's election to defer, would have been received by the employee within 2½ months after the close of the year, but only if the plan provides for elective contributions that relate to compensation that would have been received after the close of a year to be allocated to such prior year rather than the year in which the compensation would have been received.

(ii) *Elective contributions for partners and self-employed individuals.* For purposes of this paragraph (a)(4), a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year and a sole proprietor's compensation is treated as received on the last day of the individual's taxable year. Thus, an elective contribution made on behalf of a partner or sole proprietor 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 (a)(4)(i) of this section are met.

(iii) *Elective contributions for HCEs.* Elective contributions of an HCE must include any excess deferrals, as described in §1.402(g)–1(a), even if those excess deferrals are distributed, pursuant to §1.402(g)–1(e).

(5) *Elective contributions not taken into account under the ADP test*—(i) *General rule.* Elective contributions that do not satisfy the requirements of paragraph (a)(4)(i) of this section may not be taken into account in determining the ADR of an eligible employee for the plan year or applicable 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 ADP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. *See* §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Elective contributions for NHCEs.* Elective contributions of an NHCE shall not include any excess deferrals, as described in §1.402(g)–1(a), to the extent the excess deferrals are prohibited under section 401(a)(30). However, to the extent that the excess deferrals are not prohibited under section 401(a)(30), they are included in elective contributions even if distributed pursuant to §1.402(g)–1(e).

(iii) *Elective contributions treated as catch-up contributions.* Elective contributions that are treated as catch-up contributions under section 414(v) because they exceed a statutory limit or employer-provided limit (within the meaning of §1.414(v)–1(b)(1)) are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions were made, or for any other plan year.

(iv) *Elective contributions used to satisfy the ACP test.* Except to the extent necessary to demonstrate satisfaction of the requirement of §1.401(m)–2(a)(6)(ii), elective contributions taken into account for the ACP test under §1.401(m)–2(a)(6) are not taken into account under paragraph (a)(4) of this section.

(v) *Additional elective contributions pursuant to section 414(u).* Additional elective contributions made pursuant to section 414(u) by reason of an eligible employee's qualified military service are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions are made, or for any other plan year.

(vi) *Default elective contributions pursuant to section 414(w).* Default elective contributions made under an eligible automatic contribution arrangement (within the meaning of §1.414(w)–1(b)) that are distributed pursuant to §1.414(w)–1(c) for plan years beginning on or after January 1, 2008, are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions are made, or for any other plan year.

(6) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the ADP*

test. Qualified nonelective contributions and qualified matching contributions may be taken into account in determining the ADR for an eligible employee for a plan year or applicable year but only to the extent the contributions satisfy the following requirements—

(i) *Timing of allocation.* The qualified nonelective contribution or qualified matching contribution is allocated to the employee's account as of a date within that year within the meaning of paragraph (a)(4)(i)(A) of this section. Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP for the eligible NHCEs for the applicable year, a qualified nonelective contribution or qualified matching contribution must be contributed no later than the end of the 12-month period immediately following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Requirement that amount satisfy section 401(a)(4).* The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under § 1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). *See* § 1.401(a)(4)–1(b)(2). The amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under § 1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). *See* § 1.401(a)(4)–1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in § 1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iii) *Aggregation must be permitted.* The plan that contains the cash or deferred arrangement and the plan or plans to which the qualified nonelective contributions or qualified matching contributions are made, are plans that would be permitted to be aggregated under § 1.401(k)–1(b)(4). If the plan year of the plan that contains the cash or deferred arrangement is changed to satisfy the requirement under § 1.410(b)–7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if such qualified nonelective contributions and qualified matching contributions could have been taken into account under an ADP test for a plan with the same short plan year.

(iv) *Disproportionate contributions not taken into account*—(A) *General rule.* Qualified nonelective contributions cannot be taken into account for a plan year for an NHCE to the extent such contributions exceed the product of that NHCE's compensation and the greater of 5% or two times the plan's representative contribution rate. Any qualified nonelective contribution taken into account under an ACP test under § 1.401(m)–2(a)(6) (including the determination of the representative contribution rate for purposes of § 1.401(m)–2(a)(6)(v)(B)), is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate under paragraph (a)(6)(iv)(B) of this section).

(B) *Definition of representative contribution rate.* For purposes of this paragraph (a)(6)(iv), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the plan year and who is employed by the employer on the last day of the plan year).

(C) *Definition of applicable contribution rate.* For purposes of this paragraph (a)(6)(iv), the applicable contribution rate for an eligible NHCE is the sum of the qualified matching contributions taken into account under this paragraph (a)(6) for the eligible NHCE for the plan year and the qualified nonelective contributions made for the eligible NHCE for the plan year, divided by the eligible NHCE's compensation for the same period.

(D) *Special rule for prevailing wage contributions.* Notwithstanding paragraph (a)(6)(iv)(A) of this section, qualified nonelective contributions that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act (46 Stat. 1494), Public Law 71–798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89–286, or similar legislation can be taken into account for a plan year for an NHCE to the extent such contributions do not exceed 10 percent of that NHCE's compensation.

(v) *Qualified matching contributions.* Qualified matching contributions satisfy this paragraph (a)(6) only to the extent that such qualified matching contributions are matching contributions that are not precluded from being taken into account under the ACP test for the plan year under the rules of §1.401(m)–2(a)(5)(ii).

(vi) *Contributions only used once.* Qualified nonelective contributions and qualified matching contributions cannot be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ADP test, any ACP test, or the requirements of §1.401(k)–3, 1.401(m)–3 or 1.401(k)–4. Thus, for example, matching contributions that are made pursuant to §1.401(k)–3(c) cannot be taken into account under the ADP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(k)–2(c), qualified nonelective contributions that are taken into account under the current year testing method for a year may not be taken into account under the prior year testing method for the next year.

(7) *Examples.* The following examples illustrate the application of this paragraph (a):

Example 1. (i) Employer X has three employees, A, B, and C. Employer X sponsors a profit-sharing plan (Plan Z) that includes a cash or deferred arrangement. Each year, Employer X determines a bonus attributable to the prior year. Under the cash or deferred arrangement, each eligible employee may elect to receive none, all or any part of the bonus in cash. X contributes the remainder to Plan Z. The portion of the bonus paid in cash, if any, is paid 2 months after the end of the plan year and thus is included in compensation for the following plan year. Employee A is an HCE, while Employees B and C are NHCEs. The plan uses the current year testing method and defines compensation to include elective contributions and bonuses paid during each plan year. In February of 2005, Employer X determined that no bonuses will be paid for 2004. In February of 2006, Employer X provided a bonus for each employee equal to 10% of regular compensation for 2005. For the 2005 plan year, A, B, and C have the following compensation and make the following elections:

Employee	Compensation	Elective contribution
A	$100,000	$4,340
B	60,000	2,860
C	45,000	1,250

(ii) For each employee, the ratio of elective contributions to the employee's compensation for the plan year is:

Employee	Ratio of elective contribution to compensation	ADR (percent)
A	$4,340/$100,000	4.34
B	2,860/60,000	4.77
C	1,250/45,000	2.78

(iii) The ADP for the HCEs (Employee A) is 4.34%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 4.34% is less than 4.73% (3.78% multiplied by 1.25), the plan satisfies the ADP test under paragraph (a)(1)(i) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except that elective contributions are made pursuant to a salary reduction agreement throughout the plan year, and no bonuses are paid. As provided by section 414(s)(2), Employer X includes elective contributions in compensation. During the year, B and C defer the same amount as in *Example 1*, but A defers $5,770. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Compensation	Elective contributions	ADR (percent)
A	$100,000	$5,770	5.77
B	60,000	2,860	4.77
C	45,000	1,250	2.78

(ii) The ADP for the HCEs (Employee A) is 5.77%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 5.77% exceeds 4.73% (3.78% × 1.25), the plan does not satisfy the ADP test under paragraph (a)(1)(i) of this section. However, because the ADP for the HCEs does not exceed the ADP for the NHCEs by more than 2 percentage points and the ADP for the HCEs does not exceed the ADP for the NHCEs multiplied by 2 (3.78% × 2 = 7.56%), the plan satisfies the ADP test under paragraph (a)(1)(ii) of this section.

Example 3. (i) Employees D through L are eligible employees in Plan T, a profit-sharing plan that contains a cash or deferred arrangement. The plan is a calendar year plan that uses the prior year testing method. Plan T provides that elective contributions are included in compensation (as provided under section 414(s)(2)). Each eligible employee may elect to defer up to 6% of compensation under the cash or deferred arrangement. Employees D and E are HCEs. The compensation, elective contributions, and ADRs of Employees D and E for the 2006 plan year are shown below:

Employee	Compensation for 2006 plan year	Elective contributions for 2006 plan year	ADR for 2006 plan year (percent)
D	$100,000	$10,000	10
E	95,000	4,750	5

(ii) During the 2005 plan year, Employees F through L were eligible NHCEs. The compensation, elective contributions and ADRs of Employees F through L for the 2005 plan year are shown in the following table:

Employee	Compensation for 2005 plan year	Elective contributions for 2005 plan year	ADR for 2005 plan year (percent)
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

(iii) The ADP for 2006 for the HCEs is 7.5%. Because Plan T is using the prior year testing method, the applicable year for determining the NHCE ADP is the prior plan year (*i.e.*, 2005). The NHCE ADP is determined using the ADRs for NHCEs eligible during the prior plan year (without regard to whether they are eligible under the plan during the plan year). The ADP for the NHCEs is 3.71% (the sum of the individual ADRs, 26%, divided by 7 employees). Because 7.5% exceeds 4.64% (3.71% × 1.25), Plan T does not satisfy the ADP test under paragraph (a)(1)(i) of this section. In addition, because the ADP for the HCEs exceeds the ADP for the NHCEs by more than 2 percentage points, Plan T does not satisfy the ADP test under paragraph (a)(1)(ii) of this section. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 4. (i) Plan U is a calendar year profit-sharing plan that contains a cash or deferred arrangement and uses the current year testing method. Plan U provides that elective contributions are included in compensation (as provided under section 414(s)(2)). The following amounts are contributed under Plan U for the 2006 plan year: QNECs equal to 2% of each employee's compensation; Contributions equal to 6% of each employee's compensation that are not immediately vested under the terms of the plan; 3% of each employee's compensation that the employee may elect to receive as cash or to defer under the plan. Both types of nonelective contributions are made for the HCEs (employees M and N) and the NHCEs (employees O through S) for the plan year and are contributed after the end of the plan year and before the end of the following plan year. In addition, neither type of nonelective contributions is used for any other ADP or ACP test.

(ii) For the 2006 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S are shown in the following table:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
M	$100,000	$3,000	3
N	100,000	2,000	2
O	60,000	1,800	3
P	40,000	0	0
Q	30,000	0	0
R	5,000	0	0
S	20,000	0	0

(iii) The elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section because the ADP for the HCEs, consisting of employees M and N, is 2.5% and the ADP for the NHCEs is 0.6%.

(iv) The 2% QNECs satisfies the timing requirement of paragraph (a)(6)(i) of this section because it is paid within 12-month after the plan year for which allocated. All nonelective contributions also satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section (because all employees receive an 8% nonelective contribution and the nonelective contributions excluding the QNECs is 6% for all employees). In addition, the QNECs are not disproportionate under paragraph (a)(6)(iv) of this section because no QNEC for an NHCE exceeds the product of the plan's applicable contribution rate (2%) and that NHCE's compensation.

(v) Because the rules of paragraph (a)(6) of this section are satisfied, the 2% QNECs may be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section. The 6% nonelective contributions, however, may not be taken into account because they are not QNECs.

(vi) If the 2% QNECs are taken into account, the ADP for the HCEs is 4.5%, and the actual deferral percentage for the NHCEs is 2.6%. Because 4.5% is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the cash or deferred arrangement satisfies the ADP test of section 401(k)(3) under paragraph (a)(1)(ii) of this section.

Example 5. (i) The facts are the same as *Example 4*, except the plan uses the prior year testing method. In addition, the NHCE ADP for the 2005 plan year (the prior plan year) is 0.8% and no QNECs are contributed for the 2005 plan year during 2005 or 2006.

(ii) In 2007, it is determined that the elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for 2006 because the 2006 ADP for the eligible HCEs, consisting of employees M and N, is 2.5% and the 2005 ADP for the eligible NHCEs is 0.8%. An additional QNEC of 2% of compensation is made for each eligible NHCE in 2007 and allocated for 2005.

(iii) The 2% QNECs that are made in 2007 and allocated for the 2005 plan year do not satisfy the timing requirement of paragraph (a)(6)(i) of this section for the applicable year for the 2005 plan year because they were not contributed before the last day of the 2006 plan year. Accordingly, the 2% QNECs do not satisfy the rules of paragraph (a)(6) of this section and may not be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for the 2006 plan year. The cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as *Example 4*, except that the ADP for the HCEs is 4.6% and there is no 6% nonelective contribution under the plan. The employer would like to take into account the 2% QNEC in determining the ADP for the NHCEs but not in determining the ADP for the HCEs.

(ii) The elective contributions alone fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (4.6%) exceeds 0.75% (0.6% × 1.25) and 1.2% (0.6% × 2).

(iii) The 2% QNECs may not be taken into account in determining the ADP of the NHCEs because they fail to satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section. This is because the amount of nonelective contributions, excluding those QNECs that would be taken into account under the ADP test, would be 2% of compensation for the HCEs and 0% for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 7. (i) The facts are the same as Example 6, except that Employee R receives a QNEC in an amount of $500 and no QNECs are made on behalf of the other employees.

(ii) If the QNEC could be taken into account under paragraph (a)(6) of this section, the ADP for the NHCEs would be 2.6% and the plan would satisfy the ADP test. The QNEC is disproportionate under paragraph (a)(6)(iv) of this section, and cannot be taken into account under paragraph (a)(6) of this section, to the extent it exceeds the greater of 5% and two times the plan's representative contribution rate (0%), multiplied by Employee R's compensation. The plan's representative contribution rate is 0% because it is the lowest applicable contribution rate among a group of NHCEs that is at least half of all NHCEs, or all the NHCEs who are employed on the last day of the plan year. Therefore, the QNEC may be taken into account under the ADP test only to the extent it does not exceed 5% times Employee R's compensation (or $250) and the cash or deferred arrangement fails to satisfy the ADP test and must correct under paragraph (b) of this section.

Example 8. (i) The facts are the same as in *Example 4* except that the plan changes from the current year testing method to the prior year testing method for the following plan year (2007 plan year). The ADP for the HCEs for the 2007 plan year is 3.5%.

(ii) The 2% QNECs may not be taken into account in determining the ADP for the NHCEs for the applicable year (2006 plan year) in satisfying the ADP test for the 2007 plan year because they were taken into account in satisfying the ADP test for the 2006 plan year. Accordingly, the NHCE ADP for the applicable year is 0.6%. The elective contributions for the plan year fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (3.5%) exceeds the ADP limit of 1.2% (the greater of 0.75% (0.6% × 1.25) and 1.2% (0.6% × 2)), determined using the applicable year ADP for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 9. (i)(A) Employer N maintains Plan X, a profit sharing plan that contains a cash or deferred arrangement and that uses the current year testing method. Plan X provides for employee contributions, elective contributions, and matching contributions. Matching contributions on behalf of NHCEs are qualified matching contributions (QMACs) and are contributed during the 2005 plan year. Matching contributions on behalf of HCEs are not QMACs, because they fail to satisfy the nonforfeitability requirement of §1.401(k)–1(c). The elective contributions and matching contributions with respect to HCEs for the 2005 plan year are shown in the following table:

	Elective contributions	Total matching contributions	Matching contributions that are not QMACs	QMACs
Highly compensated employees	15%	5%	5%	0%

(B) The elective contributions and matching contributions with respect to the NHCEs for the 2005 plan year are shown in the following table:

	Elective contributions	Total matching contributions	Matching contributions that are not QMACs	QMACs
Nonhighly compensated employees	11%	4%	0%	4%

(ii) The plan fails to satisfy the ADP test of section 401(k)(3)(A) and paragraph (a)(1) of this section because the ADP for HCEs (15%) is more than 125% of the ADP for NHCEs (11%), and more than 2 percentage points greater than 11%. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) provided that they are not used for any other ADP or ACP test. QMACs equal to 1% of compensation are taken into account for each NHCE in applying the ADP test. After this adjustment, the applicable ADP and ACP (taking into account the provisions of §1.401(m)-2(a)(5)(ii)) for the plan year are as follows:

	Actual deferral percentage	Actual contribution percentage
HCEs	15	5
Nonhighly compensated employees	12	3

(iii) The elective contributions and QMACs taken into account for purposes of the ADP test of section 401(k)(3) satisfy the requirements of section 401(k)(3)(A)(ii) under paragraph (a)(1)(ii) of this section because the ADP for HCEs (15%) is not more than the ADP for NHCEs multiplied by 1.25 (12% × 1.25 = 15%).

(b) *Correction of excess contributions*—(1) *Permissible correction methods*—(i) *In general.* A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement, uses any of the following correction methods—

(A) *Qualified nonelective contributions or qualified matching contributions.* The employer makes qualified nonelective contributions or qualified matching contributions that are taken into account under this section and, in combination with other amounts taken into account under paragraph (a) of this section, allow the cash or deferred arrangement to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess contributions distributed.* Excess contributions are distributed in accordance with paragraph (b)(2) of this section.

(C) *Excess contributions recharacterized.* Excess contributions are recharacterized in accordance with paragraph (b)(3) of this section.

(ii) *Combination of correction methods.* A plan may provide for the use of any of the correction methods described in paragraph (b)(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. A plan may permit an HCE to elect whether any excess contributions are to be recharacterized or distributed. Similarly, a plan may permit an HCE with elective contributions for a year that includes both pre-tax elective contributions and designated Roth contributions to elect whether the excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. If the plan uses a combination of correction methods, any contribution made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction methods in paragraph (b)(1)(i)(B) or (C) of this section.

(iii) *Exclusive means of correction.* A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than the ones described in paragraphs (b)(1)(i) and (ii) of this section. Thus, 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).

(2) *Corrections through distribution*—(i) *General rule*. This paragraph (b)(2) contains the rules for correction of excess contributions through a distribution from the plan. Correction through a distribution generally involves a 4-step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess contributions among HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned excess contributions and allocable income in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions. Paragraph (b)(2)(vii) provides other rules relating to these distributions.

(ii) *Calculation of total amount to be distributed*. The following procedures must be used to determine the total amount of the excess contributions to be distributed—

(A) *Calculate the dollar amount of excess contributions for each HCE*. The amount of excess contributions attributable to a given HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ADR to equal the highest permitted ADR under the plan. To calculate the highest permitted ADR under a plan, the ADR of the HCE with the highest ADR is reduced by the amount required to cause that HCE's ADR to equal the ADR of the HCE with the next highest ADR. If a lesser reduction would enable the arrangement to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction is used in determining the highest permitted ADR.

(B) *Determination of the total amount of excess contributions*. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the arrangement would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess contributions for the plan year.

(C) *Satisfaction of ADP*. A cash or deferred arrangement satisfies this paragraph (b)(2)(ii)(C) if the arrangement would satisfy the requirements of paragraph (a)(1)(ii) of this section if the ADR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess contributions among the HCEs*. The following procedures must be used in apportioning the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section among the HCEs:

(A) *Calculate the dollar amount of excess contributions for each HCE*. The contributions of the HCE with the highest dollar amount of contributions taken into account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of the contributions taken into account under this section for the HCE with the next highest dollar amount of contributions taken into account under this section. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any individual*. For purposes of this paragraph (b)(2)(iii), the amount of contributions taken into account under this section with respect to an HCE who is an eligible employee in more than one plan of an employer is determined by taking into account all contributions otherwise taken into account with respect to such HCE under any plan of the employer during the plan year of the plan being tested as being made under the plan being tested. However, the amount of excess contributions apportioned for a plan year with respect to any HCE must not exceed the amount of contributions actually contributed to the plan for the HCE for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which elective contributions are made and whose ADR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount required to be distributed under this paragraph (b)(2)(iii) shall not exceed the contributions actually contributed to the plan and taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs*. The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section has been apportioned.

(iv) *Income allocable to excess contributions*—(A) *General rule*. For plan years beginning on or after January 1, 2008, the income allocable to excess contributions is equal to the allocable gain or loss through the end of the plan year. See paragraph (b)(2)(iv)(D) of this section for rules that apply to plan years beginning before January 1, 2008.

(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 participant's accounts. See §1.401(a)(4)–1(c)(8). A plan will not fail to use a reasonable method for computing the income allocable to excess contributions merely because the income allocable to excess contributions is determined on a date that is no more than 7 days before the distribution.

(C) *Alternative method of allocating plan year income*. A plan may allocate income to excess contributions for the plan year by multiplying the income for the plan year allocable to the elective contributions and other amounts taken into account under this section (including contributions made for the plan year), by a fraction, the numerator of which is the excess contributions for the employee for the plan year, and the denominator of which is the sum of the—

(*1*) Account balance attributable to elective contributions and other contributions taken into account under this section as of the beginning of the plan year, and

(2) Any additional amount of such contributions made for the plan year.

(D) *Plan years before 2008*. For plan years beginning before January 1, 2008, the income allocable to excess contributions is determined under §1.401(k)–2(b)(2)(iv) (as it appeared in the April 1, 2007, edition of 26 CFR part 1).

(v) *Distribution*. Within 12 months after the close of the plan year in which the excess contribution arose, the plan must distribute to each HCE the excess contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section and the allocable income. Except as otherwise provided in this paragraph (b)(2)(v) and paragraph (b)(4)(i) of this section, a distribution of excess contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. 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 an HCE is distributed prior to when the plan makes a distribution of excess contributions in accordance with this paragraph (b)(2), 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.

(vi) *Tax treatment of corrective distributions*—(A) *Corrective distributions for plan years beginning on or after January 1, 2008*. Except as provided in this paragraph (b)(2)(vi), for plan years beginning on or after January 1, 2008, a corrective distribution of excess contributions (and allocable income) is includible in the employee's gross income for the employee's taxable year in which distributed. In addition, the corrective distribution is not subject to the early distribution tax of section 72(t). See paragraph (b)(5) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months (6 months in the case of certain plans that include an eligible automatic contribution arrangement within the meaning of section 414(w)) after the end of the plan year. See also §1.402(c)–2, A–4 for restrictions on rolling over distributions that are excess contributions.

(B) *Corrective distributions for plan years beginning before January 1, 2008*. The tax treatment of corrective distributions for plan years beginning before January 1, 2008, is determined under §1.401(k)–2(b)(2)(vi) (as it appeared in the April 1, 2007, edition of 26 CFR Part 1).

(C) *Corrective distributions attributable to designated Roth contributions*. Notwithstanding paragraphs (b)(2)(vi)(A) and (B) of this section, a distribution of excess contributions is not includible in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to a corrective distribution of excess contributions that are designated Roth contributions is included in gross income in accordance with paragraph (b)(2)(vi)(A) or (B) of this section (*i.e.*, in the same manner as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions).

(vii) *Other rules*—(A) *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.

(B) *Treatment of corrective distributions as elective contributions*. Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(C) *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). *See* §1.401(a)(9)–5, A–9(b).

(D) *Partial distributions*. Any distribution of less than the entire amount of excess contributions (and allocable income) with respect to any HCE is treated as a pro rata distribution of excess contributions and allocable income.

(viii) *Examples*. The following examples illustrate the application of this paragraph (b)(2). For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Plan P, a calendar year profit-sharing plan that includes a cash or deferred arrangement, provides for distribution of excess contributions to HCEs to the extent necessary to satisfy the ADP test. For the 2006 plan year, Employee A, an HCE, has elective contributions of $12,000 and $200,000 in compensation, for an ADR of 6%, and Employee B, a second HCE, has elective contributions of $8,960 and compensation of $128,000, for an ADR of 7%. The ADP for the NHCEs is 3% for the 2006 plan year. Under the ADP test, the ADP of the two HCEs under the plan may not exceed 5% (*i.e.*, 2 percentage points more than the ADP of the NHCEs under the plan). The ADP for the 2 HCEs under the plan is 6.5%. Therefore, there must be a correction of excess contributions for the 2006 plan year.

(ii) The total amount of excess contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the elective contributions of Employee B (the HCE with the highest ADR) are reduced by $1,280 in order to reduce his ADR to 6% ($7,680/$128,000), which is the ADR of Employee A.

(iii) Because the ADP of the HCEs determined after the $1,280 reduction to Employee B still exceeds 5%, further reductions in elective contributions are necessary in order to reduce the ADP of the HCEs to 5%. The elective contributions of Employee A and Employee B are each reduced by 1% of compensation ($2,000 and $1,280 respectively). Because the ADP of the HCEs determined after the reductions equals 5%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions).

(v) Because the total amount of excess contributions has not been apportioned, further apportionment is necessary. The balance ($1,520) of the total amount of excess contributions is apportioned equally among Employee A and Employee B ($760 to each).

(vi) Therefore, the cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,800 ($3,040 + $760) and allocable income and Employee B receives a corrective distribution of $760 and allocable income.

Example 2. (i) The facts are the same as in *Example 1*, except Employee A's ADR is based on $3,000 of elective contributions to this plan and $9,000 of elective contributions to another plan of the employer.

(ii) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. The amount of elective contributions for Employee A is $12,000. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions). However, pursuant to paragraph (b)(2)(iii)(B) of this section, no more than the amount actually contributed to the plan may be apportioned to an HCE. Accordingly, no more than $3,000 may be apportioned to Employee A. Therefore, the remaining $1,560 must be apportioned to Employee B.

(iii) The cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,000 (total amount of elective contributions actually contributed to the plan for Employee A) and allocable income and Employee B receives a corrective distribution of $1,560 and allocable income.

(3) *Recharacterization of excess contributions*—(i) *General rule.* Excess contributions are recharacterized in accordance with this paragraph (b)(3) only if the excess contributions that would have to be distributed under (b)(2) of this section if the plan was correcting through distribution of excess contributions are recharacterized as described in paragraph (b)(3)(ii) of this section, and all of the conditions set forth in paragraph (b)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.* Recharacterized excess contributions are includible in the employee's gross income as if such amounts were distributed under paragraph (b)(2) of this section. The recharacterized excess contributions are treated as employee contributions for purposes of section 72, sections 401(a)(4), 401(m), § 1.401(k)–1(d) and § 1.401(k)–2. This requirement is not treated as satisfied unless the payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by timely providing such Federal tax forms and accompanying instructions and timely taking such other action as is prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (*see* § 601.601(d)(2) of this chapter) as well as the applicable Federal tax forms and accompanying instructions.

(iii) *Additional rules*—(A) *Time of recharacterization.* Excess contributions may not be recharacterized under this paragraph (b)(3) after 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 HCEs with excess contributions to be recharacterized is notified in accordance with paragraph (b)(3)(ii) of this section.

(B) *Employee contributions must be permitted under plan.* The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the HCE, may not exceed the maximum amount of employee contributions (determined without regard to the ACP test of section 401(m)(2)) permitted under the provisions of the plan as in effect on the first day of the plan year.

(C) *Treatment of recharacterized excess contributions.* Recharacterized excess contributions continue to be treated as employer contributions for all purposes under the Internal Revenue Code (other than those specified in paragraph (b)(3)(ii) of this section), including section 401(a) and sections 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of §1.401(k)–1(c); must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A).

(4) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *Treatment of excess deferrals that reduce excess contributions.* The amount of excess contributions (and allocable income) to be distributed under paragraph (b)(2) of this section or the amount of excess contributions recharacterized under paragraph (b)(3) of this section with respect to an employee for a plan year, is reduced by any amounts previously distributed to the employee from the plan to correct excess deferrals 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 required to be distributed to correct an excess deferral to an employee for a taxable year is reduced by any excess contributions (and allocable income) previously distributed or excess contributions 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 payer 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) *Forfeiture of match on distributed excess contributions.* A matching contribution is taken into account under section 401(a)(4) even if the match is with respect to an elective contribution that is distributed or recharacterized under this paragraph (b). This requires that, after correction of excess contributions, 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 elective contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(k)(3), while matching contributions attributable to those elective contributions remain allocated to the HCEs' accounts. Under section 411(a)(3)(G) and §1.411(a)–4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions or excess deferrals 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 NHCEs for the purpose of correcting a discriminatory rate of matching contributions.

(iii) *Permitted forfeiture of QMAC.* Pursuant to section 401(k)(8)(E), a qualified matching contribution is not treated as forfeitable under §1.401(k)–1(c) merely because under the plan it is forfeited in accordance with paragraph (b)(4)(ii) of this section or §1.414(w)–1(d)(2).

(iv) *No requirement for recalculation.* If excess contributions are distributed or recharacterized in accordance with paragraphs (b)(2) and (3) of this section, the cash or deferred arrangement is treated as meeting the nondiscrimination test of section 401(k)(3) regardless of whether the ADP for the HCEs, if recalculated after the distributions or recharacterizations, would satisfy section 401(k)(3).

(v) *Treatment of excess contributions that are catch-up contributions.* A cash or deferred arrangement does not fail to meet the requirements of section 401(k)(3) and paragraph (a)(1) of this section merely because excess contributions that are catch-up contributions because they exceed the ADP limit, as described in §1.414(v)–1(b)(1)(iii), are not corrected in accordance with this paragraph (b).

(5) *Failure to timely 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% excise tax on the amount of the excess contributions. *See* section 4979 and §54.4979–1 of this chapter. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (a)(6) 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 the 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.

(iii) *Special rule for eligible automatic contribution arrangements.* In the case of excess contributions under a plan that includes an eligible automatic contribution arrangement within the meaning of section 414(w), 6 months is substituted for 2½ months in paragraph (b)(5)(i) of this section. The additional time described in this paragraph (b)(5)(iii) applies to a distribution of excess contributions for a plan year beginning on or after January 1, 2010 only where all the eligible NHCEs and eligible HCEs are covered employees under the eligible automatic contribution arrangement (within the meaning of §1.414(w)–1(e)(3)) for the entire plan year (or for the portion of the plan year that the eligible NHCEs and eligible HCEs are eligible employees).

(c) *Additional rules for prior year testing method*—(1) *Rules for change in testing method*—(i) *General rule.* A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in paragraph (c)(1)(ii) of this section. For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(k)–3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year.

(ii) *Situations permitting a change to the prior year testing method.* The situations described in this paragraph (c)(1)(ii) are:

(A) The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan).

(B) The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan).

(C) A transaction described in section 410(b)(6)(C)(i) and §1.410(b)–2(f) occurs and—

(*1*) As a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and

(*2*) The change from the current year testing method to the prior year testing method occurs within the transition period described in section 410(b)(6)(C)(ii).

(2) *Calculation of ADP under the prior year testing method for the first plan year*—(i) *Plans that are not successor plans.* If, for the first plan year of any plan (other than a successor plan), the plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ADP for eligible NHCEs, or use 3% as the ADP for eligible NHCEs, for applying the ADP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting on QNECs under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined.* For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for elective contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)–7(b)) for a plan year if for such plan year the plan is aggregated under §1.401(k)–1(b)(4) with any other plan that provided for elective contributions in the prior year.

(iii) *Successor plans.* A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under a qualified cash or deferred arrangement maintained by the employer in the prior year. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ADP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ADP and ACP test.* Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ADP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ACP test for that year. For example, a plan may use the prior year testing method for the ADP test and the current year testing method for its ACP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use—

(i) The recharacterization method of paragraph (b)(3) of this section to correct excess contributions for a plan year;

(ii) The rules of §1.401(m)–2(a)(6)(ii) to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph (a)(6)(v) of this section to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage changes*—(i) *In general.* A plan that uses the prior year testing method and experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ADP for the NHCEs for the plan year is the weighted average of the ADPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes.* If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ADP for the group of eligible NHCEs for the prior year under the plan is the ADP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions.* The following definitions apply for purposes of this paragraph (c)(4):

(A) *Plan coverage change.* The term *plan coverage change* means a change in the group or groups of eligible employees under a plan on account of—

(*1*) The establishment or amendment of a plan;

(*2*) A plan merger or spinoff under section 414(l);

(*3*) A change in the way plans (within the meaning of § 1.410(b)–7(b)) are combined or separated for purposes of § 1.401(k)–1(b)(4) (*e.g.*, permissively aggregating plans not previously aggregated under § 1.410(b)–7(d), or ceasing to permissively aggregate plans under § 1.410(b)–7(d));

(*4*) A reclassification of a substantial group of employees that has the same effect as amending the plan (*e.g.*, a transfer of a substantial group of employees from one division to another division); or

(*5*) A combination of any of paragraphs (c)(4)(iii)(A)(*1*) through (*4*) of this section.

(B) *Prior year subgroup*. The term *prior year subgroup* means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan maintained by the employer that included a qualified cash or deferred arrangement and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ADPs for the prior year subgroups*. The term *weighted average of the ADPs for the prior year subgroups* means the sum, for all prior year subgroups, of the adjusted ADPs for the plan year. The term *adjusted ADP with respect to a prior year subgroup* means the ADP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Examples*. The following examples illustrate the application of this paragraph (c)(4):

Example 1. (i) Employer B maintains two calendar year plans, Plan O and Plan P, each of which includes a cash or deferred arrangement. The plans were not permissively aggregated under § 1.410(b)–7(d) for the 2005 plan year. Both plans use the prior year testing method. Plan O had 300 eligible employees who were NHCEs for the 2005 plan year, and their ADP for that year was 6%. Sixty of the eligible employees who were NHCEs for the 2005 plan year under Plan O, terminated their employment during that year. Plan P had 100 eligible employees who were NHCEs for 2005, and the ADP for those NHCEs for that plan was 4%. Plan O and Plan P are permissively aggregated under § 1.410(b)–7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under § 1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of § 1.401(k)–1(b)(4). Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) The Plan O prior year subgroup consists of the 300 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) × 300/400 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) × 100/400 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

(v) As provided in paragraph (c)(4)(iii)(B) of this section, the determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether that NHCE terminated employment during the prior year. Thus, the prior ADP for the NHCEs under Plan OP for the 2006 plan year is unaffected by the termination of the 60 NHCEs covered by Plan O during the 2005 plan year.

Example 2. (i) The facts are the same as *Example 1,* except that the 60 employees who terminated employment during the 2005 plan are instead spun-off to another plan.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under §1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of §1.401(k)–1(b)(4) and the spin-off of the 60 employees is a plan coverage change. Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) For purposes of determining the prior year subgroups, the employees who would have been eligible employees in the prior year under the plan being tested are determined as if both plan coverage changes had first been effective as of the first day of the prior plan year. The Plan O prior year subgroup consists of the 240 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and would have been eligible under Plan OP for the 2005 plan year if the spin-off had occurred at the beginning of the 2005 plan year and Plan O and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan O and the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan P. The adjusted ADP for the prior year subgroup consisting of eligible NHCEs under Plan O is 4.23%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) × 240/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the prior year subgroup consisting of the eligible NHCEs from Plan P is 1.18%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) × 100/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.41% (the sum of adjusted ADPs for the prior year subgroups, 4.23% plus 1.18%).

Example 3. (i) The facts are the same as in *Example 1,* except that instead of Plan O and Plan P being permissively aggregated for the 2006 plan year, 200 of the employees eligible under Plan O were spun-off from Plan O and merged into Plan P.

(ii) The spin-off from Plan O and merger to Plan P for the 2006 plan year are plan coverage changes for Plan P. Therefore, the prior year ADP for the NHCEs under Plan P for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan P. There are 2 subgroups under Plan P for the 2006 plan year. The Plan O prior year subgroup consists of the 200 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan P for the 2005 plan year if the spin-off and merger had occurred on the first day of the 2005 plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P for the 2005 plan year.

(iii) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.0%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) × 200/300 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1.33%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) × 100/300 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan P for the 2006 plan year is 5.33% (the sum of adjusted ADPs for the 2 prior year subgroups, 4.0% plus 1.33%).

(iv) The spin-off from Plan O for the 2006 plan year is a plan coverage change for Plan O. Therefore, the prior year ADP for the NHCEs under Plan O for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan O. In this case, there is only one prior year subgroup under Plan O, the employees who were NHCEs of Employer B for the 2005 plan year and who were eligible for the 2005 plan year under Plan O. Because there is only one prior year subgroup under Plan O, the weighted average of the ADPs for the prior year subgroup under Plan O is equal to the NHCE ADP for the prior year (2005 plan year) under Plan O, or 6%.

Example 4. (i) Employer C maintains a calendar year plan, Plan Q, which includes a cash or deferred arrangement that uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 2005, Plan Q had 500 eligible employees who were NHCEs, and the ADP for those NHCEs for 2005 was 2%. Effective January 1, 2006, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 2006. In addition, effective on that same date, Employer C establishes a new calendar year plan, Plan R, which includes a cash or deferred arrangement that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of paragraph (c)(2)(iii) of this section (because all of the employees were eligible employees under Plan Q in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes within the meaning of paragraph (c)(4)(iii)(A) of this section for Plan Q and Plan R. Accordingly, each plan must determine the NHCE ADP for the 2006 plan year under the rules set forth in paragraph (c)(4) of this section.

(iv) The prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 2005 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 plan year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as if the plan amendment had not occurred.

(v) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 2005 plan year if the plan were established as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

Example 5. (i) The facts are the same as in *Example 4*, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any qualified cash or deferred arrangement maintained by Employer C.

(ii) Plan R is a successor plan (because 100 of Plan R's 150 eligible employees were eligible employees under another qualified cash or deferred arrangement maintained by Employer C in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any qualified cash or deferred arrangement of Employer C for the prior plan year, they do not comprise a prior year subgroup. Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

[T.D. 9169, 69 FR 78154, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 10, Jan. 3, 2006; T.D. 9447, 74 FR 8207, Feb. 24, 2009]

§ 1.401(k)–3 Safe harbor requirements.

(a) *ADP test safe harbor*—(1) *Section 401(k)(12) safe harbor*. A cash or deferred arrangement satisfies the ADP safe harbor provision of section 401(k)(12) for a plan year if the arrangement satisfies the safe harbor contribution requirement of paragraph (b) or (c) of this section for the plan year, the notice requirement of paragraph (d) of this section, the plan year requirements of paragraph (e) of this section, and the additional rules of paragraphs (f), (g), and (h) of this section, as applicable.

(2) *Section 401(k)(13) safe harbor*. For plan years beginning on or after January 1, 2008, a cash or deferred arrangement satisfies the ADP safe harbor provision of section 401(k)(13) for a plan year if the arrangement is described in paragraph (j) of this section and satisfies the safe harbor contribution requirement of paragraph (k) of this section for the plan year, the notice requirement of paragraph (d) of this section (modified to include the information set forth in paragraph (k)(4) of this section), the plan year requirements of paragraph (e) of this section, and the additional rules of paragraphs (f), (g), and (h) of this section, as applicable. A cash or deferred arrangement that satisfies the requirements of this paragraph (a)(2) is referred to as a qualified automatic contribution arrangement.

(3) *Requirements applicable to safe harbor contributions*. Pursuant to section 401(k)(12)(E)(ii) and section 401(k)(13)(D)(iv), the safe harbor contribution requirement of paragraph (b), (c), or (k) of this section must be satisfied without regard to section 401(l). The contributions made under paragraph (b) or (c) of this section (and the corresponding contributions under

paragraph (k) of this section) are referred to as safe harbor nonelective contributions and safe harbor matching contributions.

(b) *Safe harbor nonelective contribution requirement*—(1) *General rule.* The safe harbor nonelective contribution requirement of this paragraph is satisfied if, under the terms of the plan, the employer is required to make a qualified nonelective contribution on behalf of each eligible NHCE equal to at least 3% of the employee's safe harbor compensation.

(2) *Safe harbor compensation defined.* For purposes of this section, safe harbor compensation means compensation as defined in §1.401(k)–6 (which incorporates the definition of compensation in §1.414(s)–1); provided, however, that the rule in the last sentence of §1.414(s)–1(d)(2)(iii) (which generally permits a definition of compensation to exclude all compensation in excess of a specified dollar amount) does not apply in determining the safe harbor compensation of NHCEs. Thus, for example, the plan may limit the period used to determine safe harbor compensation to the eligible employee's period of participation.

(c) *Safe harbor matching contribution requirement*—(1) *In general.* The safe harbor matching contribution requirement of this paragraph (c) is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible NHCE in an amount determined under the basic matching formula of section 401(k)(12)(B)(i)(I), as described in paragraph (c)(2) of this section, or under an enhanced matching formula of section 401(k)(12)(B)(i)(II), as described in paragraph (c)(3) of this section.

(2) *Basic matching formula.* Under the basic matching formula, each eligible NHCE receives qualified matching contributions in an amount equal to the sum of—

(i) 100% of the amount of the employee's elective contributions that do not exceed 3% of the employee's safe harbor compensation; and

(ii) 50% of the amount of the employee's elective contributions that exceed 3% of the employee's safe harbor compensation but that do not exceed 5% of the employee's safe harbor compensation.

(3) *Enhanced matching formula.* Under an enhanced matching formula, each eligible NHCE receives a matching contribution under a formula that, at any rate of elective contributions by the employee, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been provided under the basic matching formula of paragraph (c)(2) of this section. In addition, under an enhanced matching formula, the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective contributions may not increase as the amount of an employee's elective contributions increases.

(4) *Limitation on HCE matching contributions.* The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if the ratio of matching contributions made on account of an HCE's elective contributions under the cash or deferred arrangement for a plan year to those elective contributions is greater than the ratio of matching contributions to elective contributions that would apply with respect to any eligible NHCE with elective contributions at the same percentage of safe harbor compensation.

(5) *Use of safe harbor match not precluded by certain plan provisions*—(i) *Safe harbor matching contributions on employee contributions.* The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions on the same terms as safe harbor matching contributions are made with respect to elective contributions. Alternatively, the safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching

contributions are made on both elective contributions and employee contributions if safe harbor matching contributions on elective contributions are not affected by the amount of employee contributions.

(ii) *Periodic matching contributions.* The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because the plan provides that safe harbor matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that safe harbor matching contributions with respect to any elective contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(6) *Permissible restrictions on elective contributions by NHCEs*—(i) *General rule.* The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if elective contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (c)(6).

(ii) *Restrictions on election periods.* A plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (d) of this section) to make or change a cash or deferred election for the plan year. For purposes of this paragraph (c)(6)(ii), a 30-day period is deemed to be a reasonable period to make or change a cash or deferred election.

(iii) *Restrictions on amount of elective contributions.* A plan is permitted to limit the amount of elective contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (c)(6)(v) of this section) to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of elective contributions. However, a plan may require eligible employees to make cash or deferred elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred.* A plan may limit the types of compensation that may be deferred by an eligible employee under a plan, provided that each eligible NHCE is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2). Thus, the definition of compensation from which elective contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code.* A plan may limit the amount of elective contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make elective contributions has been suspended for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E).

(7) *Examples.* The following examples illustrate the safe harbor contribution requirement of this paragraph (c):

Example 1. (i) Beginning January 1, 2006, Employer A maintains Plan L covering employees in Divisions D and E, each of which includes HCEs and NHCEs. Plan L contains a cash or deferred arrangement and provides qualified matching contributions equal to 100% of each eligible employee's elective contributions up to 3% of compensation and 50% of the next 2% of compensation. For purposes of the matching contribution formula, safe harbor compensation is defined as all compensation within the meaning of section 415(c)(3) (a definition that satisfies section 414(s)). Also, each employee is permitted to make elective contributions from all safe harbor compensation within the meaning of section 415(c)(3) and may change a cash or deferred election at any time. Plan L limits the amount of an employee's elective contributions for purposes of section 402(g) and section 415, and, in the case of a hardship distribution, suspends an employee's ability to make elective contributions for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E). All contributions under Plan L are nonforfeitable and are subject to the withdrawal restrictions of section 401(k)(2)(B). Plan L provides for no other contributions and Employer A maintains no other plans. Plan L is maintained on a calendar-year basis, and all contributions for a plan year are made within 12 months after the end of the plan year.

(ii) Based on these facts, matching contributions under Plan L are safe harbor matching contributions because they are qualified matching contributions equal to the basic matching formula. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 2. (i) The facts are the same as in *Example 1*, except that instead of providing a basic matching contribution, Plan L provides a qualified matching contribution equal to 100% of each eligible employee's elective contributions up to 4% of safe harbor compensation.

(ii) Plan L's formula is an enhanced matching formula because each eligible NHCE receives safe harbor matching contributions at a rate that, at any rate of elective contributions, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been received under the basic safe harbor matching formula, and the rate of matching contributions does not increase as the rate of an employee's elective contributions increases. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 3. (i) The facts are the same as in *Example 2*, except that instead of permitting each employee to make elective contributions from all compensation within the meaning of section 415(c)(3), each employee's elective contributions under Plan L are limited to 15% of the employee's basic compensation. *Basic compensation* is defined under Plan L as compensation within the meaning of section 415(c)(3), but excluding overtime pay.

(ii) The definition of basic compensation under Plan L is a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2).

(iii) Plan L will not fail to satisfy the safe harbor contribution requirement of this paragraph (c) merely because Plan L limits the amount of elective contributions and the types of compensation that may be deferred by eligible employees, provided that each eligible NHCE may make elective contributions equal to at least 4% of the employee's safe harbor compensation.

Example 4. (i) The facts are the same as in *Example 1*, except that Plan L provides that only employees employed on the last day of the plan year will receive a safe harbor matching contribution.

(ii) Even if the plan that provides for employee contributions and matching contributions satisfies the minimum coverage requirements of section 410(b)(1) taking into account this last-day requirement, Plan L would not satisfy the safe harbor contribution requirement of this paragraph (c) because safe harbor matching contributions are not made on behalf of all eligible NHCEs who make elective contributions.

(iii) The result would be the same if, instead of providing safe harbor matching contributions, Plan L provides for a 3% safe harbor nonelective contribution that is restricted to eligible employees under the cash or deferred arrangement who are employed on the last day of the plan year.

Example 5. (i) The facts are the same as in *Example 1*, except that instead of providing qualified matching contributions under the basic matching formula to employees in both Divisions D and E, employees in Division E are provided qualified matching contributions under the basic matching formula, while safe harbor matching contributions continue to be provided to employees in Division D under the enhanced matching formula described in *Example 2*.

(ii) Even if Plan L satisfies §1.401(a)(4)–4 with respect to each rate of matching contributions available to employees under the plan, the plan would fail to satisfy the safe harbor contribution requirement of this paragraph (c) because the rate of matching contributions with respect to HCEs in Division D at a rate of elective contributions between 3% and 5% would be greater than that with respect to NHCEs in Division E at the same rate of elective contributions. For example, an HCE in Division D who would have a 4% rate of elective contributions would have a rate of matching contributions of 100% while an NHCE in Division E who would have the same rate of elective contributions would have a lower rate of matching contributions.

(d) *Notice requirement*—(1) *General rule.* The notice requirement of this paragraph (d) is satisfied for a plan year if each eligible employee is given notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement of paragraph (d)(2) of this section and the timing requirement of paragraph (d)(3) of this section. The notice must be in writing or in such other form as may be approved by the Commissioner. See §1.401(a)–21 of this chapter for rules permitting the use of electronic media to provide applicable notices to recipients with respect to retirement plans.

(2) *Content requirement*—(i) *General rule.* The content requirement of this

paragraph (d)(2) is satisfied if the notice is—

(A) Sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan; and

(B) Written in a manner calculated to be understood by the average employee eligible to participate in the plan.

(ii) *Minimum content requirement.* Subject to the requirements of paragraph (d)(2)(iii) of this section, a notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes—

(A) The safe harbor matching contribution or safe harbor nonelective contribution formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan);

(B) Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;

(C) The plan to which safe harbor contributions will be made (if different than the plan containing the cash or deferred arrangement);

(D) The type and amount of compensation that may be deferred under the plan;

(E) How to make cash or deferred elections, including any administrative requirements that apply to such elections;

(F) The periods available under the plan for making cash or deferred elections;

(G) Withdrawal and vesting provisions applicable to contributions under the plan; and

(H) Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information.

(iii) *References to SPD.* A plan will not fail to satisfy the content requirements of this paragraph (d)(2) merely because, in the case of information described in paragraph (d)(2)(ii)(B) of this section (relating to any other contributions under the plan), paragraph (d)(2)(ii)(C) of this section (relating to the plan to which safe harbor contributions will be made) or paragraph (d)(2)(ii)(D) of this section (relating to the type and amount of compensation that may be deferred under the plan), the notice cross-references the relevant portions of a summary plan description that provides the same information that would be provided in accordance with such paragraphs and that has been provided (or is concurrently provided) to employees.

(3) *Timing requirement*—(i) *General rule.* The timing requirement of this paragraph (d)(3) is satisfied if the notice is provided within a reasonable period before the beginning of the plan year (or, in the year an employee becomes eligible, within a reasonable period before the employee becomes eligible). The determination of whether a notice satisfies the timing requirement of this paragraph (d)(3) is based on all of the relevant facts and circumstances.

(ii) *Deemed satisfaction of timing requirement.* The timing requirement of this paragraph (d)(3) is deemed to be satisfied if at least 30 days (and no more than 90 days) before the beginning of each plan year, the notice is given to each eligible employee for the plan year. In the case of an employee who does not receive the notice within the period described in the previous sentence because the employee becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the employee becomes eligible (and no later than the date the employee becomes eligible). Thus, for example, the preceding sentence would apply in the case of any employee eligible for the first plan year under a newly established plan that provides for elective contributions, or would apply in the case of the first plan year in which an employee becomes eligible under an existing plan that provides for elective contributions. If it is not practicable for the notice to be provided on or before the date specified in the plan that an employee becomes eligible, the notice will nonetheless be treated as provided timely if it is provided as soon as practicable after that date and the employee is permitted to elect to defer from all types of compensation that may be deferred under the plan earned beginning on the date the employee becomes eligible.

(e) *Plan year requirement*—(1) *General rule*. Except as provided in this paragraph (e) or in paragraph (f) of this section, a plan will fail to satisfy the requirements of sections 401(k)(12), 401(k)(13), and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of the plan year and remain in effect for an entire 12-month plan year. In addition, except as provided in paragraph (g) of this section or in guidance of general applicability published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), a plan which includes provisions that satisfy the rules of this section will not satisfy the requirements of §1.401(k)–1(b) if it is amended to change such provisions for that plan year. Moreover, if, as described under paragraph (h)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions under that other plan specifying that the safe harbor contributions will be made and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) *Initial plan year*. A newly established plan (other than a successor plan within the meaning of §1.401(k)–2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (e) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a cash or deferred arrangement will not fail to satisfy the requirement of this paragraph (e) if it is added to an existing profit sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that—

(i) The plan is not a successor plan; and

(ii) The cash or deferred arrangement is made effective no later than 3 months prior to the end of the plan year.

(3) *Change of plan year*. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section (determined without regard to paragraph (g) of this section) for the immediately following plan year (or for the immediately following 12 months if the immediately following plan year is less than 12 months).

(4) *Final plan year*. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the final plan year is less than 12 months, provided that the plan satisfies the requirement of this section through the date of termination and either—

(i) The plan would satisfy the requirements of paragraph (g) of this section, treating the termination of the plan as a reduction or suspension of safe harbor contributions, other than the requirements of paragraph (g)(1)(i)(A) or (g)(1)(ii)(A) of this section (relating to the employer's financial condition and information included in the initial notice for the plan year) and paragraph (g)(1)(i)(D) or (g)(1)(ii)(D) of this section (requiring that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections); or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(c).

(f) *Plan amendments adopting safe harbor nonelective contributions*—(1) *General rule*. Notwithstanding paragraph (e)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section, effective as of the first day of the plan year, using nonelective contributions under paragraph (b) of this section, but only if the plan provides the contingent and follow-up notices described in this section. A plan amendment made pursuant to this paragraph (f)(1) for a plan year may provide for the use of the safe harbor method described in this section solely for that plan year and a plan sponsor is not limited in the number of years for which it is permitted to adopt an amendment providing for the safe harbor method of this section using nonelective contributions under paragraph (b) of this section and this paragraph (f).

(2) *Contingent notice provided.* A plan satisfies the requirement to provide the contingent notice under this paragraph (f)(2) if it provides a notice that would satisfy the requirements of paragraph (d) of this section, except that, in lieu of setting forth the safe harbor contributions used under the plan as set forth in paragraph (d)(2)(ii)(A) of this section, the notice specifies that the plan may be amended during the plan year to include the safe harbor nonelective contribution and that, if the plan is amended, a follow-up notice will be provided.

(3) *Follow-up notice requirement.* A plan satisfies the requirement to provide a follow-up notice under this paragraph (f)(3) if, no later than 30 days before the last day of the plan year, each eligible employee is given a notice that states that the safe harbor nonelective contributions will be made for the plan year. The notice must be in writing or in such other form as may be prescribed by the Commissioner and is permitted to be combined with a contingent notice provided under paragraph (f)(2) of this section for the next plan year.

(g) *Permissible reduction or suspension of safe harbor contributions*—(1) *General rule*—(i) *Matching contributions.* A plan that provides for safe harbor matching contributions intended to satisfy the requirements of paragraph (c) of this section for a plan year will not fail to satisfy the requirements of section 401(k)(3) merely because the plan is amended during the plan year to reduce or suspend safe harbor matching contributions on future elective contributions (and, if applicable, employee contributions) provided that—

(A) In the case of plan years beginning on or after January 1, 2015, the employer either—

(*1*) Is operating at an economic loss as described in section 412(c)(2)(A) for the plan year; or

(*2*) Includes in the notice described in paragraph (d) of this section a statement that the plan may be amended during the plan year to reduce or suspend safe harbor matching contributions and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension;

(B) All eligible employees are provided a supplemental notice that satisfies the requirements of paragraph (g)(2) of this section;

(C) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice described in paragraph (g)(2) of this section;

(D) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(E) The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(k)–2(a)(2)(ii); and

(F) The plan satisfies the requirements of this section (other than this paragraph (g)) with respect to amounts deferred through the effective date of the amendment.

(ii) *Nonelective contributions.* For amendments adopted after May 18, 2009, a plan that provides for safe harbor nonelective contributions intended to satisfy the requirements of paragraph (b) of this section for the plan year will not fail to satisfy the requirements of section 401(k)(3) merely because the plan is amended during the plan year to reduce or suspend safe harbor nonelective contributions provided that—

(A) The employer either—

(*1*) Is operating at an economic loss, as described in section 412(c)(2)(A) for the plan year; or

(*2*) Includes in the notice described in paragraph (d) of this section a statement that the plan may be amended during the plan year to reduce or suspend safe harbor nonelective contributions and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension;

(B) All eligible employees are provided a supplemental notice that satisfies the requirements of paragraph (g)(2) of this section;

(C) The reduction or suspension of safe harbor nonelective contributions is effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice described in paragraph (g)(2) of this section;

(D) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of nonelective contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(E) The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(k)–2(a)(2)(ii); and

(F) The plan satisfies the requirements of this section (other than this paragraph (g)) with respect to safe harbor compensation paid through the effective date of the amendment.

(2) *Supplemental notice.* The supplemental notice requirement of this paragraph (g)(2) is satisfied if each eligible employee is given a notice (in writing or such other form as prescribed by the Commissioner) that explains—

(i) The consequences of the amendment that reduces or suspends future safe harbor contributions;

(ii) The procedures for changing their cash or deferred elections and, if applicable, their employee contribution elections; and

(iii) The effective date of the amendment.

(h) *Additional rules*—(1) *Contributions taken into account.* A contribution is taken into account for purposes of this section for a plan year if and only if the contribution would be taken into account for such plan year under the rules of §1.401(k)–2(a) or 1.401(m)–2(a). Thus, for example, a safe harbor matching contribution must be made within 12 months of the end of the plan year. Similarly, an elective contribution that would be taken into account for a plan year under §1.401(k)–2(a)(4)(i)(B)(*2*) must be taken into account for such plan year for purposes of this section, even if the compensation would have been received after the close of the plan year.

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests.* A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4). Thus, these contributions are not subject to the limitations on qualified nonelective contributions under §1.401(k)–2(a)(6)(ii), but are subject to the rules generally applicable to nonelective contributions under section 401(a)(4). See §1.401(a)(4)–1(b)(2)(ii). However, pursuant to section 401(k)(12)(E)(ii) and section 401(k)(13)(D)(iv), to the extent they are needed to satisfy the safe harbor contribution requirement of paragraph (b) of this section, safe harbor nonelective contributions may not be taken into account under any plan for purposes of section 401(l) (including the imputation of permitted disparity under §1.401(a)(4)–7).

(3) *Early participation rules.* Section 401(k)(3)(F) and §1.401(k)–2(a)(1)(iii)(A),

which provide an alternative nondiscrimination rule for certain plans that provide for early participation, do not apply for purposes of section 401(k)(12), section 401(k)(13), and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees. However, a plan is permitted to apply the rules of section 410(b)(4)(B) to treat the plan as two separate plans for purposes of section 410(b) and apply the safe harbor requirements of this section to one plan and apply the requirements of §1.401(k)–2 to the other plan. See §1.401(k)–1(b)(4)(vi), *Example 2*.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan.* Safe harbor matching or nonelective contributions may be made to the plan that contains the cash or deferred arrangement or to another defined contribution plan that satisfies section 401(a) or 403(a). If safe harbor contributions are made to another defined contribution plan, the safe harbor plan must specify the plan to which the safe harbor contributions are made and the contribution requirement of paragraph (b) or (c) of this section must be satisfied in the other defined contribution plan in the same manner as if the contributions were made to the plan that contains the cash or deferred arrangement. Consequently, the plan to which the contributions are made must have the same plan year as the plan containing the cash and deferred arrangement and each employee eligible under the plan containing the cash or deferred arrangement must be eligible under the same conditions under the other defined contribution plan. The plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

(5) *Contributions used only once.* Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

(i) [Reserved]

(j) *Qualified automatic contribution arrangement*—(1) *Automatic contribution requirement*—(i) *In general.* A cash or deferred arrangement is described in this paragraph (j) if it is an automatic contribution arrangement described in paragraph (j)(1)(ii) of this section where the default election under that arrangement is a contribution equal to the qualified percentage described in paragraph (j)(2) of this section multiplied by the eligible employee's compensation from which elective contributions are permitted to be made under the cash or deferred arrangement. For plan years beginning on or after January 1, 2010, the compensation used for this purpose must be safe harbor compensation as defined under paragraph (b)(2) of this section.

(ii) *Automatic contribution arrangement.* An automatic contribution arrangement is a cash or deferred arrangement within the meaning of §1.401(k)–1(a)(2) that provides that, in the absence of an eligible employee's affirmative election, a default election applies under which the employee is treated as having made an election to have a specified contribution made on his or her behalf under the plan. The default election begins to apply with respect to an eligible employee no earlier than a reasonable period of time after receipt of the notice describing the automatic contribution arrangement. The default election ceases to apply with respect to an eligible employee for periods of time with respect to which the employee has an affirmative election that is currently in effect to—

(A) Have elective contributions made in a different amount on his or her behalf (in a specified amount or percentage of compensation); or

(B) Not have any elective contributions made on his or her behalf.

(iii) *Exception to automatic enrollment for certain current employees.* An automatic contribution arrangement will not fail to be a qualified automatic contribution arrangement merely because the default election provided under paragraph (j)(1)(i) of this section is not applied to an employee who was an eligible employee under the cash or deferred arrangement (or a predecessor arrangement) immediately prior to the effective date of the qualified automatic contribution arrangement and on that effective date had an affirmative election in effect (that remains in effect) to—

(A) Have elective contributions made on his or her behalf (in a specified amount or percentage of compensation); or

(B) Not have elective contributions made on his or her behalf.

(2) *Qualified percentage*—(i) *In general.* A percentage is a qualified percentage only if it—

(A) Is uniform for all employees (except to the extent provided in paragraph (j)(2)(iii) of this section);

(B) Does not exceed 10 percent; and

(C) Satisfies the minimum percentage requirements of paragraph (j)(2)(ii) of this section.

(ii) *Minimum percentage requirements*—(A) *Initial-period requirement.* The minimum percentage requirement of this paragraph (j)(2)(ii)(A) is satisfied only if the percentage that applies for the initial period is at least 3 percent. For this purpose, the initial period begins when the employee first has contributions made pursuant to a default election under an arrangement that is intended to be a qualified automatic contribution arrangement for a plan year and ends on the last day of the following plan year.

(B) *Second-year requirement.* The minimum percentage requirement of this paragraph (j)(2)(ii)(B) is satisfied only if the percentage that applies for the plan year immediately following the last day described in paragraph (j)(2)(ii)(A) of this section is at least 4 percent.

(C) *Third-year requirement.* The minimum percentage requirement of this paragraph (j)(2)(ii)(C) is satisfied only if the percentage that applies for the plan year immediately following the plan year described in paragraph (j)(2)(ii)(B) of this section is at least 5 percent.

(D) *Later years requirement.* A percentage satisfies the minimum percentage requirement of this paragraph (j)(2)(ii)(D) only if the percentage that applies for all plan years following the plan year described in paragraph (j)(2)(ii)(C) of this section is at least 6 percent.

(iii) *Exception to uniform percentage requirement.* A plan does not fail to satisfy the uniform percentage requirement of paragraph (j)(2)(i)(A) of this section merely because—

(A) The percentage varies based on the number of years (or portions of years) since the beginning of the initial period for an eligible employee;

(B) The rate of elective contributions under a cash or deferred election that is in effect for an employee immediately prior to the effective date of the default percentage under the qualified automatic contribution arrangement is not reduced;

(C) The rate of elective contributions is limited so as not to exceed the limits of sections 401(a)(17), 402(g) (determined with or without catch-up contributions described in section 402(g)(1)(C) or 402(g)(7)), and 415; or

(D) The default election provided under paragraph (j)(1)(i) of this section is not applied during the period an employee is not permitted to make elective contributions in order for the plan to satisfy the requirements of §1.401(k)–3(c)(6)(v)(B).

(iv) *Treatment of periods without default contributions.* The minimum percentages described in paragraph (j)(2)(ii) of this section are based on the date the initial period begins, regardless of whether the employee is eligible to make elective contributions under the plan after that date. Thus, for example, if an employee is ineligible to make contributions under the plan for 6 months because the employee had a hardship withdrawal and the 6-month period includes a date as of which the default minimum percentage is increased, then the default percentage must reflect that increase when the employee is permitted to resume contributions. However, for purposes of determining the date the initial period described in paragraph (j)(2)(ii)(A) of this section begins, a plan is permitted to treat an employee who for an entire plan year did not have contributions made pursuant to a default election under the qualified automatic contribution arrangement as if the employee had not had such contributions made for any prior plan year as well.

(k) *Modifications to contribution requirements and notice requirements for* *automatic contribution safe harbor*—(1) *In general.* A cash or deferred arrangement satisfies the contribution requirements of this paragraph (k) only if it satisfies the contribution requirements of either paragraph (b) or (c) of this section, as modified by the rules of paragraphs (k)(2) and (k)(3) of this section. In addition, a cash or deferred arrangement satisfies the notice requirement of section 401(k)(13)(E) only if the notice satisfies the additional requirements of paragraph (k)(4) of this section.

(2) *Lower matching requirement.* In applying the requirement of paragraph (c) of this section in the case of a cash or deferred arrangement, the basic matching formula is modified so that each eligible NHCE must receive the sum of—

(i) 100 percent of the employee's elective contributions that do not exceed 1 percent of the employee's safe harbor compensation; and

(ii) 50 percent of the employee's elective contributions that exceed 1 percent of the employee's safe harbor compensation but that do not exceed 6 percent of the employee's safe harbor compensation.

(3) *Modified nonforfeiture requirement.* A cash or deferred arrangement described in paragraph (j) of this section will not fail to satisfy the requirements of paragraph (b) or (c) of this section, as applicable, merely because the safe harbor contributions are not qualified nonelective contributions or qualified matching contributions provided that—

(i) The contributions are subject to the withdrawal restrictions that apply to QNECs and QMACs, as set forth in § 1.401(k)–1(d); and

(ii) Any employee who has completed 2 years of service (within the meaning of section 411(a)) has a nonforfeitable right to the account balance attributable to the safe harbor contributions.

(4) *Additional notice requirements*—(i) *In general.* A notice satisfies the requirements of this paragraph (k)(4) only if it includes the additional information described in paragraph (k)(4)(ii) of this section and satisfies the timing requirements of paragraph (k)(4)(iii) of this section.

(ii) *Additional information.* A notice satisfies the additional information requirement of this paragraph (k)(4)(ii) only if it explains—

(A) The level of elective contributions which will be made on the employee's behalf if the employee does not make an affirmative election;

(B) The employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made in a different amount or percentage of compensation); and

(C) How contributions under the arrangement will be invested (including, in the case of an arrangement under which the employee may elect among 2 or more investment options, how contributions will be invested in the absence of an investment election by the employee).

(iii) *Timing requirements.* A notice satisfies the timing requirements of this paragraph (k)(4)(iii) only if it is provided sufficiently early so that the employee has a reasonable period of time after receipt of the notice to make the elections described under paragraph (k)(4)(ii)(B) and (C) of this section. However, the requirement in the preceding sentence that an employee have a reasonable period of time after receipt of the notice to make an alternative election does not permit a plan to make the default election effective any later than the earlier of—

(A) The pay date for the second payroll period that begins after the date the notice is provided; and

(B) The first pay date that occurs at least 30 days after the notice is provided.

[T.D. 9169, 69 FR 78154, Dec. 29, 2004, as amended by T.D. 9294, 71 FR 61887, Oct. 20, 2006; T.D. 9447, 74 FR 8208, Feb. 24, 2009; T.D. 9641, 78 FR 68737, Nov. 15, 2013]

§ 1.401(k)–4 SIMPLE 401(k) plan requirements.

(a) *General rule.* A cash or deferred arrangement satisfies the SIMPLE 401(k) plan provision of section 401(k)(11) for a plan year if the arrangement satisfies the requirements of paragraphs (b) through (i) of this section for that year. A plan that contains a cash or deferred arrangement that satisfies this section is referred to as a SIMPLE 401(k) plan. Pursuant to section

401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the ADP test of section 401(k)(3)(A)(ii) for that year.

(b) *Eligible employer*—(1) *General rule.* A SIMPLE 401(k) plan must be established by an eligible employer. Eligible employer for purposes of this section means, with respect to any plan year, an employer that had no more than 100 employees who each received at least $5,000 of SIMPLE compensation, as defined in paragraph (e)(5) of this section, from the employer for the prior calendar year.

(2) *Special rule.* An eligible employer that establishes a SIMPLE 401(k) plan for a plan year and that fails to be an eligible employer for any subsequent plan year, is treated as an eligible employer for the 2 plan years following the last plan year the employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence applies only if the provisions of section 410(b)(6)(C)(i) are satisfied.

(c) *Exclusive plan*—(1) *General rule.* The SIMPLE 401(k) plan must be the exclusive plan for each SIMPLE 401(k) plan participant for the plan year. This requirement is satisfied if there are no contributions made, or benefits accrued, for services during the plan year on behalf of any SIMPLE 401(k) plan participant under any other qualified plan maintained by the employer. Other qualified plan for purposes of this section means any plan, contract, pension, or trust described in section 219(g)(5)(A) or (B).

(2) *Special rule.* A SIMPLE 401(k) plan will not be treated as failing the requirements of this paragraph (c) merely because any SIMPLE 401(k) plan participant receives an allocation of forfeitures under another plan of the employer.

(d) *Election and notice*—(1) *General rule.* An eligible employer establishing or maintaining a SIMPLE 401(k) plan must satisfy the election and notice requirements in paragraphs (d)(2) and (3) of this section.

(2) *Employee elections*—(i) *Initial plan year of participation.* For the plan year in which an employee first becomes eligible under the SIMPLE 401(k) plan, the employee must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before.

(ii) *Subsequent plan years.* For each subsequent plan year, each eligible employee must be permitted to make or modify his cash or deferred election during the 60-day period immediately preceding such plan year.

(iii) *Election to terminate.* An eligible employee must be permitted to terminate his cash or deferred election at any time. If an employee does terminate his cash or deferred election, the plan is permitted to provide that such employee cannot have elective contributions made under the plan for the remainder of the plan year.

(3) *Employee notices.* The employer must notify each eligible employee within a reasonable time prior to each 60-day election period, or on the day the election period starts, that he or she can make a cash or deferred election, or modify a prior election, if applicable, during that period. The notice must state whether the eligible employer will make the matching contributions described in paragraph (e)(3) of this section or the nonelective contributions described in paragraph (e)(4) of this section.

(e) *Contributions*—(1) *General rule.* A SIMPLE 401(k) plan satisfies the contribution requirements of this paragraph (e) for a plan year only if no contributions may be made to the SIMPLE 401(k) plan during such year, other than contributions described in this paragraph (e) and rollover contributions described in § 1.402(c)–2, Q&A–1(a).

(2) *Elective contributions.* Subject to the limitations on annual additions under section 415, each eligible employee must be permitted to make an election to have up to $10,000 of elective contributions made on the employee's behalf under the SIMPLE 401(k) plan for a plan year. The $10,000 limit is increased beginning in 2006 in the same manner as the $160,000 amount is adjusted under section 415(d), except that pursuant to section 408(p)(2)(E)(ii) the base period shall be the calendar quarter beginning July 1, 2004 and any increase which is not a multiple of $500 is rounded to the next lower multiple of $500.

(3) *Matching contributions.* Each plan year, the eligible employer must contribute a matching contribution to the account of each eligible employee on whose behalf elective contributions were made for the plan year. The amount of the matching contribution must equal the lesser of the eligible employee's elective contributions for the plan year or 3% of the eligible employee's SIMPLE compensation for the entire plan year.

(4) *Nonelective contributions.* For any plan year, in lieu of contributing matching contributions described in paragraph (e)(3) of this section, an eligible employer may, in accordance with plan terms, contribute a nonelective contribution to the account of each eligible employee in an amount equal to 2% of the eligible employee's SIMPLE compensation for the entire plan year. The eligible employer may limit the nonelective contributions to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire plan year.

(5) *SIMPLE compensation.* Except as otherwise provided, the term *SIMPLE compensation* for purposes of this section means the sum of wages, tips, and other compensation from the eligible employer subject to federal income tax withholding (as described in section 6051(a)(3)) and the employee's elective contributions made under any other plan, and if applicable, elective deferrals under a section 408(p) SIMPLE IRA plan, a section 408(k)(6) SARSEP, or a plan or contract that satisfies the requirements of section 403(b), and compensation deferred under a section 457 plan, required to be reported by the employer on Form W-2 (as described in section 6051(a)(8)). For self-employed individuals, SIMPLE compensation means net earnings from self-employment determined under section 1402(a) prior to subtracting any contributions made under the SIMPLE 401(k) plan on behalf of the individual.

(f) *Vesting.* All benefits attributable to contributions described in paragraph (e) of this section must be nonforfeitable at all times.

(g) *Plan year.* The plan year of a SIMPLE 401(k) plan must be the whole calendar year. Thus, in general, a SIMPLE 401(k) plan can be established only on January 1 and can be terminated only on December 31. However, in the case of an employer that did not previously maintain a SIMPLE 401(k) plan, the establishment date can be as late as October 1 (or later in the case of an employer that comes into existence after October 1 and establishes the SIMPLE 401(k) plan as soon as administratively feasible after the employer comes into existence).

(h) *Other rules.* A SIMPLE 401(k) plan is not treated as a top-heavy plan under section 416. See section 416(g)(4)(G).

[T.D. 9169, 69 FR 78154, Dec. 29, 2004]

§ 1.401(k)–5 Special rules for mergers, acquisitions and similar events. [Reserved]

[T.D. 9169, 69 FR 78154, Dec. 29, 2004]

§ 1.401(k)–6 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(k) and the regulations thereunder.

Actual contribution percentage (ACP) test. Actual contribution percentage test or *ACP test* means the test described in § 1.401(m)–2(a)(1).

Actual deferral percentage (ADP). Actual deferral percentage or *ADP* means the ADP of the group of eligible employees as defined in § 1.401(k)–2(a)(2).

Actual deferral percentage (ADP) test. Actual deferral percentage test or *ADP test* means the test described in § 1.401(k)–2(a)(1).

Actual deferral ratio (ADR). Actual deferral ratio or *ADR* means the ADR of an eligible employee as defined in § 1.401(k)–2(a)(3).

Cash or deferred arrangement. Cash or deferred arrangement is defined in § 1.401(k)–1(a)(2).

Cash or deferred election. Cash or deferred election is defined in § 1.401(k)–1(a)(3).

Compensation. 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. A plan 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. In the case of an HCE whose ADR is determined under §1.401(k)–2(a)(3)(ii), period of participation includes periods under another plan for which elective contributions are aggregated under §1.401(k)–2(a)(3)(ii). See also section 401(a)(17) and §1.401(a)(17)–1(c)(1).

Current year testing method. Current year testing method means the testing method described in §1.401(k)–2(a)(2)(ii) or 1.401(m)–2(a)(2)(ii) under which the applicable year is the current plan year.

Designated Roth account. Designated Roth account means a separate account maintained by a plan to which only designated Roth contributions (including income, expenses, gains and losses attributable thereto) are made.

Designated Roth contributions. Designated Roth contributions means designated Roth contributions as defined in §1.401(k)–1(f)(1).

Elective contributions. Elective contributions means employer contributions made to a plan pursuant 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 §1.401(k)–1(a)(4)).

Eligible employee—(1) *General rule. 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.

(2) *Conditions on eligibility*. 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 §1.401(k)–1(e)(5), 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).

(3) *Certain one-time elections*. An employee is not an eligible employee merely because the employee, no later than the employee's first becoming eligible to make a cash or deferred election under any plan or arrangement of the employer (described in section 219(g)(5)(A)), 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 or arrangement 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 §1.401(k)–1(a)(3)(v) 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 or arrangement (whether or not terminated) of the employer.

Eligible HCE. Eligible HCE means an eligible employee who is an HCE.

Eligible NHCE. Eligible NHCE means an eligible employee who is not an HCE.

Employee. Employee means an employee within the meaning of §1.410(b)–9.

Employee stock ownership plan (ESOP). Employee stock ownership plan or *ESOP* means the portion of a plan that is an ESOP within the meaning of §1.410(b)–7(c)(2).

Employer. Employer means an employer within the meaning of §1.410(b)–9.

Excess contributions. Excess contributions means, with respect to a plan year, the amount of total excess contributions apportioned to an HCE under §1.401(k)–2(b)(2)(iii).

Excess deferrals. Excess deferrals means excess deferrals as defined in §1.402(g)–1(e)(3).

Highly compensated employee (HCE). Highly compensated employee or *HCE* has the meaning provided in section 414(q).

Matching contributions. Matching contributions means matching contributions as defined in §1.401(m)–1(a)(2).

Nonelective contributions. Nonelective contributions 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.

Non-employee stock ownership plan (non-ESOP). Non-employee stock ownership plan or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)–7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or *NHCE* means an employee who is not an HCE.

Plan. Plan is defined in §1.401(k)–1(b)(4).

Pre-ERISA money purchase pension plan. (1) *Pre-ERISA money purchase pension plan* is a pension plan—

(i) That is a defined contribution plan (as defined in section 414(i));

(ii) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement; and

(iii) 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.

(2) 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.

Pre-tax elective contributions. Pre-tax elective contributions means elective contributions under a qualified cash or deferred arrangement that are not designated Roth contributions.

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)–2(a)(2)(ii) or 1.401(m)–2(a)(2)(ii).

Qualified matching contributions (QMACs). Qualified matching contributions or *QMACs* means matching contributions that, except as provided otherwise in §1.401(k)–1(c) and (d), satisfy the requirements of §1.401(k)–1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ACP test under §1.401(m)–2(a)(6). Thus, the matching contributions must satisfy the vesting requirements of §1.401(k)–1(c) and be subject to the distribution requirements of §1.401(k)–1(d) when they are contributed to the plan. See also §1.401(k)–2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) as a result of being a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution, or it is forfeitable under §1.414(w)–1(d)(2).

Qualified nonelective contributions (QNECs). Qualified nonelective contributions or *QNECs* means employer contributions, other than elective contributions or matching contributions, that, except as provided otherwise in §1.401(k)–1(c) and (d), satisfy the requirements of §1.401(k)–1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ACP test under §1.401(m)–2(a)(6). Thus, the nonelective contributions must satisfy the vesting requirements of §1.401(k)–1(c) and be subject to the distribution requirements of §1.401(k)–1(d) when they are contributed to the plan.

Rural cooperative plans. Rural cooperative plan means a plan described in section 401(k)(7).

[T.D. 9169, 69 FR 78154, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 10, Jan. 3, 2006; T.D. 9447, 74 FR 8210, Feb. 24, 2009]

§ 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.

(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.

[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)–6 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(a)(3) or (a)(2), 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; T.D. 9169, 69 FR 78153, Dec. 29, 2004]

§ 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.

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§ 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 paragraph (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×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
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

TABLE II—Continued

[Social security retirement age 66]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
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
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

TABLE I—Continued

[Social security retirement age 67]

Age at which benefits commence	Annual factor in maximum excess allowance and maximum offset allowance (percent)
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
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 (0.67×45). 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 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(m)–1 through 1.401(m)–5.

LIST OF SECTIONS

LIST OF PARAGRAPHS

(ii) Aggregation of employee contributions and matching contributions within a plan.
(iii) Aggregation of plans.
(A) In general.
(B) Arrangements with inconsistent ACP testing methods.
(iv) Disaggregation of plans and separate testing.
(A) In general.
(B) Restructuring prohibited.
(v) Certain disaggregation rules not applicable.
(c) Additional requirements.
(1) Separate testing for employee contributions and matching contributions.
(2) Plan provision requirement.
(d) Effective date.
(1) General rule.
(2) Early implementation permitted.
(3) Applicability of prior regulations.

§ 1.401(m)–2 ACP test.

(a) Actual contribution percentage (ACP) test.
(1) In general.
(i) ACP test formula.
(ii) HCEs as sole eligible employees.
(iii) Special rule for early participation.
(2) Determination of ACP.
(i) General rule.
(ii) Determination of applicable year under current year and prior year testing method.
(3) Determination of ACR.
(i) General rule.
(ii) ACR of HCEs eligible under more than one plan.
(A) General rule.
(B) Plans not permitted to be aggregated.
(iii) Example.
(4) Employee contributions and matching contributions taken into account under the ACP test.
(i) Employee contributions.
(ii) Recharacterized elective contributions.
(iii) Matching contributions.
(5) Employee contributions and matching contributions not taken into account under the ACP test.
(i) General rule.
(ii) Disproportionate matching contributions.
(A) Matching contributions in excess of 100%.
(B) Representative matching rate.
(C) Definition of matching rate.
(iii) Qualified matching contributions used to satisfy the ADP test.
(iv) Matching contributions taken into account under safe harbor provisions.
(v) Treatment of forfeited matching contributions.
(vi) Additional employee contributions or matching contributions pursuant to section 414(u).
(6) Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test.
(i) Timing of allocation.
(ii) Elective contributions taken into account under the ACP test.
(iii) Requirement that amount satisfy section 401(a)(4).
(iv) Aggregation must be permitted.
(v) Disproportionate contributions not taken into account.
(A) General rule.
(B) Definition of representative contribution rate.
(C) Definition of applicable contribution rate.
(D) Special rule for prevailing wage contributions.
(vi) Contribution only used once.
(7) Examples.
(b) Correction of excess aggregate contributions.
(1) Permissible correction methods.
(i) In general.
(A) Additional contributions.
(B) Excess aggregate contributions distributed or forfeited.
(ii) Combination of correction methods.
(iii) Exclusive means of correction.
(2) Correction through distribution.
(i) General rule.
(ii) Calculation of total amount to be distributed.
(A) Calculate the dollar amount of excess aggregate contributions for each HCE.
(B) Determination of the total amount of excess aggregate contributions.
(C) Satisfaction of ACP.
(iii) Apportionment of total amount of excess aggregate contributions among the HCEs.
(A) Calculate the dollar amount of excess aggregate contributions for each HCE.
(B) Limit on amount apportioned to any HCE.
(C) Apportionment to additional HCEs.
(iv) Income allocable to excess aggregate contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating income for the plan year.
(D) Plan years before 2008.
(E) Alternative method of allocating plan year and gap period income.
(F) Allocable income for recharacterized elective contributions.
(v) Distribution and forfeiture.
(vi) Tax treatment of corrective distributions.
(A) Corrective distributions for plan years beginning on or after January 1, 2008.
(B) Corrective distributions for plan years beginning before January 1, 2008.
(C) Corrective distributions attributable to designated Roth contributions.
(3) Other rules.
(i) No employee or spousal consent required.

[T.D. 9169, 69 FR 78184, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 10, Jan. 3, 2006; T.D. 9447, 74 FR 8210, Feb. 24, 2009; T.D. 9641, 78 FR 68738, Nov. 15, 2013]

§ 1.401(m)–1 Employee contributions and matching contributions.

(a) *General nondiscrimination rules*—(1) *Nondiscriminatory amount of contributions*—(i) *Exclusive means of amounts testing*. A defined contribution plan does not satisfy section 401(a) for a plan year unless the amount of employee contributions and matching contributions to the plan for the plan year satisfies section 401(a)(4). The amount of employee contributions and matching contributions under a plan satisfies the requirements of section 401(a)(4) with respect to amounts if and only if the amount of employee contributions and matching contributions satisfies the nondiscrimination test of section 401(m) under paragraph (b) of this section and the plan satisfies the additional requirements of paragraph (c) of this section. See § 1.401(a)(4)–1(b)(2)(ii)(B).

(ii) *Testing benefits, rights and features*. A plan that provides for employee contributions or matching contributions must satisfy the requirements of section 401(a)(4) relating to benefits, rights and features in addition to the requirement regarding amounts described in paragraph (a)(1)(i) of this section. For example, the right to make each level of employee contributions and the right to each level of matching contributions under the plan are benefits, rights or features subject to the requirements of section 401(a)(4). See §1.401(a)(4)–4(e)(3)(i) and (iii)(F) through (G).

(2) *Matching contributions*—(i) *In general*. For purposes of section 401(m), this section and §§1.401(m)–2 through 1.401(m)–5, matching contributions are—

(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; and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals.

(ii) *Employer contributions made on account of an employee contribution or elective deferral*. Whether an employer contribution is made on account of an employee contribution or an elective deferral is determined on the basis of all the relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. 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 other arrangement described in §1.402(g)–1(b) is not a matching contribution.

(iii) *Employer contributions not on account of an employee contribution or elective deferral*—(A) *General rule*. Employer contributions are not matching contributions made on account of elective deferrals if they are contributed before the cash or deferred election is made or before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier). In addition, an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution.

(B) *Exceptions for forfeitures and released ESOP shares*. The rule of paragraph (a)(3)(iii)(A) of this section does not apply to a forfeiture that is allocated as a matching contribution. In addition, an allocation of shares from an ESOP loan suspense account described in §54.4975–11(c) and (d) of this chapter will not fail to be treated as a matching contribution solely because the employer contribution that resulted in the release and allocation of those shares from the suspense account is made before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier) provided that—

(*1*) The contribution is for a required payment that is due under the loan terms; and

(*2*) The contribution is not made early with a principal purpose of accelerating deductions.

(C) *Exception for bona fide administrative considerations*. The timing of contributions will not be treated as failing to satisfy the requirements of this paragraph (a)(3)(iii) merely because contributions are occasionally made before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier) in order to accommodate bona fide administrative considerations and are not paid early with a principal purpose of accelerating deductions.

(3) *Employee contributions*—(i) *In general*. For purposes of section 401(m), this section and §§1.401(m)–2 through 1.401(m)–5, employee contributions are

contributions to a plan that are designated or treated at the time of contribution as after-tax employee contributions (*e.g.*, by treating the contributions as taxable income subject to applicable withholding requirements) and are allocated to an individual account for each eligible employee to which attributable earnings and losses are allocated. See § 1.401(k)–1(a)(2)(ii). The term *employee contributions includes*—

(A) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(B) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(C) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions under § 1.401(k)–2(b)(3); and

(D) Employee contributions to a plan or contract that satisfies the requirements of section 403(b).

(ii) *Certain contributions not treated as employee contributions.* The term employee contributions does not include designated Roth contributions, repayment of loans, rollover contributions, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to the plan from another plan.

(iii) *Qualified cost-of-living arrangements.* Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B) are treated as employee contributions to a defined contribution plan, without regard to the requirement that the employee contributions be allocated to an individual account to which attributable earnings and losses are allocated.

(b) *Nondiscrimination requirements for amount of contributions*—(1) *Matching contributions and employee contributions.* The matching contributions and employee contributions under a plan satisfy this paragraph (b) for a plan year only if the plan satisfies—

(i) The ACP test of section 401(m)(2) described in § 1.401(m)–2;

(ii) The ACP safe harbor provisions of section 401(m)(11) described in § 1.401(m)–3; or

(iii) The ACP safe harbor provisions of section 401(m)(12) described in § 1.401(m)–3; or

(iv) The SIMPLE 401(k) provisions of sections 401(k)(11) and 401(m)(10) described in § 1.401(k)–4.

(2) *Automatic satisfaction by certain plans.* Notwithstanding paragraph (b)(1) of this section, the requirements of this section are treated as satisfied with respect to employee contributions 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). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof) and, accordingly such plans are not required to comply with this section. See sections 401(a)(5)(G), 403(b)(12)(C) and 410(c)(1)(A).

(3) *Anti-abuse provisions.* Sections 1.401(m)–1 through 1.401(m)–5 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ACP for NHCEs (which is used as a benchmark for testing the ACP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring*—(i) *In general.* This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans that provide for employee contributions and matching contributions for purposes of this section and §§1.401(m)–2 through 1.401(m)–5.

(ii) *Aggregation of employee contributions and matching contributions within a plan.* Except as otherwise specifically provided in this paragraph (b)(4) and §1.401(m)–3(j)(6), a plan must be subject to a single test under paragraph (b)(1) of this section with respect to all employee contributions and matching contributions and all eligible employees under the plan. Thus, for example, if two groups of employees are eligible for matching contributions under a plan, all employee contributions and matching contributions under the plan must be subject to a single test, even if they have significantly different features, such as different rates of match.

(iii) *Aggregation of plans*—(A) *In general.* 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), as modified by paragraph (b)(4)(v) 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 sections 401(k) and 401(m).

(B) *Arrangements with inconsistent ACP testing methods.* Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all employee contributions and matching contributions and all eligible employees under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)–7(d), an employer may not aggregate plans (within the meaning of §1.410(b)–7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)–7) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)–7) that is using the ACP safe harbor provisions of section 401(m)(11) or 401(m)(12) and another plan that is using the ACP test of section 401(m)(2).

(iv) *Disaggregation of plans and separate testing*—(A) *In general.* If employee contributions or matching contributions are included in a plan (within the meaning of §1.410(b)–7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the matching contributions and employee contributions under that plan must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a plan which provides for employee contributions or matching contributions are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(m), unless the employer is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan. Similarly, if a plan that provides for employee contributions or matching contributions under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the plan must be treated as two separate plans, one comprising all eligible employees who have met the minimum age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the minimum age and service requirements of section 410(a)(1), unless the plan is using the rule in §1.401(m)–2(a)(1)(iii)(A).

(B) *Restructuring prohibited.* 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).

(v) *Certain disaggregation rules not applicable.* The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)–7(c)(1) and to ESOP and non-

ESOP portions of a plan set forth in §1.410(b)–7(c)(2) shall not apply for purposes of this section and §§1.401(m)–2 through 1.401(m)–5. Accordingly, notwithstanding §1.410(b)–7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of section 414(l), as described in §1.410(b)–7(b)) are permitted to be aggregated for these purposes.

(c) *Additional requirements*—(1) *Separate testing for employee contributions and matching contributions.* Under §1.410(b)–7(c)(1), the group of employees who are eligible to make employee contributions or eligible to receive matching contributions must satisfy the requirements of section 410(b) as if those employees were covered under a separate plan. The determination of whether the separate plan satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. In addition, except as expressly permitted under section 401(k), 410(b)(2)(A)(ii), or 416(c)(2)(A), employee contributions, matching contributions and elective contributions taken into account under §1.401(m)–2(a)(6) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee contributions or matching contributions are made) satisfy the requirements of section 401(a). See also §1.401(a)(4)–11(g)(3)(vii) for special rules relating to corrections of violations of the minimum coverage requirements or discriminatory rates of matching contributions.

(2) *Plan provision requirement.* A plan that provides for employee contributions or matching contributions satisfies this section only if it provides that the nondiscrimination requirements of section 401(m) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ACP test of section 401(m)(2), as described in paragraph (b)(1)(i) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ACP for eligible NHCEs for the first plan year is 3% or the ACP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(m)(11) or 401(m)(12), as described in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section, must specify the default percentages that apply for the plan year and whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution, and is not permitted to provide that ACP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (c)(2), a plan may incorporate by reference the provisions of section 401(m)(2) and §1.401(m)–2 if that is the nondiscrimination test being applied. The Commissioner may, in guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), specify the options that will apply under the plan if the nondiscrimination test is incorporated by reference in accordance with the preceding sentence.

(d) *Effective date*—(1) *General rule.* Except as otherwise provided in this paragraph (d), this section and §§1.401(m)–2 through 1.401(m)–5 apply to plan years that begin on or after January 1, 2006.

(2) *Early implementation permitted.* A plan is permitted to apply the rules of this section and §§1.401(m)–2 through 1.401(m)–5 to any plan year that ends after December 29, 2004, provided the plan applies all the rules of this section and §§1.401(m)–2 through 1.401(m)–5 and all the rules of §§1.401(k)–1 through 1.401(k)–6, to the extent applicable, for that plan year and all subsequent plan years.

(3) *Applicability of prior regulations.* For any plan year, before a plan applies this section and §§1.401(m)–2 through 1.401(m)–5 (either the first plan year beginning on or after January 1, 2006 or such earlier year, as provided in paragraph (d)(2) of this section), §1.401(m)–1 and §1.401(m)–2 (as they appeared in the April 1, 2004 edition of 26 CFR part 1) apply to the plan to the extent those sections, as they so appear, reflect the

statutory provisions of section 401(m) as in effect for the relevant year.

[T.D. 9169, 69 FR 78184, Dec. 29, 2004, as amended by T.D. 9447, 74 FR 8210, Feb. 24, 2009]

§ 1.401(m)–2 ACP test.

(a) *Actual contribution percentage (ACP) test*—(1) *In general*—*(i) ACP test formula.* A plan satisfies the ACP test for a plan year only if—

(A) The ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ACP for the eligible HCEs for the plan year over the ACP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees.* If, for the applicable year there are no eligible NHCEs (*i.e.*, all of the eligible employees under the plan for the applicable year are HCEs), the plan is deemed to satisfy the ACP test.

(iii) *Special rule for early participation.* If a plan providing for employee contributions or matching contributions provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the plan meets the requirements of section 410(b)(1), then in determining whether the plan meets the requirements under paragraph (a)(1) of this section either—

(A) Pursuant to section 401(m)(5)(C), the ACP test is performed under the plan (determined without regard to disaggregation under §1.410(b)–7(c)(3)), using the ACP for all eligible HCEs for the plan year and the ACP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(m)–1(b)(4), the plan is disaggregated into separate plans and the ACP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ACP*—(i) *General rule.* The ACP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ACRs of eligible employees in the group for that year. The ACP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method.* The ACP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ACP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ACP test is being calculated. Under the prior year testing method, the ACP for the eligible NHCEs is determined using the ACRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ACP test is being performed. Under the current year testing method, the applicable year for determining the ACP for eligible NHCEs is the same plan year as the plan year for which the ACP test is being calculated. Under either method, the ACP for the eligible HCEs is determined using the ACRs of eligible employees who are HCEs for the plan year for which the ACP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ACR*—(i) *General rule.* The ACR of an eligible employee for the plan year or applicable year is the sum of the employee contributions and matching contributions taken into account with respect to such employee (determined under the rules of paragraphs (a)(4) and (5) of this section), and the qualified nonelective and elective contributions taken into account under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ACR is calculated to the nearest hundredth of a percentage

point. If no employee contributions, matching contributions, elective contributions, or qualified nonelective contributions are taken into account under this section with respect to an eligible employee for the year, the ACR of the employee is zero.

(ii) *ACR of HCEs eligible under more than one plan*—(A) *General rule*. Pursuant to section 401(m)(2)(B), the ACR of an HCE who is an eligible employee in more than one plan of an employer to which matching contributions or employee contributions are made is calculated by treating all contributions with respect to such HCE under any such plan as being made under the plan being tested. Thus, the ACR for such an HCE is calculated by accumulating all matching contributions and employee contributions under any plan (other than a plan described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the plan under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ACR for the plan year of that plan for an HCE who participates in multiple plans of the same employer that provide for matching contributions or employee contributions is the sum of all such contributions during such 12-month period that would be taken into account with respect to the HCE under all plans in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(m)–3.

(B) *Plans not permitted to be aggregated*. Contributions under plans that are not permitted to be aggregated under §1.401(m)–1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(m)–1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)–7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Example*. The following example illustrates the application of paragraph (a)(3)(ii) of this section. See also §1.401(k)–2(a)(3)(iii) for additional examples of the application of the parallel rule under section 401(k)(3)(A). The example is as follows:

Example. Employee A, an HCE with compensation of $120,000, is eligible to make employee contributions under Plan S and Plan T, two calendar-year profit-sharing plans of Employer H. Plan S and Plan T use the same definition of compensation. Plan S provides a match equal to 50% of each employee's contributions and Plan T has no match. During the current plan year, Employee A elects to contribute $4,000 in employee contributions to Plan T and $4,000 in employee contributions to Plan S. There are no other contributions made on behalf of Employee A. Each plan must calculate Employee A's ACR by dividing the total employee contributions by Employee A and matching contributions under both plans by $120,000. Therefore, Employee A's ACR under each plan is 8.33% ($4,000 + $4,000 + $2,000/$120,000).

(4) *Employee contributions and matching contributions taken into account under the ACP test*—(i) *Employee contributions*. An employee contribution is taken into account in determining the ACR for an eligible employee for the plan year or applicable year in which the contribution is made. For purposes of the preceding sentence, an amount withheld from an employee's pay (or a payment by the employee to an agent of the plan) is treated as contributed at the time of such withholding (or payment) if the funds paid are transmitted to the trust within a reasonable period after the withholding (or payment).

(ii) *Recharacterized elective contributions*. Excess contributions recharacterized in accordance with §1.401(k)–2(b)(3) are taken into account as employee contributions 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)–2(b)(3)(ii).

(iii) *Matching contributions*. A matching contribution is taken into account in determining the ACR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied—

(A) The matching contribution is allocated to the employee's account under the terms of the plan as of a date within that year;

(B) The matching contribution is made on account of (or the matching contribution is allocated on the basis of) the employee's elective deferrals or employee contributions for that year; and

(C) The matching contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year that contains that date.

(5) *Employee contributions and matching contributions not taken into account under the ACP test*—(i) *General rule.* Matching contributions that do not satisfy the requirements of paragraph (a)(4)(iii) of this section may not be taken into account in the ACP test for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the ACP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. *See* §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Disproportionate matching contributions*—(A) *Matching contributions in excess of 100%.* A matching contribution with respect to an elective deferral for an NHCE is not taken into account under the ACP test to the extent it exceeds the greatest of:

(*1*) 5% of compensation;

(*2*) the employee's elective deferrals for a year; and

(*3*) the product of 2 times the plan's representative matching rate and the employee's elective deferrals for a year.

(B) *Representative matching rate.* For purposes of this paragraph (a)(5)(ii), the plan's representative matching rate is the lowest matching rate for any eligible NHCE among a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year who make elective deferrals for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals for the plan year).

(C) *Definition of matching rate.* For purposes of this paragraph (a)(5)(ii), the matching rate for an employee generally is the matching contributions made for such employee divided by the employee's elective deferrals for the year. If the matching rate is not the same for all levels of elective deferrals for an employee, the employee's matching rate is determined assuming that an employee's elective deferrals are equal to 6 percent of compensation.

(D) *Application to matching contributions that match employee contributions.* If a plan provides a match with respect to the sum of the employee's employee contributions and elective deferrals, that sum is substituted for the amount of the employee's elective deferrals in paragraphs (a)(5)(ii) (A) and (C) of this section and employees who make either employee contributions or elective deferrals are taken into account under paragraph (a)(5)(ii)(B) of this section. Similarly, if a plan provides a match with respect to the employee's employee contributions, but not elective deferrals, the employee's employee contributions are substituted for the amount of the employee's elective deferrals in paragraphs (a)(5)(ii) (A) and (C) of this section and employees who make employee contributions are taken into account under paragraph (a)(5)(ii)(B) of this section.

(iii) *Qualified matching contributions used to satisfy the ADP test.* Qualified matching contributions that are taken into account for the ADP test of section 401(k)(3) under §1.401(k)–2(a)(6) are not taken into account in determining an eligible employee's ACR.

(iv) *Matching contributions taken into account under safe harbor provisions.* A plan that satisfies the ACP safe harbor requirements of section 401(m)(11) or 401(m)(12) for a plan year but nonetheless must satisfy the requirements of this section because it provides for employee contributions for such plan year is permitted to apply this section disregarding all matching contributions with respect to all eligible employees. In addition, a plan that satisfies the ADP safe harbor requirements of §1.401(k)–3 for a plan year using qualified matching contributions but does not satisfy the ACP safe harbor requirements of section 401(m)(11) or 401(m)(12) for such plan year is permitted to apply this section by excluding matching contributions with respect to all eligible employees that do not exceed 4 percent (3½ percent in the case of a plan that satisfies the ADP safe harbor under section 401(k)(13)) of each employee's compensation. If a plan disregards matching contributions pursuant to this paragraph (a)(5)(iv), the disregard must apply with respect to all eligible employees.

(v) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited because the contribution to which it relates is treated as an excess contribution, excess deferral, excess aggregate contribution, or default elective contribution that is distributed under section 414(w), is not taken into account for purposes of this section.

(vi) *Additional employee contributions or matching contributions pursuant to section 414(u).* Additional employee contributions and matching contributions made by reason of an eligible employee's qualified military service under section 414(u) are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions are made, or for any other plan year.

(6) *Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test.* Qualified nonelective contributions and elective contributions may be taken into account in determining the ACR for an eligible employee for a plan year or applicable year, but only to the extent the contributions satisfy the following requirements—

(i) *Timing of allocation.* The qualified nonelective contribution is allocated to the employee's account as of a date within that year (within the meaning of §1.401(k)–2(a)(4)(i)(A)) and the elective contribution satisfies §1.401(k)–2(a)(4)(i). Consequently, under the prior year testing method, in order to be taken into account in calculating the ACP for the group of eligible NHCEs for the applicable year, a qualified nonelective contribution must be contributed no later than the end of the 12-month period following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Elective contributions taken into account under the ACP test.* Elective contributions may be taken into account for the ACP test only if the cash or deferred arrangement under which the elective contributions are made is required to satisfy the ADP test in §1.401(k)–2(a)(1) and, then only to the extent that the cash or deferred arrangement would satisfy that test, including such elective contributions in the ADP for the plan year or applicable year. Thus, for example, elective deferrals made pursuant to a salary reduction agreement under an annuity described in section 403(b) are not permitted to be taken into account in an ACP test. Similarly, elective contributions under a cash or deferred arrangement that is using the section 401(k) safe harbor described in §1.401(k)–3 cannot be taken into account in an ACP test. In addition, for plan years ending on or after November 8, 2007, elective contributions which are not permitted to be taken into account for the ADP test for the plan year under §1.401(k)–2(a)(5)(ii), (iii), (v), or (vi) are not permitted to be taken into account for the ACP test.

(iii) *Requirement that amount satisfy section 401(a)(4).* The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)–2(a)(6), and the amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) for the ACP test and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan, then the determination of whether the qualifiednonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iv) *Aggregation must be permitted.* The plan that provides for employee or matching contributions and the plan or plans to which the qualified nonelective contributions or elective contributions are made are plans that would be permitted to be aggregated under §1.401(m)–1(b)(4). If the plan year of the plan that provides for employee or matching contributions is changed to satisfy the requirement under §1.410(b)–7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and elective contributions may be taken into account in the resulting short plan year only if such qualified nonelective and elective contributions could have been taken into account under an ADP test for a plan with that same short plan year.

(v) *Disproportionate contributions not taken into account*—(A) *General rule.* Qualified nonelective contributions cannot be taken into account for an applicable year for an NHCE to the extent such contributions exceed the product of that NHCE's compensation and the greater of 5% and 2 times the plan's representative contribution rate. Any qualified nonelective contribution taken into account in an ADP test under §1.401(k)–2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(k)–2(a)(6)(iv)(B)) is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate for purposes of paragraph (a)(6)(v)(B) of this section).

(B) *Definition of representative contribution rate.* For purposes of this paragraph (a)(6)(v), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the applicable year and who is employed by the employer on the last day of the applicable year).

(C) *Definition of applicable contribution rate.* For purposes of this paragraph (a)(6)(v), the applicable contribution rate for an eligible NHCE is the sum of the matching contributions taken into account under this section for the employee for the plan year and the qualified nonelective contributions made for that employee for the plan year, divided by that employee's compensation for the same period.

(D) *Special rule for prevailing wage contributions.* Notwithstanding paragraph (a)(6)(v)(A) of this section, qualified nonelective contributions that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act (46 Stat. 1494), Pub. L. 71–798, Service Contract Act of 1965 (79 Stat. 1965), Pub. L. 89–286, or similar legislation can be taken into account for a plan year for an NHCE to the extent such contributions do not exceed 10 percent of that NHCE's compensation.

(vi) *Contribution only used once.* Qualified nonelective contributions cannot be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ACP test, any ADP test, or the requirements of §1.401(k)–3, 1.401(m)–3 or 1.401(k)–4. Thus, for example, qualified nonelective contributions that are made pursuant to §1.401(k)–3(b) cannot be taken into account under the ACP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(m)–2(c)(1), qualified nonelective contributions that are taken into account under the current year testing method for a plan year may not be taken into account under the prior year testing method for the next plan year.

(7) *Examples*. The following examples illustrate the application of this paragraph (a). See §1.401(k)–2(a)(6) for additional examples of the parallel rules under section 401(k)(3)(A). The examples are as follows:

Example 1. (i) Employer L maintains Plan U, a profit-sharing plan under which $.50 matching contributions are made for each dollar of employee contributions. Plan U uses the current year testing method. The chart below shows the average employee contributions (as a percentage of compensation) and matching contributions (as a percentage of compensation) for Plan U's HCEs and NHCEs for the 2006 plan year:

	Employee contributions (percentage)	Matching contributions (percentage)	Actual contribution (percentage)
Highly compensated employees	4	2	6
Nonhighly compensated employees	3	1.5	4.5

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees.

(iii) Because the ACP for the HCEs (6.0%) exceeds 5.63% (4.5%×1.25), Plan U does not satisfy the ACP test under paragraph (a)(1)(i)(A) of this section. However, because the ACP for the HCEs does not exceed the ACP for the NHCEs by more than 2 percentage points and the ACP for the HCEs does not exceed the ACP for the NHCEs multiplied by 2 (4.5%×2 = 9%), the plan satisfies the ACP test under paragraph (a)(1)(i)(B) of this section.

Example 2. (i) Employees A through F are eligible employees in Plan V, a profit-sharing plan of Employer M that includes a cash or deferred arrangement and permits employee contributions. Under Plan V, a $.50 matching contribution is made for each dollar of elective contributions and employee contributions. Plan V uses the current year testing method and does not provide for elective contributions to be taken into account in determining an eligible employee's ACR. For the 2006 plan year, Employees A and B are HCEs and the remaining employees are NHCEs. The compensation, elective contributions, employee contributions, and matching contributions for the 2006 plan year are shown in the following table:

Employee	Compensation	Elective contributions	Employee contributions	Matching contributions
A	$190,000	$15,000	$3,500	$9,250
B	100,000	5,000	10,000	7,500
C	85,000	12,000	0	6,000
D	70,000	9,500	0	4,750
E	40,000	10,000	0	5,000
F	10,000	0	0	0

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees, as shown in the following table:

Employee	Compensation	Employee contributions	Matching contributions	ACR (percent)
A	$190,000	$3,500	$9,250	6.71
B	100,000	10,000	7,500	17.50
C	85,000	0	6,000	7.06
D	70,000	0	4,750	6.79
E	40,000	0	5,000	12.50
F	10,000	0	0	0

(iii) The ACP for the HCEs is 12.11% ((6.71% + 17.50%)/2). The ACP for the NHCEs is 6.59% ((7.06% + 6.79% + 12.50% + 0.%)/4). Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(A) of this section because the ACP of HCEs is more than 125% of the ACP of the NHCEs (6.59%×1.25=8.24%). In addition, Plan

V fails to satisfy the ACP test under paragraph (a)(1)(i)(B) of this section because the ACP for the HCEs exceeds the ACP of the other employees by more than 2 percentage points (6.59% + 2% = 8.59%). Therefore, the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 3. (i) The facts are the same as *Example 2*, except that the plan provides that the NHCEs' elective contributions may be used to meet the requirements of section 401(m) to the extent needed under that section.

(ii) Pursuant to paragraph (a)(6)(ii) of this section, the $10,000 of elective contributions for Employee E may be taken into account in determining the ACP rather than the ADP to the extent that the plan satisfies the requirements of §1.401(k)–2(a)(1) excluding from the ADP this $10,000. In this case, if the $10,000 were excluded from the ADP for the NHCEs, the ADP for the HCEs is 6.45% (7.89% + 5.00%) /2 and the ADP for the NHCEs would be 6.92% (14.12% + 13.57% + 0% +0%)/4) and the plan would satisfy the requirements of §1.401(k)–2(a)(1) excluding from the ADP the elective contributions for NHCEs that are taken into account under section 401(m).

(iii) After taking into account the $10,000 of elective contributions for Employee E in the ACP test, the ACP for the NHCEs is 12.84% (7.06% + 6.79% + 37.50 % + 0%) /4. Therefore the plan satisfies the ACP test because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs.

Example 4. (i) The facts are the same as *Example 2*, except that Plan V provides for a higher than 50% match rate on the elective contributions and employee contributions for all NHCEs. The match rate is defined as the rate, rounded up to the next whole percent, necessary to allow the plan to satisfy the ACP test, but not in excess of 100%. In this case, an increase in the match rate from 50% to 74% will be sufficient to allow the plan to satisfy the ACP test. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions at a 74% match rate of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective contributions	Employee contributions	Matching contributions
C	$85,000	$12,000	$0	$8,880
D	70,000	9,500	0	7,030
E	40,000	10,000	0	7,400
F	10,000	0	0	0

(ii) The matching rate for all NHCEs is 74% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Therefore, the matching contributions may be taken into account in determining the ACP for the NHCEs.

(iii) The ACP for the NHCEs is 9.75% (10.45% + 10.04% + 18.50% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m).

Example 5. (i) The facts are the same as *Example 4*, except that: Employee E's elective contributions are $2,000 (rather than $10,000) and pursuant to paragraph (a)(6)(ii) of this section, the $2,000 of elective contributions for Employee E are taken into account in determining the ACP rather than the ADP. In addition, Plan V provides that the higher match rate is not limited to 100% and applies only for a specified group of NHCEs. The only member of that group is Employee E. Under the plan provision, the higher match rate is a 400% match. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective contributions	Employee contributions	Matching contributions
C	$85,000	$12,000	$0	$6,000
D	70,000	9,500	0	4,750
E	40,000	2,000	0	8,000
F	10,000	0	0	0

(ii) If the entire matching contribution made on behalf of Employee E were taken into account under the ACP test, Plan V would satisfy the test, because the ACP for the NHCEs would be 9.71% (7.06% + 6.79% + 25.00% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times what the ACP for the NHCEs would be, the plan would satisfy the requirements of section 401(m).

(iii) Pursuant to paragraph (a)(5)(ii) of this section, however, matching contributions for an eligible NHCE that exceed the greatest of 5% of compensation, the employee's elective deferrals and 2 times the product of the plan's representative matching rate and the employee's elective deferrals cannot be taken into account in applying the ACP test. The plan's representative matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year who make elective contributions for the plan year. For Plan V, the group of NHCEs who make such contributions consists of Employees C, D and E. The matching rates for these three employees are 50%, 50% and 400% respectively. The lowest matching rate for a group of NHCEs that is at least half of all the NHCEs who make elective contributions (or 2 NHCEs) is 50%. Because 400% is more than twice the plan's representative matching rate and the matching contributions exceed 5% of compensation, the full amount of matching contributions is not taken into account. Only $2,000 of the matching contributions made on behalf of Employee E (matching contributions that do not exceed the greatest of 5% of compensation, the employee's elective deferrals, or the product of 100% (2 times the representative matching rate) and the employee's elective deferrals) satisfy the requirements of paragraph (a)(5)(ii) of this section and may be taken into account under the ACP test. Accordingly, the ACP for the NHCEs is 5.96% (7.06% + 6.79% + 10% + 0%)/4 and the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as *Example 2*, except that Plan V provides a QNEC equal to 13% of pay for Employee F that will be taken into account under the ACP test to the extent the contributions satisfy the requirements of paragraph (a)(6) of this section.

(ii) Pursuant to paragraph (a)(6)(v) of this section, a QNEC cannot be taken into account in determining an NHCE's ACR to the extent it exceeds the greater of 5% and the product of the employee's compensation and the plan's representative contribution rate. The plan's representative contribution rate is two times the lowest applicable contribution rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year. For Plan V, the applicable contribution rates for Employees C, D, E and F are 7.06%, 6.79%, 12.5% and 13% respectively. The lowest applicable contribution rate for a group of NHCEs that is at least half of all the NHCEs is 12.50% (the lowest applicable contribution rate for the group of NHCEs that consists of Employees E and F).

(iii) Under paragraph (a)(6)(v)(B) of this section, the plan's representative contribution rate is 2 times 12.50% or 25.00%. Accordingly, the QNECs for Employee F can be taken into account under the ACP test only to the extent they do not exceed 25.00% of compensation. In this case, all of the QNECs for Employee F may be taken into account under the ACP test.

(iv) After taking into account the QNECs for Employee F, the ACP for the NHCEs is 9.84% (7.06% + 6.79% + 12.50% + 13%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m)(2) and paragraph (a)(1) of this section.

(b) *Correction of excess aggregate contributions*—(1) *Permissible correction methods*—(i) *In general*. A plan that provides for employee contributions or matching contributions does not fail to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan, uses either of the following correction methods—

(A) *Additional contributions*. The employer makes additional contributions that are taken into account for the ACP test under this section that, in combination with the other contributions taken into account under this section, allow the plan to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess aggregate contributions distributed or forfeited*. Excess aggregate contributions are distributed or forfeited in accordance with paragraph (b)(2) of this section.

(ii) *Combination of correction methods*. A plan may provide for the use of either of the correction methods described in paragraph (b)(1)(i) of this section, may limit employee contributions or matching contributions in a manner that prevents excess aggregate contributions from being made, or may use a combination of these methods, to avoid or correct excess aggregate contributions. If a plan uses a combination of correction methods, any contributions made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction method in paragraph (b)(1)(i)(B) of this section.

(iii) *Exclusive means of correction*. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than one described in paragraph (b)(1)(i) or (ii) of this section. Thus, excess aggregate contributions for a plan year may not be corrected by forfeiting vested matching contributions, distributing nonvested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Similarly, 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).

(2) *Correction through distribution*—(i) *General rule*. This paragraph (b)(2) contains the rules for correction of excess aggregate contributions through a distribution from the plan. Correction through a distribution generally involves a 4-step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess aggregate contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess aggregate contributions among the HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess aggregate contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned contributions, together with allocable income (or forfeit the apportioned matching contributions, if forfeitable) in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions.

(ii) *Calculation of total amount to be distributed*. The following procedures must be used to determine the total amount of the excess aggregate contributions to be distributed—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE*. The amount of excess aggregate contributions attributable to an HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ACR to equal the highest permitted ACR under the plan. To calculate the highest permitted ACR under a plan, the ACR of the HCE with the highest ACR is reduced by the amount required to cause that HCE's ACR to equal the ACR of the HCE with the next highest ACR. If a lesser reduction would enable the plan to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction applies.

(B) *Determination of the total amount of excess aggregate contributions*. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the plan would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess aggregate contributions for the plan year.

(C) *Satisfaction of ACP*. A plan satisfies this paragraph (b)(2)(ii)(C) if the plan would satisfy the requirements of paragraph (a)(1)(i) of this section if the ACR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess aggregate contributions among the HCEs*. The following procedures must be used in apportioning the total amount of excess aggregate contributions determined under paragraph (b)(2)(ii) of this section among the HCEs—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE*. The contributions with respect to the HCE with the highest dollar amount of contributions taken account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of contributions taken into account under this section for the HCE with the next highest dollar amount of such contributions. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess aggregate contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any HCE*. For purposes of this paragraph (b)(2)(iii), the contributions for an HCE who is an eligible employee in more than one plan of an employer to which matching contributions and employee contributions are made is determined by adding together all contributions otherwise taken into account in determining the ACR of the HCE under the rules of paragraph (a)(3)(ii) of this section. However, the amount of contributions apportioned with respect to an HCE must not exceed the amount of contributions taken into account under this section that were actually made on behalf of the HCE to the plan for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which employee contributions or matching contributions are made and whose ACR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount distributed under this paragraph (b)(2)(iii) will not exceed such contributions actually contributed to the plan for the plan year that are taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs.* The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess aggregate contributions have been apportioned.

(iv) *Income allocable to excess aggregate contributions*—(A) *General rule.* For plan years beginning on or after January 1, 2008, the income allocable to excess aggregate contributions is equal to the allocable gain or loss through the end of the plan year. See paragraph (b)(2)(iv)(D) of this section for rules that apply to plan years beginning before January 1, 2008.

(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). A plan will not fail to use a reasonable method for computing the income allocable to excess contributions merely because the income allocable to excess aggregate contributions is determined on a date that is no more than 7 days before the distribution.

(C) *Alternative method of allocating income for the plan year.* A plan may allocate income to excess aggregate contributions for the plan year by multiplying the income for the plan year allocable to employee contributions, matching contributions and other amounts taken into account under this section (including the contributions for the year), by a fraction, the numerator of which is the excess aggregate contributions for the employee for the plan year, and the denominator of which is the sum of the—

(*1*) Account balance attributable to employee contributions and matching contributions and other amounts taken into account under this section as of the beginning of the plan year; and

(*2*) Any additional such contributions for the plan year.

(D) *Plan years before 2008.* For plan years beginning before January 1, 2008, the income allocable to excess aggregate contributions is determined under §1.401(m)–2(b)(2)(iv) (as it appeared in the April 1, 2007, edition of 26 CFR part 1).

(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)–2(b)(2)(iv).

(v) *Distribution and forfeiture.* Within 12 months after the close of the plan year in which the excess aggregate contribution arose, the plan must distribute to each HCE the contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section (and the allocable income) to the extent they are vested or forfeit such amounts, if forfeitable. Except as otherwise provided in this paragraph (b)(2)(v), a distribution of excess aggregate contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. 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 an HCE is distributed prior to when the plan makes a distribution of excess aggregate contributions in accordance with this paragraph (b)(2), 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.

(vi) *Tax treatment of corrective distributions*—(A) *Corrective distributions for plan years beginning on or after January 1, 2008.* Except as otherwise provided in this paragraph (b)(2)(vi), for plan years beginning on or after January 1, 2008, a corrective distribution of excess aggregate contributions (and allocable income) 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 and is therefore not subject to tax 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). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months (6 months in the case of certain plans that include an eligible automatic contribution arrangement within the meaning of section 414(w)) after the end of the plan year. See also §1.402(c)–2, A–4, prohibiting rollover of distributions that are excess aggregate contributions.

(B) *Corrective distributions for plan years beginning before January 1, 2008.* The tax treatment of corrective distributions for plan years beginning before January 1, 2008, is determined under §1.401(m)–2(b)(2)(vi) (as it appeared in the April 1, 2007, edition of 26 CFR Part 1). If the total amount of excess aggregate contributions determined under this paragraph (b)(2), and excess contributions determined under §1.401(k)–2(b)(2) distributed to a recipient under a plan for any plan year is 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, except to the extent the corrective distribution is a return of employee contributions, or as provided in paragraph (b)(2)(vi)(C) of this section.

(C) *Corrective distributions attributable to designated Roth contributions.* Notwithstanding paragraphs (b)(2)(vi)(A) and (B) of this section, a distribution of excess aggregate contributions is not includible in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to a corrective distribution of excess aggregate contributions that are designated Roth contributions is taxed in accordance with paragraph (b)(2)(vi)(A) or (B) of this section (*i.e.*, in the same manner as income allocable to a corrective distribution of excess aggregate contributions that are not designated Roth contributions).

(3) *Other rules*—(i) *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.

(ii) *Treatment of corrective distributions and forfeited contributions as employer contributions.* Excess aggregate contributions (other than amounts attributable to employee 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.

(iii) *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). See §1.401(a)(9)–5, A–9(b).

(iv) *Partial correction.* Any distribution of less than the entire amount of excess aggregate contributions (and allocable income) is treated as a pro rata distribution of excess aggregate contributions and allocable income.

(v) *Matching contributions on excess contributions, excess deferrals and excess aggregate contributions*—(A) *Corrective distributions not permitted.* 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.

(B) *Coordination with section 401(a)(4).* A matching contribution is taken into account under section 401(a)(4) even if the match is distributed, unless the distributed contribution is an excess aggregate contribution. This requires that, after correction of excess aggregate contributions, 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 (b) to HCEs to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the HCEs' accounts. This is because the level of matching contributions will be higher for a group of employees that consists entirely of HCEs. Under section 411(a)(3)(G) and §1.411(a)–4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions and excess deferrals 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 NHCEs for the purpose of correcting a discriminatory rate of matching contributions. A plan is permitted to provide for which contributions are to be distributed to satisfy the ACP test so as to avoid discriminatory matching rates that would otherwise violate section 401(a)(4). For example, the plan may provide that unmatched employee contributions will be distributed before matched employee contributions.

(vi) *No requirement for recalculation.* If the distributions and forfeitures described in paragraph (b)(2) of this section are made, the employee contributions and matching contributions are treated as meeting the nondiscrimination test of section 401(m)(2) regardless of whether the ACP for the HCEs, if recalculated after the distributions and forfeitures, would satisfy section 401(m)(2).

(4) *Failure to timely 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% excise tax on the amount of the excess aggregate contributions. See section 4979 and §54.4979–1 of this chapter. Qualified nonelective contributions properly taken into account under paragraph (a)(6) 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 trust.

(iii) *Special rule for eligible automatic contribution arrangements.* In the case of excess aggregate contributions under a plan that includes an eligible automatic contribution arrangement (within the meaning of section 414(w)), 6 months is substituted for 2½ months in paragraph (b)(4)(i) of this section. The additional time described in this paragraph (b)(4)(iii) applies to a distribution of excess aggregate contributions for a plan year beginning on or after January 1, 2010 only where all the eligible NHCEs and eligible HCEs are covered employees under the eligible automatic contribution arrangement (within the meaning of §1.414(w)–1(e)(3)) for the entire plan year (or for the portion of the plan year that the eligible NHCEs and eligible HCEs are eligible employees).

(5) *Examples*. The following examples illustrate the application of this paragraph. See also §1.401(k)–2(b) for additional examples of the parallel correction rules applicable to cash or deferred arrangements. For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Employer L maintains a plan that provides for employee contributions and fully vested matching contributions. The plan provides that failures of the ACP test are corrected by distribution. In 2006, the ACP for the eligible NHCEs is 6%. Thus, the ACP for the eligible HCEs may not exceed 8%. The three HCEs who participate have the following compensation, contributions, and ACRs:

Employee	Compensation	Employee contributions and matching contributions	Actual contribution ratio (percent)
A	200,000	14,000	7
B	150,000	13,500	9
C	100,000	12,000	12
			Average 9.33

(ii) The total amount of excess aggregate contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the matching and employee contributions of Employee C (the HCE with the highest ACR) is reduced by 3% of compensation (or $3,000) in order to reduce the ACR of that HCE to 9%, which is the ACR of Employee B.

(iii) Because the ACP of the HCEs determined after the $3,000 reduction still exceeds 8%, further reductions in matching contributions and employee contributions are necessary in order to reduce the ACP of the HCEs to 8%. The employee contributions and matching contributions for Employees B and C are reduced by an additional .5% of compensation or $1,250 ($750 and $500 respectively). Because the ACP of the HCEs determined after the reductions now equals 8%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess aggregate contributions ($4,250) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of matching contributions and employee contributions. Therefore, Employee A is apportioned $500 (the amount required to cause A's matching contributions and employee contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(v) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($3,750) of the total amount of excess aggregate contributions is apportioned equally among Employees A and B ($1,500 to each, the amount required to cause their contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(vi) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($750) of the total amount of excess aggregate contributions is apportioned equally among Employees A, B and C ($250 to each, the amount required to allocate the total amount of excess aggregate contributions for the plan).

(vii) Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess aggregate contributions equal to $2,250 ($500 + $1,500 + $250) and allocable income, Employee B receives a corrective distribution of $250 and allocable income and Employee C receives a corrective distribution of $1,750 ($1,500 + $250) and allocable income.

Example 2. (i) Employee D is the sole HCE who is eligible to participate in a cash or deferred arrangement maintained by Employer M. The plan that includes the arrangement, Plan X, permits employee contributions and provides a fully vested matching contribution equal to 50% of elective contributions. Plan X is a calendar year plan. Plan X corrects excess contributions by recharacterization and provides that failures of the ACP test are corrected by distribution. For the 2006 plan year, D's compensation is $200,000, and D's elective contributions are $15,000. The actual deferral percentages and actual contribution percentages for Employee D and the other eligible employees under Plan X are shown in the following table:

	Actual deferral percentage	Actual contribution percentage
Employee D	7.5	3.75
NHCEs	4	2

(ii) In February 2007, Employer M determines that D's actual deferral ratio must be reduced to 6%, or $12,000, which requires a recharacterization of $3,000 as an employee contribution. This increases D's actual contribution ratio to 5.25% ($7,500 in matching contributions plus $3,000 recharacterized as employee contributions, divided by $200,000 in compensation). Since D's actual contribution ratio must be limited to 4% for Plan X to satisfy the actual contribution percentage test, Plan X must distribute 1.25% or $2,500 of D's employee contributions and matching contributions together with allocable income. If $2,500 in matching contributions and allocable income 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. (i) The facts are the same as in *Example 2*, except that Employee D also had elective contributions under Plan Y, maintained by an employer unrelated to M. In January 2007, D requests and receives a distribution of $1,200 in excess deferrals from Plan X. Pursuant to the terms of Plan X, D forfeits the $600 match on the excess deferrals to correct a discriminatory rate of match.

(ii) The $3,000 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the $1,200 already distributed as an excess deferral, leaving $1,800 to be recharacterized. See §1.401(k)–2(b)(4)(i)(A). D's actual contribution ratio is now 4.35% ($7,500 in matching contributions plus $1,800 in recharacterized contributions less $600 forfeited matching contributions attributable to the excess deferrals, divided by $200,000 in compensation).

(iii) The matching and employee contributions for Employee D must be reduced by .35% of compensation in order to reduce the ACP of the HCEs to 4%. The plan must provide for forfeiture of additional matching contributions to prevent a discriminatory rate of matching contributions. See *Example 8*.

Example 4. (i) The facts are the same as in *Example 3*, except that D does not request a distribution of excess deferrals until March 2007. Employer X has already recharacterized $3,000 as employee contributions.

(ii) 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. (i) For the 2006 plan year, Employee F defers $10,000 under Plan M and $6,000 under Plan N. Plans M and N, which have calendar plan years are maintained by unrelated employers. Plan M provides a fully vested, 100% matching contribution, does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k) and provides that excess contributions and excess aggregate contributions are corrected by distribution. Under Plan M, Employee F is allocated excess contributions of $600 and excess aggregate contributions of $1,600. Employee F timely requests and receives a distribution of the $1,000 excess deferral from Plan M and, pursuant to the terms of Plan M, forfeits the corresponding $1,000 matching contribution.

(ii) No distribution is required or permitted to correct the excess contributions because $1,000 has been distributed by Plan M 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 Employee F had corrected the excess deferrals of $1,000 by withdrawing $1,000 from Plan N, Plan M would have had to correct the $600 excess contributions in Plan M by distributing $600. Since Employee F then would have forfeited $600 (instead of $1,000) in matching contributions, Employee F would have had $1,000 ($1,600 in excess aggregate contributions minus $600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan M. These would have been corrected by distributing an additional $1,000 from Plan M.

Example 6. (i) Employee G is the sole HCE in a profit sharing plan under which the employer matches 100% of employee contributions up to 2% of compensation, and 50% of employee contributions up to the next 4% of compensation. For the 2008 plan year, Employee G has compensation of $100,000 and makes a 7% employee contribution of $7,000. Employee G receives a 4% matching contribution or $4,000. Thus, Employee G's actual contribution ratio (ACR) is 11%. The actual contribution percentage for the NHCEs is 5%, and the employer determines that Employee G's ACR must be reduced to 7% to comply with the rules of section 401(m).

(ii) In this case, the plan satisfies the requirements of section 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 Employee G with 4% employee contributions, and 3% matching contributions, for an ACR of 7%. Alternatively, the plan could distribute all matching contributions and satisfy this section. However, the plan could not distribute $4,000 of Employee G's employee contributions without forfeiting the related matching contributions because this would result in a discriminatory rate of matching contributions. See also *Example 7*.

Example 7. (i) Employee H is an HCE in Employer X's profit sharing plan, which matches 100% of employee contributions up to 5% of compensation. The matching contribution is vested at the rate of 20% per year. In 2006, Employee H makes $5,000 in employee contributions and receives $5,000 of matching contributions. Employee H is 60% vested in the matching contributions at the end of the 2006 plan year. In February 2007, Employer X determines that Employee H has excess aggregate contributions of $1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(ii) Employer X has two options available in distributing Employee H's excess aggregate 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 Employee H'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.

(iii) 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% must vest in each of the next 2 years.

(iv) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are forfeited because the effect is that matching contributions for HCEs vest more rapidly than those for NHCEs. See §1.401(m)–2(b)(3)(v)(B).

Example 8. (i) Employer Y maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100%. After-tax employee contributions are permitted under the plan only for NHCEs and are matched at the same rate. No employees make excess deferrals. Employee J, an HCE, makes an $8,000 elective contribution and receives an $8,000 matching contribution.

(ii) Employer Y performs the actual deferral percentage (ADP) and the actual contribution percentage (ACP). 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, Employee J's contributions for the year are $7,000 of elective contributions and $7,500 of matching contributions. As a result, Employee J has received a higher effective rate of matching contributions than NHCEs ($7,000 of elective contributions matched by $7,500 is an effective matching rate of 107 percent). If this amount remains in Employee J's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only an HCE 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 NHCEs. See §1.401(a)(4)–11(g)(3)(vii)(B) and (6), Example 7.

(c) *Additional rules for prior year testing method*—(1) *Rules for change in testing method*. A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in §1.401(k)–2(c)(1)(ii). For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(m)–3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year

(2) *Calculation of ACP under the prior year testing method for the first plan year*—(i) *Plans that are not successor plans*. If, for the first plan year of any plan (other than a successor plan), a plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ACP for the eligible NHCEs, or 3% as the ACP for eligible NHCEs, for applying the ACP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year for determining the ACP for the eligible NHCEs is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting under paragraph

(a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined.* For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for employee contributions or matching contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)–7) for a plan year if for such plan year the plan is aggregated under §1.401(m)–1(b)(4) with any other plan that provides for employee or matching contributions in the prior year.

(iii) *Plans that are successor plans.* A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under another plan maintained by the employer in the prior year that provides for employee contributions or matching contributions. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ACP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ACP and ADP test.* Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ACP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ADP test for that year. For example, a plan may use the prior year testing method for the ACP test and the current year testing method for its ADP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use—

(i) The recharacterization method of §1.401(k)–2(b)(3) to correct excess contributions for a plan year;

(ii) The rules of paragraph (a)(6)(ii) of this section to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph §1.401(k)–2(a)(6) to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage change*—(i) *In general.* A plan that uses the prior year testing method that experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ACP for the NHCEs for the plan year is the weighted average of the ACPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes.* If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ACP for the group of eligible NHCEs for the prior year under the plan is the ACP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions.* The following definitions apply for purposes of this paragraph (c)(4)—

(A) *Plan coverage change.* The term *plan coverage change* means a change in the group or groups of eligible employees under a plan on account of—

(*1*) The establishment or amendment of a plan;

(*2*) A plan merger or spinoff under section 414(l);

(*3*) A change in the way plans (within the meaning of §1.410(b)–7) are combined or separated for purposes of §1.401(m)–1(b)(4) (*e.g.*, permissively aggregating plans not previously aggregated under §1.410(b)–7(d), or ceasing to permissively aggregate plans under §1.410(b)–7(d));

(*4*) A reclassification of a substantial group of employees that has the same effect as amending the plan (*e.g.*, a transfer of a substantial group of employees from one division to another division); or

(*5*) A combination of any of paragraphs (c)(4)(iii)(A)(*1*) through (*4*) of this section.

(B) *Prior year subgroup.* The term *prior year subgroup* means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan that provides for employee contributions or matching contributions maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ACPs for the prior year subgroups.* The term *weighted average of the ACPs for the prior year subgroups* means the sum, for all prior year subgroups, of the adjusted ACPs for the plan year. The term *adjusted ACP with respect to a prior year subgroup* means the ACP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Example.* The following example illustrate the application of this paragraph (c)(4). See also §1.401(k)–2(c)(4) for examples of the parallel rules applicable to the ADP test. The example is as follows:

Example. (i) Employer B maintains two plans, Plan N and Plan P, each of which provides for employee contributions or matching contributions. The plans were not permissively aggregated under §1.410(b)–7(d) for the 2005 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 2005, and their ACP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 2005, and the ACP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively aggregated under §1.410(b)–7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 2006 testing year under §1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP). Therefore, the prior year ACP for the NHCEs under Plan NP for the 2006 testing year is the weighted average of the ACPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ACPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 2006 testing year, an employee is a member of a prior year subgroup if the employee was an NHCE of Employer B for the 2005 plan year, was an eligible employee for the 2005 plan year under any section 401(k) plan maintained by Employer B, and would have been an eligible employee in the 2005 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year. The NHCEs who were eligible employees under separate plans for the 2005 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP for the 2006 testing year: the 300 NHCEs who were eligible employees under Plan N for the 2005 plan year and the 100 NHCEs who were eligible employees under Plan P for the 2005 plan year.

(iv) The weighted average of the ACPs for the prior year subgroups is the sum of the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ACP for the NHCEs under Plan N for the prior year) × 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ACP for the NHCEs under Plan P for the prior year) × 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%. Thus, the prior year ACP for NHCEs under Plan NP for the 2006 testing year is 5.5% (the sum of adjusted ACPs for the prior year subgroups, 4.5% plus 1%).

[T.D. 9169, 69 FR 78184, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 10, Jan. 3, 2006; T.D. 9447, 74 FR 8210, Feb. 24, 2009; 74 FR 12551, Mar. 25, 2009]

§ 1.401(m)–3 Safe harbor requirements.

(a) *ACP test safe harbor*—(1) *Section 401(m)(11) safe harbor*. Matching contributions under a plan satisfy the ACP safe harbor provisions of section 401(m)(11) for a plan year if the plan satisfies the safe harbor contribution requirement of paragraph (b) or (c) of this section for the plan year, the limitations on matching contributions of paragraph (d) of this section, the notice requirement of paragraph (e) of this section, the plan year requirements of paragraph (f) of this section, and the additional rules of paragraphs (g), (h) and (j) of this section, as applicable.

(2) *Section 401(m)(12) safe harbor.* For a plan year beginning on or after January 1, 2008, matching contributions under a plan satisfy the ACP safe harbor provisions of section 401(m)(12) for a plan year if the matching contributions are made with respect to an automatic contribution arrangement described in paragraph §1.401(k)–3(j) that satisfies the safe harbor requirements of §1.401(k)–3, the limitations on matching contributions of paragraph (d) of this section, the notice requirement of paragraph (e) of this section, the plan year requirements of paragraph (f) of this section, and the additional rules of paragraphs (g), (h) and (j) of this section, as applicable.

(3) *Requirements applicable to safe harbor contributions.* Pursuant to sections 401(k)(12)(E)(ii) and 401(k)(13)(D)(iv), the safe harbor contribution requirement of paragraph (b) or (c) of this section and §1.401(k)–3(k) must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section and §1.401(k)–3(k) are referred to as safe harbor nonelective contributions and safe harbor matching contributions.

(b) *Safe harbor nonelective contribution requirement.* A plan satisfies the safe harbor nonelective contribution requirement of this paragraph (b) if it satisfies the safe harbor nonelective contribution requirement of §1.401(k)–3(b).

(c) *Safe harbor matching contribution requirement.* A plan satisfies the safe harbor matching contribution requirement of this paragraph (c) if it satisfies the safe harbor matching contribution requirement of §1.401(k)–3(c).

(d) *Limitation on contributions—(1) General rule.* A plan that provides for matching contributions meets the requirements of this section only if it satisfies the limitations on contributions set forth in this paragraph (d).

(2) *Matching rate must not increase.* A plan that provides for matching contributions meets the requirements of this paragraph (d) only if the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective deferrals and employee contributions, does not increase as the amount of an employee's elective deferrals and employee contributions increases.

(3) *Limit on matching contributions.* A plan that provides for matching contributions satisfies the requirements of this section only if—

(i) Matching contributions are not made with respect to elective deferrals or employee contributions that exceed 6% of the employee's safe harbor compensation (within the meaning of §1.401(k)–3(b)(2)); and

(ii) Matching contributions that are discretionary do not exceed 4% of the employee's safe harbor compensation.

(4) *Limitation on rate of match.* A plan meets the requirements of this section only if the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) for that plan year is no greater than the ratio of matching contributions to elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) that would apply with respect to any NHCE for whom the elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) are the same percentage of safe harbor compensation. An employee is taken into account for purposes of this paragraph (d)(4) if the employee is an eligible employee under the cash or deferred arrangement with respect to which the contributions required by paragraph (b) or (c) of this section are being made for a plan year. A plan will not fail to satisfy this paragraph (d)(4) merely because the plan provides that matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that matching contributions with respect to any elective deferrals or employee contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(5) *HCEs participating in multiple plans.* The rules of section 401(m)(2)(B)

and §1.401(m)–2(a)(3)(ii) apply for purposes of determining the rate of matching contributions under paragraph (d)(4) of this section. However, a plan will not fail to satisfy the safe harbor matching contribution requirements of this section merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that—

(i) The HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and

(ii) The period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan.

(6) *Permissible restrictions on elective deferrals by NHCEs*—(i) *General rule.* A plan does not satisfy the safe harbor requirements of this section, if elective deferrals or employee contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (d)(6).

(ii) *Restrictions on election periods.* A plan may limit the frequency and duration of periods in which eligible employees may make or change contribution elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (e) of this section) to make or change a contribution election for the plan year. For purposes of this section, a 30-day period is deemed to be a reasonable period to make or change a contribution election.

(iii) *Restrictions on amount of contributions.* A plan is permitted to limit the amount of contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (d)(6)(v) of this section) to make contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of contributions. However, a plan may require eligible employees to make contribution elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred.* A plan may limit the types of compensation that may be deferred or contributed by an eligible employee under a plan, provided that each eligible NHCE is permitted to make contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2). Thus, the definition of compensation from which contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code.* A plan may limit the amount of contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make contributions has been suspended for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E).

(e) *Notice requirement.* A plan satisfies the notice requirement of this paragraph (e) if it satisfies the notice requirement of §1.401(k)–3(d).

(f) *Plan year requirement*—(1) *General rule.* Except as provided in this paragraph (f) or in paragraph (g) of this section, a plan will fail to satisfy the requirements of section 401(m)(11), section 401(m)(12), and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of that plan year and remain in effect for an entire 12-month plan year. In addition, except as provided in paragraph (h) of this section or in guidance of general applicability published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), a plan which includes provisions that satisfy the rules of this section will not satisfy the requirements of §1.401(m)–1(b) if it is amended to change such provisions for that plan year. Moreover, if, as described in paragraph (j)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions under that other plan specifying that the safe harbor contributions will be made and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) *Initial plan year*. A newly established plan (other than a successor plan within the meaning of §1.401(m)–2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (f) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a plan will not fail to satisfy the requirements of this paragraph (f) for the first plan year in which matching contributions are provided under the plan provided that—

(i) The plan is not a successor plan; and

(ii) The amendment providing for matching contributions is made effective at the same time as the adoption of a cash or deferred arrangement that satisfies the requirements of §1.401(k)–3, taking into account the rules of §1.401(k)–3(e)(2).

(3) *Change of plan year*. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section (determined without regard to paragraph (h) of this section) for the immediately following plan year or for the immediately following 12 months if the immediately following plan year is less than 12 months.

(4) *Final plan year*. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the final plan year is less than 12 months, provided that the plan satisfies the requirement of this section through the date of termination and either—

(i) The plan would satisfy the requirements of paragraph (h) of this section, treating the termination of the plan as a reduction or suspension of safe harbor contributions, other than the requirements of paragraph (h)(1)(i)(A) or (h)(1)(ii)(A) of this section (relating to the employer's financial condition and information included in the initial notice for the plan year) and paragraph (h)(1)(i)(D) or (h)(1)(ii)(D) of this section (requiring that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections); or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship, comparable to a substantial business hardship described in section 412(c).

(g) *Plan amendments adopting nonelective safe harbor contributions*. Notwithstanding paragraph (f)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section, effective as of the first day of the plan year, using nonelective contributions under paragraph (b) of this section if the plan satisfies the requirements of §1.401(k)–3(f).

(h) *Permissible reduction or suspension of safe harbor contributions*—(1) *General rule*—(i) *Matching contributions*. A plan that provides for safe harbor matching contributions intended to satisfy the requirements of paragraph (c) of this section for a plan year will not fail to satisfy the requirements of section 401(m)(2) merely because the plan is amended during the plan year to reduce or suspend safe harbor matching contributions on future elective deferrals (and, if applicable, employee contributions) provided that—

(A) In the case of plan years beginning on or after January 1, 2015, the employer either—

(*1*) Is operating at an economic loss as described in section 412(c)(2)(A) for the plan year; or

(*2*) Includes in the notice described in paragraph (e) of this section, a statement that the plan may be amended during the plan year to reduce or suspend safe harbor matching contributions and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension;

(B) All eligible employees are provided a supplemental notice that satisfies the requirements of paragraph (h)(2) of this section;

(C) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice described in paragraph (h)(2) of this section;

(D) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(E) The plan is amended to provide that the ACP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(m)–2(a)(2)(ii); and

(F) The plan satisfies the requirements of this section (other than this paragraph (h)) with respect to amounts deferred through the effective date of the amendment.

(ii) *Nonelective contributions.* For plan amendments adopted after May 18, 2009, a plan that provides for safe harbor nonelective contributions intended to satisfy the requirements of paragraph (b) of this section will not fail to satisfy the requirements of section 401(m)(2) for the plan year merely because the plan is amended during the plan year to reduce or suspend safe harbor nonelective contributions provided that—

(A) The employer either—

(*1*) Is operating at an economic loss as described in section 412(c)(2)(A) for the plan year; or

(*2*) Includes in the notice described in paragraph (e) of this section a statement that the plan may be amended during the plan year to reduce or suspend safe harbor nonelective contributions and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension;

(B) All eligible employees are provided a supplemental notice that satisfies the requirements of paragraph (h)(2) of this section;

(C) The reduction or suspension of safe harbor nonelective contributions is effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice described in paragraph (h)(2) of this section;

(D) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of nonelective contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(E) The plan is amended to provide that the ACP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(m)–2(a)(2)(ii); and

(F) The plan satisfies the requirements of this section (other than this paragraph (h)) with respect to safe harbor compensation paid through the effective date of the amendment.

(2) *Supplemental notice.* The supplemental notice requirement of this paragraph (h)(2) is satisfied if each eligible employee is given a notice that satisfies the requirements of §1.401(k)–3(g)(2).

(i) [Reserved]

(j) *Other rules*—(1) *Contributions taken into account.* A contribution is taken into account for purposes of this section for a plan year under the same rules as §1.401(k)–3(h)(1).

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests.* A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies

section 401(a)(4) under the same rules as § 1.401(k)–3(h)(2).

(3) *Early participation rules.* Section 401(m)(5)(C) and § 1.401(m)–2(a)(1)(iii)(A), which provide an alternative nondiscrimination rule for certain plans that provide for early participation, do not apply for purposes of section 401(m)(11), section 401(m)(12), and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan.* Safe harbor matching or nonelective contributions may be made to another defined contribution plan under the same rules as § 1.401(k)–3(h)(4). Consequently, each NHCE under the plan providing for matching contributions must be eligible under the same conditions under the other defined contribution plan and the plan to which the contributions are made must have the same plan year as the plan providing for matching contributions.

(5) *Contributions used only once.* Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

(6) *Plan must satisfy ACP with respect to employee contributions.* If the plan provides for employee contributions, in addition to satisfying the requirements of this section, it must also satisfy the ACP test of § 1.401(m)–2. See § 1.401(m)–2(a)(5)(iv) for special rules under which the ACP test is permitted to be performed disregarding some or all matching when this section is satisfied with respect to the matching contributions.

[T.D. 9169, 69 FR 78184, Dec. 29, 2004, as amended by T.D. 9447, 74 FR 8211, Feb. 24, 2009; T.D. 9641, 78 FR 68738, Nov. 15, 2013]

§ 1.401(m)–4 Special rules for mergers, acquisitions and similar events. [Reserved]

§ 1.401(m)–5 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(m) and the regulations thereunder.

Actual contribution percentage (ACP). Actual contribution percentage or *ACP* means the ACP of the group of eligible employees as defined in § 1.401(m)–2(a)(2)(i).

Actual contribution percentage (ACP) test. Actual contribution percentage test or *ACP test* means the test described in § 1.401(m)–2(a)(1).

Actual contribution ratio (ACR). Actual contribution ratio or *ACR* means the ACR of an eligible employee as defined in § 1.401(m)–2(a)(3).

Actual deferral percentage (ADP) test. Actual deferral percentage test or *ADP test* means the test described in § 1.401(k)–2(a)(1).

Compensation. 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. A plan 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. See also section 401(a)(17) and § 1.401(a)(17)–1(c)(1). For this purpose, in case of an HCE whose ACR is determined under § 1.401(m)–2(a)(3)(ii), period of participation includes periods under another plan for which matching contributions or employee contributions are aggregated under § 1.401(m)–2(a)(3)(ii).

Current year testing method. Current year testing method means the testing method under which the applicable year is the current plan year, as described in § 1.401(k)–2(a)(2)(ii) or 1.401(m)–2(a)(2)(ii)

Designated Roth contributions. Designated Roth contributions means designated Roth contributions as defined in § 1.401(k)–1(f)(1).

Elective contributions. Elective contributions means elective contributions as defined in § 1.401(k)–6.

Elective deferrals. *Elective deferrals* means elective deferrals described in section 402(g)(3).

Eligible employee—(1) *General rule.* *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 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 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.

(2) *Conditions on eligibility.* An employee who is unable to make employee contributions 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 treated as an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make employee contributions or receive an allocation of matching contributions 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).

(3) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, no later than the employee's first becoming eligible under any plan or arrangement described in section 219(g)(5)(A) and providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee in fact does elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan or arrangement 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 or arrangement (whether or not terminated) of the employer.

Eligible HCE. *Eligible HCE* means an eligible employee who is an HCE.

Eligible NHCE. *Eligible NHCE* means an eligible employee who is not an HCE.

Employee. *Employee* means an employee within the meaning of §1.410(b)–9.

Employee contributions. *Employee contributions* means employee contributions as defined in §1.401(m)–1(a)(3).

Employee stock ownership plan (ESOP). *Employee stock ownership plan* or *ESOP* the portion of a plan that is an ESOP within the meaning of §1.410(b)–7(c)(2).

Employer. *Employer* means an employer within the meaning of §1.410(b)–9.

Excess aggregate contributions. *Excess aggregate contributions* means, with respect to a plan year, the amount of excess aggregate contributions apportioned to an HCE under §1.401(m)–2(b)(2)(iii).

Excess contributions. *Excess contributions* means with respect to a plan year, the amount of excess contributions apportioned to an HCE under §1.401(k)–2(b)(2)(iii).

Excess deferrals. *Excess deferrals* means excess deferrals as defined in §1.402(g)–1(e)(3).

Highly compensated employee (HCE). *Highly compensated employee* or *HCE* has the meaning provided in section 414(q).

Matching contributions. *Matching contribution* is defined in §1.401(m)–1(a)(2).

Nonelective contributions. Nonelective contributions 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.

Non-employee stock ownership plan (non-ESOP). Non-employee stock ownership plan or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)–7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or *NHCE* means an employee who is not an HCE.

Plan. Plan means plan as defined in §1.401(m)–1(b)(4).

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)–2(a)(2)(ii) or 1.401(m)–2(a)(2)(ii)

Qualified matching contributions (QMAC). Qualified matching contributions or *QMAC* means matching contributions that satisfy the requirements of §1.401(k)–1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account as elective contributions under §1.401(k)–2(a)(6). See also §1.401(k)–2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

Qualified nonelective contributions (QNEC). Qualified nonelective contributions or *QNEC* means employer contributions, other than elective contributions or matching contributions, that satisfy the requirements of §1.401(k)–1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ADP test under §1.401(m)–2(a)(6).

[T.D. 9169, 69 FR 78184, Dec. 29, 2004, as amended by T.D. 9237, 71 FR 10, Jan. 3, 2006]

§ 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. Paragraph (e) of this section provides rules relating to use of a qualified pension, annuity, profit-sharing, or stock bonus plan to provide accident or health benefits or coverage otherwise described in sections 104, 105, or 106.

(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. In the case of a distribution of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed) are included in determining the fair market value of the contract. In addition, in the case of a transfer of property that occurs on or after August 29, 2005 where a trust described in section 401(a) and exempt under section 501(a) transfers property to a plan participant or beneficiary in exchange for consideration and where the fair market value of the property transferred exceeds the value of the consideration, then the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is treated as a distribution to the distributee under the plan for all purposes under the Internal Revenue Code. Where such a transfer occurs before that date, the excess of the fair market value of the property transferred by the trust over the value of the consideration received by the trust is includible in the gross income of the participant or beneficiary under section 61. However, such a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection occurring before that date is not treated as a distribution for purposes of applying the requirements of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code.

(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 in which the trust is exempt, and the contract contains 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 §1.401–9(b)(1). For additional requirements regarding distributions of annuity contracts, see, *e.g.*, §§1.401(a)–20, Q&A–2, 1.401(a)(31)–1, Q&A–17, and 1.401(a)(9)–6, Q&A–4. However, the distribution of an annuity contract must be treated as a lump sum distribution for purposes of determining the amount of tax under the 10-year averaging rule of section 402(e) (as in effect prior to amendment by the Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085). If, however, the contract distributed by such exempt trust is a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of the 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 the 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), or the contract is treated as a rollover contribution under section 402(c). If the contract distributed by such trust is a transferable annuity contract, or a retirement income, endowment, or other life insurance contract and such contract is not treated as a rollover contribution under section 402(c), then, notwithstanding the preceding sentence, the fair market value of the contract is includible in the distributee's gross income unless, within such 60 days, such contract is 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 requited, 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)(iv) and (2)(iv) 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)–6 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)(5)(iv)(B). 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(a)(2) 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)(v) 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)(3)(v)(B) 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)(5)(iv)(B), 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.

(e) *Medical, accident, etc. benefits paid from a qualified pension, annuity, profit-sharing, or stock bonus plan*—(1) *Payment of premiums*—(i) *General rule*. Except as provided in paragraph (e)(1)(iii) of this section, a payment made from a qualified trust that is a premium for accident or health insurance (including a qualified long-term care insurance contract under section 7702B) constitutes a distribution under section 402(a) to the participant for whose benefit the premium is charged. The amount of the distribution equals the amount of the premium charged against the participant's benefits under the plan. If a defined contribution plan pays these premiums from a current year contribution or forfeiture that has not been allocated to a participant's account, then the amount of the premium for each participant is treated as first being allocated to the participant and then charged against the participant's benefits under the plan, so that the amount of the distribution is treated in the same manner as determined under the preceding sentence. Except as provided in paragraphs (e)(2) and (e)(3) of this section, a distribution described in this paragraph (e)(1) is not excludable from gross income.

(ii) *Treatment of amounts received through accident or health insurance.* To the extent that the payment of a premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through accident or health insurance are neither paid by the employer nor attributable to contributions by the employer that are excludable from the gross income of the employee. Accordingly, to the extent the premium for accident or health insurance constitutes a distribution under this paragraph (e)(1), amounts received through the accident or health insurance for personal injuries or sickness are excludable from gross income under section 104(a)(3) and are not treated as distributions from the plan. If those amounts are paid to the plan instead of to the employee, those amounts are treated as having been paid to the employee and then contributed by the employee to the plan (and must satisfy the qualification requirements applicable to employee contributions).

(iii) *Exception for disability insurance that replaces retirement contributions.* The rules of paragraph (e)(1)(i) of this section do not apply to the payment made from a qualified trust that is a premium paid to an insurance company for a contract providing for payment of benefits to be made to the trust in the event of an employee's inability to continue employment with the employer due to disability, provided that the payment of benefits with respect to the employee's account for each year does not exceed the reasonable expectation of the annual contributions that would have been made to the plan on the employee's behalf for the period of disability within that year, reduced by any other contributions made on the employee's behalf for the period of disability within that year. The payment of premiums described in the preceding sentence is not treated as a distribution under section 402(a), but instead constitutes incidental accident or health insurance as provided in §1.401–1(b)(1)(ii). The Commissioner may issue rules of general applicability in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin further describing the tax treatment of disability coverage described in this paragraph (e)(1)(iii).

(2) *Medical benefits for retired employees provided under an account described in section 401(h).* The payment of medical benefits under a pension or annuity plan from an account described in section 401(h) is treated in the same manner as a payment of accident or health benefits attributable to employer contributions, or employer-provided coverage under an accident or health plan. See §1.401–14(a) for the definition of medical benefits described in section 401(h). Accordingly, amounts applied for the payment of accident or health benefits, or for the payment of accident or health coverage, from a section 401(h) account are not includible in the gross income of the participant on whose behalf such contributions are made to the extent they are excludible from gross income under section 104, 105, or 106.

(3) *Distributions to eligible retired public safety officers.* See section 402(l) (and any guidance issued under section 402(l)) for a limited exclusion from gross income for distributions used to pay for certain accident or health premiums (including premiums for qualified long-term care insurance contracts). This limited exclusion applies to eligible retired public safety officers, as defined in section 402(l)(4)(B).

(4) *Effect of distribution of insurance premiums on plan qualification.* See §1.401–1(b)(1) for rules concerning the types and amount of medical coverage and benefits that are permitted to be provided under a plan that is part of a trust described in section 401(a). For example, §1.401–1(b)(1)(ii) provides that a profit-sharing plan is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide incidental accident or health insurance for the participant and the participant's family. See also section 401(k)(2)(B) for certain restrictions on

the distribution of elective contributions.

(5) *Applicability to beneficiaries and alternate payees.* This paragraph (e) applies to the payment of premiums charged against the benefits of a beneficiary or an alternate payee in the same manner as the payment of premiums charged against the account of a participant.

(6) *Examples.* The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts.* Employer A sponsors a profit-sharing plan qualified under section 401(a). The plan provides solely for non-elective employer profit-sharing contributions. The plan's trustee enters into a contract with a third-party insurance carrier to provide health insurance for certain plan participants. The insurance contract provides for the payment of medical expenses incurred by those participants. The plan limits the amounts used to provide medical benefits to comply with the incidental benefit rules. The trustee makes monthly payments of $1,000 to pay the premiums due for Participant P's health insurance and Participant P's account balance is reduced by $1,000 at the time of each premium payment. In June 2015, Participant P is admitted to the hospital for covered medical care, and in July 2015, the health insurer pays the hospital $5,000 for the medical care provided to Participant P in June.

(ii) *Conclusion.* Under paragraph (e)(1) of this section, each of the trustee's payments of $1,000 constitutes a taxable distribution under section 402(a) to Participant P on the date of each payment. The amount of these distributions may constitute payments for medical care under section 213. The $5,000 payment to the hospital is excludable from Participant P's gross income under section 104(a)(3) and is not treated as a distribution from the plan.

Example 2. (i) *Facts.* Employer B sponsors a profit-sharing plan qualified under section 401(a). The plan provides for elective contributions described in section 401(k) and matching contributions as well as non-elective employer profit-sharing contributions. The plan does not provide that a disabled participant's compensation for purposes of determining plan contributions includes amounts that the participant would have received in the absence of the disability, and accordingly Employer B does not make any contributions to the plan for the benefit of a disabled employee for the period of disability. The plan's trustee enters into a contract with a third-party insurance carrier to provide disability insurance for plan participants who elect to be covered under the insurance contract. The insurance contract provides for the payment of an amount to the trustee on a participant's behalf during the period of the participant's disability. Amounts to be paid to the trustee from the insurance contract with respect to a participant are equal to the sum of the elective, matching, and non-elective employer profit-sharing contributions that would have been made on the participant's behalf during the participant's disability (based on the participant's rate of compensation before becoming disabled) with the payments to continue for the duration of the disability until age 65 (or 5 years after the participant became disabled, if later). Participant Q elects to be covered under the insurance contract, and the trustee makes the periodic premium payments out of the account balance of Participant Q. In June 2015, Participant Q becomes disabled. During the period Participant Q is absent from employment due to disability, the insurer pays the trust the amount of the elective, matching, and non-elective employer profit-sharing contributions that would have been made to the trust with respect to Participant Q had Participant Q not been disabled. The amount of the premiums for the insurance contract satisfies the limitations on incidental benefits under §1.401–1(b)(1)(ii).

(ii) *Conclusion.* The payment of premiums from the trust is described in paragraph (e)(1)(iii) of this section. Accordingly, none of the premium payments under the contract constitute a distribution under section 402(a) to Participant Q. Further, amounts paid from the insurance contract to the trust also do not constitute a distribution to Participant Q. However, when Participant Q's account balance is distributed from the trust, the distribution will be subject to taxation in the year of distribution in accordance with the rules in section 402.

(7) *Effective/applicability date.* This paragraph (e) applies for taxable years beginning on or after January 1, 2015.

[T.D. 6500, 25 FR 11675, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.402(a)–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§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 determinable or for any other reason is not known, then, except as set forth in rules 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), such amount shall be either—

(i) The excess of—

(A) The amount determined as of the end of such taxable year in accordance with the formula described in §1.403(b)–1(d)(4), as it appeared in the April 1, 2006, edition of 26 CFR Part 1; over

(B) The amount determined as of the end of the prior taxable year in accordance with the formula described in paragraph (a)(2)(i)(A) of this section; or

(ii) 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 the employee's interest in such trust is determined in accordance with rules prescribed by the Commissioner under the authority in paragraph (a)(2) of this section.

(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, as amended by T.D. 9340, 72 FR 41140, July 26, 2007]

§ 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)–7(b), 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)–7(b) 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)) and employee contributions that, pursuant to rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), are returned to the employee (together with the income allocable thereto) in order to comply with the section 415 limitations.

(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)–2(b)(2), 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) Prohibited allocations that are treated as deemed distributions pursuant to section 409(p).

(h) A distribution that is a permissible withdrawal from an eligible automatic contribution arrangement within the meaning of section 414(w).

(i) [Reserved]

(j) Distributions of premiums for accident or health insurance under § 1.402(a)–1(e)(1)(i). This paragraph A–4(j) applies for taxable years beginning on or after January 1, 2015.

(k) 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; T.D. 9169, 69 FR 78153, Dec. 29, 2004; T.D. 9302, 71 FR 76137, Dec. 20, 2006; T.D. 9319, 72 FR 16894, Apr. 5, 2007; T.D. 9340, 72 FR 41159, July 26, 2007; T.D. 9447, 74 FR 8211, Feb. 24, 2009; T.D. 9665, 79 FR 26843, May 12, 2014]

EDITORIAL NOTE: By T.D. 9169, 69 FR 78153, Dec. 29, 2004, the Internal Revenue Service published a document in the FEDERAL REGISTER, attempting to amend Q&A–4(c) of §1.402(c)–2, by removing ''1.401(k)–1(f)'' and inserting ''1.401(k)–2(b)(2)''. However, because of inaccurate language, this amendment could not be incorporated.

§ 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)–7(b), 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. Yes. See §1.401(a)–21 of this chapter for rules permitting the use of electronic media to provide applicable notices to recipients with respect to retirement plans.

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; T.D. 9294, 71 FR 61887, Oct. 20, 2006; T.D. 9340, 72 FR 41159, July 26, 2007]

§ 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.

[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 (that is, the individual's excess deferrals for the year) must be included in gross income for the year, except to the extent the excess deferrals are comprised of designated Roth contributions, and thus, are already includible in gross income. A designated Roth contribution is treated as an excess deferral only to the extent that the total amount of designated Roth contributions for an individual exceeds the applicable limit for the taxable year or the designated Roth contributions are identified as excess deferrals and the individual receives a distribution of the excess deferrals and allocable income under paragraph (e)(2) or (e)(3) of this section.

(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.

(5) Any designated Roth contributions described in section 402A (before applying the limits of section 402(g) or this section).

(6) Any elective employer contributions to a SIMPLE retirement account, on behalf of an employee pursuant to a qualified salary reduction arrangement as described in section 408(p)(2) (before applying the limits of section 402(g) or this section).

(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)(v), 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 provided under paragraph (d)(2) of this section, the applicable limit for an individual's taxable year is the applicable dollar amount set forth in section 402(g)(1)(B). This applicable dollar amount is increased for the taxable year beginning in 2007 and later years in the same manner as the dollar amount under section 415(b)(1)(A) is adjusted pursuant to section 415(d). See §1.402(g)–2 for the treatment of catch-up contributions described in section 414(v).

(2) *Special adjustment for elective deferrals with respect to section 403(b) annuity contracts for certain long-term employees.* The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(7)(C)) and has elective deferrals described in paragraph (b)(3) or (5) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section in accordance with section 402(g)(7).

(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 non-highly 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 an excess deferral under paragraph (a) of this section:

(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 elective deferrals were made of the amount of the excess deferrals received by the plan. If any designated Roth contributions were made to a plan, the notification must also identify the extent, if any, to which the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) 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 and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions. 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. If any designated Roth contributions were made to a plan, the notification must identify the extent to which, if any, the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions.

(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 for a taxable year that begins on or after January 1, 2007 is equal to the sum of the allocable gain or loss for the taxable year of the individual and, to the extent the excess deferrals are or will be credited with gain or loss for the period after the close of the taxable year and prior to the distribution (the gap period) if the total account were to be distributed, the allocable gain or loss during that period. The income allocable to excess deferrals for a taxable year that begins before 2007 is determined using the 1.402(g)–1(e)(5) (as it appeared in the April 1, 2006 edition of 26 CFR Part 1).

(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). A plan will not fail to use a reasonable method for computing the income allocable to excess deferrals merely because the income allocable to excess deferrals is determined on a date that is no more than 7 days before the distribution.

(iii) *Alternative method of allocating taxable year income.* A plan may determine the income allocable to excess deferrals for the taxable year by multiplying the income for the taxable year allocable to elective deferrals 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 deferrals as of the beginning of the taxable year, plus

(B) The employee's elective deferrals for the taxable year.

(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.

(v) *Alternative method for allocating taxable year and gap period income.* A plan may determine the allocable gain or loss for the aggregate of the taxable year and the gap period by applying the alternative method provided by paragraph (e)(5)(iii) of this section to this aggregate period. This is accomplished by substituting the income for the taxable year and the gap period for the income for the taxable year and by substituting the elective deferrals for the taxable year and the gap period for the elective deferrals for the taxable year in determining the fraction that is multiplied by that income.

(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)–2(b)(4)(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.

(iv) *Distributions of excess deferrals from a designated Roth account.* The rules of paragraph (e)(8)(iii) of this section generally apply to distributions of excess deferrals that are designated Roth contributions and the attributable income. Thus, if a designated Roth account described in section 402A includes any excess deferrals, any distribution of amounts attributable to those excess deferrals are includible in gross income (without adjustment for any return of investment in the contract under section 72(e)(8)). In addition, such distributions cannot be qualified distributions described in section 402A(d)(2) and are not eligible rollover distributions within the meaning of section 402(c)(4). For this purpose, if a designated Roth account includes any excess deferrals, any distributions from the account are treated as attributable to those excess deferrals until the total amount distributed from the designated Roth account equals the total of such deferrals and attributable income.

(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; T.D. 9169, 69 FR 78153, Dec. 29, 2004; T.D. 9324, 72 FR 21110, Apr. 30, 2007]

§ 1.402(g)–2 Increased limit for catch-up contributions.

(a) *General rule.* Under section 402(g)(1)(C), in determining the amount of elective deferrals that are includible in gross income under section 402(g) for a catch-up eligible participant (within the meaning of § 1.414(v)–1(g)), the otherwise applicable dollar limit under section 402(g)(1)(B) (as increased under section 402(g)(7), to the extent applicable) shall be further increased by the applicable dollar catch-up limit as set forth under § 1.414(v)–1(c)(2).

(b) *Participants in multiple plans.* Paragraph (a) of this section applies without regard to whether the applicable employer plans (within the meaning of section 414(v)(6)) treat the elective deferrals as catch-up contributions. Thus, a catch-up eligible participant who makes elective deferrals under applicable employer plans of two or more employers that in total exceed the applicable dollar amount under section 402(g)(1) by an amount that does not exceed the applicable dollar catch-up limit under either plan may exclude the elective deferrals from gross income, even if neither applicable employer plan treats those elective deferrals as catch-up contributions.

(c) *Effective date*—(1) *Statutory effective date.* Section 402(g)(1)(C) applies to contributions in taxable years beginning on or after January 1, 2002.

(2) *Regulatory effective date.* Paragraphs (a) and (b) of this section apply to contributions in taxable years beginning on or after January 1, 2004.

[T.D. 9072, 68 FR 40515, July 8, 2003]

§ 1.402(g)(3)–1 Employer contributions to purchase a section 403(b) contract under a salary reduction agreement.

(a) *General rule.* With respect to an annuity contract under section 403(b), except as provided in paragraph (b) of this section, an elective deferral means an employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement within the meaning of section 3121(a)(5)(D).

(b) *Special rule.* Notwithstanding paragraph (a) of this section, for purposes of section 403(b), an elective deferral only includes a contribution that is made pursuant to a cash or deferred election (as defined at § 1.401(k)–1(a)(3)). Thus, for purposes of section 402(g)(3)(C), an elective deferral does not include a contribution that is made pursuant to an employee's one-time irrevocable election made on or before the employee's first becoming eligible to participate under the employer's plans or a contribution made as a condition of employment that reduces the employee's compensation.

(c) *Applicable date.* This section is applicable for taxable years beginning after December 31, 2008.

[T.D. 9340, 72 FR 41140, July 26, 2007]

§ 1.402A–1 Designated Roth Accounts.

Q–1. What is a designated Roth account?

A–1. A designated Roth account is a separate account under a qualified cash or deferred arrangement under a section 401(a) plan, or under a section 403(b) plan, to which designated Roth contributions are permitted to be made in lieu of elective contributions and that satisfies the requirements of § 1.401(k)–1(f) (in the case of a section 401(a) plan) or § 1.403(b)–3(c) (in the case of a section 403(b) plan).

Q–2. How is a distribution from a designated Roth account taxed?

A–2. (a) The taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the distributee's gross income.

(b) Except as otherwise provided in paragraph (c) of this A–2, a qualified distribution is a distribution that is both—

(1) Made after the 5-taxable-year period of participation defined in A–4 of this section has been completed; and

(2) Made on or after the date the employee attains age 59½, made to a beneficiary or the estate of the employee on

or after the employee's death, or attributable to the employee's being disabled within the meaning of section 72(m)(7).

(c) A distribution from a designated Roth account is not a qualified distribution to the extent it consists of a distribution of excess deferrals and attributable income described in § 1.402(g)–1(e). See A–11 of this section for other amounts that are not treated as qualified distributions, including excess contributions described in section 401(k)(8), and excess aggregate contributions described in section 401(m)(8), and income, on any of these excess amounts.

Q–3. How is a distribution from a designated Roth account taxed if it is not a qualified distribution?

A–3. Except as provided in A–11 of this section, a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under section 402 in the case of a plan qualified under section 401(a) and under section 403(b)(1) in the case of a section 403(b) plan. For this purpose, a designated Roth account is treated as a separate contract under section 72. Thus, except as otherwise provided in A–5 of this section for a rollover, if a distribution is before the annuity starting date, the portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(e)(8), treating the designated Roth account as a separate contract. Similarly, in the case of any amount received as an annuity, if a distribution is on or after the annuity starting date, the portion of any annuity payment that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(b) or (d), as applicable, treating the designated Roth account as a separate contract. For purposes of section 72, designated Roth contributions are described in section 72(f)(1) or 72(f)(2), to the extent applicable.

Q–4. What is the 5-taxable-year period of participation described in A–2 of this section?

A–4. (a) The 5-taxable-year period of participation described in A–2 of this section for a plan is the period of 5 consecutive taxable years that begins with the first day of the first taxable year in which the employee makes a designated Roth contribution to any designated Roth account established for the employee under the same plan and ends when 5 consecutive taxable years have been completed. For this purpose, the first taxable year in which an employee makes a designated Roth contribution is the year in which the amount is includible in the employee's gross income. Notwithstanding the preceding, however, a contribution that is returned as an excess deferral or excess contribution does not begin the 5 taxable-year period of participation. Similarly, a contribution returned as a permissible withdrawal under section 414(w) does not begin the 5 taxable-year period of participation.

(b) Generally, an employee's 5-taxable-year period of participation is determined separately for each plan (within the meaning of section 414(l)) in which the employee participates. Thus, if an employee has elective deferrals made to designated Roth accounts under two or more plans, the employee may have two or more different 5-taxable-year periods of participation, depending on when the employee first had contributions made to a designated Roth account under each plan. However, if a direct rollover contribution of a distribution from a designated Roth account under another plan is made by the employee to the plan, the 5-taxable-year period of participation begins on the first day of the employee's taxable year in which the employee first had designated Roth contributions made to such other designated Roth account, if earlier than the first taxable year in which a designated Roth contribution is made to the plan. See A–5(c) of this section for additional rules on determining the start of the 5-taxable-year of participation in the case of an indirect rollover.

(c) The beginning of the 5-taxable-year period of participation is not redetermined for any portion of an employee's designated Roth account. This is true even if the entire designated Roth account is distributed during the 5-taxable-year period of participation and the employee subsequently makes additional designated Roth contributions under the plan.

(d) The rule in paragraph (c) of this section applies if the employee dies or the account is divided pursuant to a qualified domestic relations order (QDRO), and thus, a portion of the account is not payable to the employee and is payable to the employee's beneficiary or an alternate payee. In the case of distribution to an alternate payee or beneficiary, generally, the age, death, or disability of the employee is used to determine whether the distribution to an alternate payee or beneficiary is qualified. However, if an alternate payee or a spousal beneficiary rolls the distribution into a designated Roth account in a plan maintained by his or her own employer, such individual's age, disability, or death is used to determine whether a distribution from the recipient plan is qualified. In addition, if the rollover is a direct rollover contribution to the alternate payee's or spousal beneficiary's own designated Roth account, the 5-taxable-year period of participation under the recipient plan begins on the earlier of the date the employee's 5-taxable-year period of participation began under the distributing plan or the date the 5-taxable-year period of participation applicable to the alternate payee's or spousal beneficiary's designated Roth account began under the recipient plan.

(e) If a designated Roth contribution is made by a reemployed veteran for a year of qualified military service pursuant to section 414(u) that is before the year in which the contribution is actually made, the contribution is treated as having been made in the year of qualified military service to which the contribution relates, as designated by the reemployed veteran. Reemployed veterans may identify the year of qualified military service for which a contribution is made for other purposes, such as for entitlement to a match, and the treatment for the 5-taxable-year period of participation rule follows that identification. In the absence of such designation, for purposes of determining the first year of the five years of participation under section 402A(d)(2)(B), the contribution is treated as relating to the first year of qualified military service for which the reemployed veteran could have made designated Roth contributions under the plan, or if later the first taxable year in which designated Roth contributions could be made under the plan.

Q–5. How do the taxation rules apply to a distribution from a designated Roth account that is rolled over?

A–5. (a) An eligible rollover distribution from a designated Roth account is permitted to be rolled over into another designated Roth account or a Roth IRA, and the amount rolled over is not currently includible in gross income. In accordance with section 402(c)(2), to the extent that a portion of a distribution from a designated Roth account is not includible in income (determined without regard to the rollover), if that portion of the distribution is to be rolled over into a designated Roth account, the rollover must be accomplished through a direct rollover (i.e., a 60-day rollover to another designated Roth account is not available for this portion of the distribution). For this purpose, any amount paid in a direct rollover is treated as a separate distribution from any amount paid directly to the employee. If a distribution from a designated Roth account is instead made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within the 60-day period described in section 402(c)(3).

(b) In the case of an eligible rollover distribution from a designated Roth account that is not a qualified distribution and not paid as a direct rollover contribution, if less than the entire amount of the distribution is rolled over, the part that is rolled over is deemed to consist first of the portion of the distribution that is attributable to income under section 72(e)(8).

(c) If an employee receives a distribution from a designated Roth account, the portion of the distribution that would be includible in gross income is permitted to be rolled over into a designated Roth account under another plan. In such a case, §1.402A–2, A–3, provides for additional reporting by the recipient plan. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of satisfying the 5-taxable-year period of participation requirement under the recipient plan. Generally, the taxable year in which the recipient plan accepts such rollover contribution is the taxable year that begins the participant's new 5-taxable-year period of participation. However, if the participant is rolling over to a plan in which the participant already has a pre-existing designated Roth account with a longer period of participation, the starting date of the recipient account is used to measure the participant's 5-taxable-year period of participation.

(d) The following example illustrates the application of this A–5:

Example. Employee B receives a $14,000 eligible rollover distribution that is not a qualified distribution from B's designated Roth account, consisting of $11,000 of investment in the contract and $3,000 of income. Within 60 days of receipt, Employee B rolls over $7,000 of the distribution into a Roth IRA. The $7,000 is deemed to consist of $3,000 of income and $4,000 of investment in the contract. Because the only portion of the distribution that could be includible in gross income (the income) is rolled over, none of the distribution is includible in Employee B's gross income.

(e) This A–5 applies for taxable years beginning on or after January 1, 2006.

Q–6. In the case of a rollover contribution to a designated Roth account, how is the amount that is treated as investment in the contract under section 72 determined?

A–6. (a) If a distribution from a designated Roth account is rolled over to another designated Roth account in a direct rollover, the amount of the rollover contribution allocated to investment in the contract in the recipient designated Roth account is the amount that would not have been includible in gross income (determined without regard to section 402(e)(4)) if the distribution had not been rolled over. Thus, if an amount that is a qualified distribution is rolled over, the entire amount of the rollover contribution is allocated to investment in the contract.

(b) If the entire account balance of a designated Roth account is rolled over to another designated Roth account in a direct rollover, and, at the time of the distribution, the investment in the contract exceeds the balance in the designated Roth account, the investment in the contract in the distributing plan is included in the investment in the contract of the recipient plan.

Q–7. After a qualified distribution from a designated Roth account has been made, how is the remaining investment in the contract of the designated Roth account determined under section 72?

A–7. (a) The portion of any qualified distribution that is treated as a recovery of investment in the contract is determined in the same manner as if the distribution were not a qualified distribution. (See A–3 of this section) Thus, the remaining investment in the contract in a designated Roth account after a qualified distribution is determined in the same manner after a qualified distribution as it would be determined if the distribution were not a qualified distribution.

(b) The following example illustrates the application of this A–7:

Example. Employee C receives a $12,000 distribution, which is a qualified distribution that is attributable to the employee being disabled within the meaning of section 72(m)(7), from C's designated Roth account. Immediately prior to the distribution, the account consisted of $21,850 of investment in the contract (i.e., designated Roth contributions) and $1,150 of income. For purposes of determining recovery of investment in the contract under section 72, the distribution is deemed to consist of $11,400 of investment in the contract [$12,000 × 21,850/(1,150 + 21,850)], and $600 of income [$12,000 × 1,150/(1,150 + 21,850)]. Immediately after the distribution, C's designated Roth account consists of $10,450 of investment in the contract and $550 of income. This determination of the remaining investment in the contract will be needed if C subsequently is no longer disabled and takes a nonqualified distribution from the designated Roth account.

Q–8. What is the relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B)?

A–8. (a) There is no relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B). A plan that makes a hardship distribution under section 401(k)(2)(B) from elective deferrals that includes designated Roth contributions must separately determine the amount of elective deferrals available for hardship and the amount of investment in the contract attributable to designated Roth contributions for purposes of section 72. Thus, the entire amount of a hardship distribution is treated as reducing the otherwise maximum distributable amount for purposes of applying the rule in section 401(k)(2)(B) and §1.401(k)–1(d)(3)(ii) that generally limits hardship distributions to the principal amount of elective deferrals made less the amount of elective deferrals previously distributed from the plan, even if a portion of the distribution is treated as income under section 72(e)(8).

(b) The following example illustrates the application of this A–8:

Example. The facts are the same as in the *Example* in A–7 of this section, except that instead of being disabled, Employee C is receiving a hardship distribution. In addition, Employee C has made elective deferrals that are not designated Roth contributions totaling $20,000 and has received no previous distributions of elective deferrals from the plan. The adjustment to the investment in the contract is the same as in A–7 of this section, but for purposes of determining the amount of elective deferrals available for future hardship distribution, the entire amount of the distribution is subtracted from the maximum distributable amount. Thus, Employee C has only $29,850 ($41,850 − $12,000) available for hardship distribution from C's designated Roth account.

Q–9. Can an employee have more than one separate contract for designated Roth contributions under a plan qualified under section 401(a) or a section 403(b) plan?

A–9. (a) Except as otherwise provided in paragraph (b) of this A–9, for purposes of section 72, there is only one separate contract for an employee with respect to the designated Roth contributions under a plan. Thus, if a plan maintains one separate account for designated Roth contributions made under the plan and another separate account for rollover contributions received from a designated Roth account under another plan (so that the rollover account is not required to be subject to the distribution restrictions otherwise applicable to the account consisting of designated Roth contributions made under the plan), both separate accounts are considered to be one contract for purposes of applying section 72 to the distributions from either account.

(b) If a separate account with respect to an employee's accrued benefit consisting of designated Roth contributions is established and maintained for an alternate payee pursuant to a qualified domestic relations order and another designated Roth account is maintained for the employee, each account is treated as a separate contract for purposes of section 72. The alternate payee's designated Roth account is also a separate contract for purposes of section 72 with respect to any other account maintained for that alternate payee. Similarly, if separate accounts are established and maintained for different beneficiaries after the death of an employee, the separate account for each beneficiary is treated as a separate contract under section 72 and is also a separate contract with respect to any other account maintained for that beneficiary under the plan that is not a designated Roth account. When the separate account is established for an alternate payee or for a beneficiary (after an employee's death), each separate account must receive a proportionate amount attributable to investment in the contract.

Q–10. What is the tax treatment of employer securities distributed from a designated Roth account?

A–10. (a) If a distribution of employer securities from a designated Roth account is not a qualified distribution, section 402(e)(4)(B) applies. Thus, in the case of a lump-sum distribution that includes employer securities, unless the taxpayer elects otherwise, net unrealized appreciation attributable to the employer securities is not includible in gross income; and such net unrealized appreciation is not included in the basis of the distributed securities and is capital gain to the extent such appreciation is realized in a subsequent taxable transaction.

(b) In the case of a qualified distribution of employer securities from a designated Roth account, the distributee's basis in the distributed securities for purposes of subsequent disposition is their fair market value at the time of distribution.

Q–11. Can an amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account be a qualified distribution?

A–11. No. An amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account cannot be a qualified distribution. Such an amount is taxable under the rules of §§1.72–16(b), 1.72(p)–1, A–11 through A–13, 1.402(g)–1(e)(8), 1.401(k)–2(b)(2)(vi), 1.401(m)–2(b)(2)(vi), or 1.404(k)–1T. Thus, for example, loans that are treated as deemed distributions pursuant to section 72(p), or dividends paid on employer securities as described in section 404(k) are not qualified distributions even if the deemed distributions occur or the dividends are paid after the employee attains age 59½ and the 5-taxable-year period of participation defined in A–4 of this section has been satisfied. However, if a dividend is reinvested in accordance with section 404(k)(2)(A)(iii)(II), the amount of such a dividend is not precluded from being a qualified distribution if later distributed. Further, an amount is not precluded from being a qualified distribution merely because it is described in section 402(c)(4) as an amount not eligible for rollover. Thus, a hardship distribution is not precluded from being a qualified distribution.

Q–12. If any amount from a designated Roth account is included in a loan to an employee, do the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the total amount an employee is permitted to borrow from the plan, even though the designated Roth account generally is treated as a separate contract under section 72?

A–12. Yes. If any amount from a designated Roth account is included in a loan to an employee, notwithstanding the general rule that the designated Roth account is treated as a separate contract under section 72, the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the maximum amount the employee is permitted to borrow from the plan and such amount is based on the total of the designated Roth contribution amounts and the other amounts under the plan. To the extent a loan is from a designated Roth account, the repayment requirement of section 72(p)(2)(C) must be satisfied separately with respect to that portion of the loan and with respect to the portion of the loan from other accounts under the plan.

Q–13. Does a transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of transferring value from the other accounts into the designated Roth account violate the separate accounting requirement of section 402A?

A–13. (a) Yes. Any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A. However, any transaction that merely exchanges investments between accounts at fair market value will not violate the separate accounting requirement.

(b) In the case of an annuity contract which contains both a designated Roth account and any other accounts, the Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter), to provide additional rules for allocation of income, expenses, gains and losses among the accounts under the contract.

(c) This A–13 applies to designated Roth accounts for taxable years beginning on or after January 1, 2006.

Q–14. How is an annuity contract that is distributed from a designated

Roth account treated for purposes of section 402A?

A–14. A qualified plan distributed annuity contract within the meaning of §1.402(c)–2, A–10(a) that is distributed from a designated Roth account is not treated as a distribution for purposes of section 402 or 402A. Instead, the amounts paid under the annuity contract are treated as distributions for purposes of sections 402 and 402A. Thus, the period after the annuity contract is distributed and before a payment from the annuity contract is made is included in determining whether the five-year period of participation is satisfied. Further, for purposes of determining if a distribution is a qualified distribution, the determination of whether a distribution is made on or after the date the employee attains age 59½, made to a beneficiary or the estate of the employee on or after the employee's death, or attributable to the employee's being disabled within the meaning of section 72(m)(7) is made based on the facts at the time the distribution is made from the annuity contract. Thus for example, if an employee first makes a designated Roth contribution to a designated Roth account in 2006 at age 56, receives a distributed annuity contract within the meaning of §1.402(c)–2, A–10(a) in 2007 purchased only with assets from the designated Roth account, and then receives a distribution from the contract in 2011 at age 60, the distribution is a qualified distribution.

Q–15. When are section 402A and this §1.402A–1 applicable?

A–15. Section 402A is applicable for taxable years beginning on or after January 1, 2006. Except as otherwise provided in A–5 and A–13 of this section, the rules of this §1.402A–1 apply for taxable years beginning on or after January 1, 2007.

[T.D. 9324, 72 FR 21111, Apr. 30, 2007; 72 FR 30974, June 5, 2007, as amended by T.D. 9340, 72 FR 41140, July 26, 2007]

§ 1.402A–2 Reporting and recordkeeping requirements with respect to designated Roth accounts.

Q–1. Who is responsible for keeping track of the 5-taxable-year period of participation and the investment in the contract, i.e., the amount of unrecovered designated Roth contributions for the employee?

A–1. The plan administrator or other responsible party with respect to a plan with a designated Roth account is responsible for keeping track of the 5-taxable-year period of participation for each employee and the amount of investment in the contract (unrecovered designated Roth contributions) on behalf of such employee. For purposes of the preceding sentence, in the absence of actual knowledge to the contrary, the plan administrator or other responsible party is permitted to assume that an employee's taxable year is the calendar year. In the case of a direct rollover from another designated Roth account, the plan administrator or other responsible party of the recipient plan can rely on reasonable representations made by the plan administrator or responsible party with respect to the plan with the other designated Roth account. See A–2 of this section for statements required in the case of rollovers.

Q–2. In the case of an eligible rollover distribution from a designated Roth account, what additional information must be provided with respect to such distribution?

A–2. (a) Pursuant to section 6047(f), if an amount is distributed from a designated Roth account, the plan administrator or other responsible party with respect to the plan must provide a statement as described below in the following situations—

(1) In the case of a direct rollover of a distribution from a designated Roth account under a plan to a designated Roth account under another plan, the plan administrator or other responsible party must provide to the plan administrator or responsible party of the recipient plan either a statement indicating the first year of the 5-taxable-year period described in A–1 of this section and the portion of the distribution that is attributable to investment in the contract under section 72, or a statement that the distribution is a qualified distribution.

(2) If the distribution is not a direct rollover to a designated Roth account under another plan, the plan administrator or responsible party must provide to the employee, upon request, the

same information described in paragraph (a)(1) of this A–2, except the statement need not indicate the first year of the 5-taxable-year period described in A–1 of this section.

(b) The statement described in paragraph (a) of this A–2 must be provided within a reasonable period following the direct rollover or distributee request but in no event later than 30 days following the direct rollover or distributee request.

Q–3. If a plan qualified under section 401(a) or a section 403(b) plan accepts a 60-day rollover of earnings from a designated Roth account, what report to the IRS must be provided with respect to such rollover contribution?

A–3. To the extent required in Forms and Instructions, if a plan qualified under section 401(a), or a section 403(b) plan, accepts a rollover contribution (other than a direct rollover contribution) under section 402(c)(2), or section 403(b)(8)(B), of the portion of a distribution from a designated Roth account that would have been includable in gross income, the plan administrator or other responsible party for the recipient plan must notify the Commissioner of its acceptance of the rollover contribution no later than the due date for filing Form 1099–R, '' Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,.'' The Forms and Instructions will specify the address to which the notification is required to be sent and will require inclusion of the employee's name and social security number, the amount rolled over, the year in which the rollover contribution was made, and such other information as the Commissioner may prescribe in order to determine that the amount rolled over is a valid rollover contribution.

Q–4. When is this §1.402A–2 applicable?

A–4. The rules of this §1.402A–2 are applicable for taxable years beginning on or after January 1, 2007.

[T.D. 9324, 72 FR 21111, Apr. 30, 2007; 72 FR 30974, June 5, 2007]

§ 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 through 1.403(b)–10 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) The rules of §1.402(a)–1(e) apply for purposes of determining the treatment of amounts paid to provide accident and health insurance benefits.

[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; T.D. 9340, 72 FR 41159, July 26, 2007; T.D. 9665, 79 FR 26843, May 12, 2014]

§ 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)–0 Taxability under an annuity purchased by a section 501(c)(3) organization or a public school.

This section lists the headings that appear in §§1.403(b)–1 through 1.403(b)–11.

§ 1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.

§ 1.403(b)–2 Definitions.

(a) Application of definitions.
(b) Definitions.

§ 1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.

(a) Exclusion for section 403(b) contracts.
(b) Application of requirements.
(c) Special rules for designated Roth section 403(b) contributions.
(d) Effect of failure.

§ 1.403(b)–4 Contribution limitations.

(a) Treatment of contributions in excess of limitations.
(b) Maximum annual contribution.
(c) Section 403(b) elective deferrals.
(d) Employer contributions for former employees.
(e) Special rules for determining years of service.
(f) Excess contributions of deferrals.

§ 1.403(b)–5 Nondiscrimination rules.

(a) Nondiscrimination rules for contributions other than section 403(b) elective deferrals.
(b) Universal availability required for section 403(b) elective deferrals.
(c) Plan required.
(d) Church plans exception.
(e) Other rules.

§ 1.403(b)–6 Timing of distributions and benefits.

(a) Distributions generally.
(b) Distributions from contracts other than custodial accounts or amounts attributable to section 403(b) elective deferrals.
(c) Distributions from custodial accounts that are not attributable to section 403(b) elective deferrals.
(d) Distribution of section 403(b) elective deferrals.
(e) Minimum required distributions for eligible plans.
(f) Loans.
(g) Death benefits and other incidental benefits.
(h) Special rule regarding severance from employment.

§ 1.403(b)–7 Taxation of distributions and benefits.

(a) General rules for when amounts are included in gross income.
(b) Rollovers to individual retirement arrangements and other eligible retirement plans.
(c) Special rules for certain corrective distributions.
(d) Amounts taxable under section 72(p)(1).
(e) Special rules relating to distributions from a designated Roth account.
(f) Certain rules relating to employment taxes.

§ 1.403(b)–8 Funding.

(a) Investments.
(b) Contributions to the plan.
(c) Annuity contracts.
(d) Custodial accounts.
(e) Retirement income accounts.
(f) Combining assets.

§ 1.403(b)–9 Special rules for church plans.

(a) Retirement income accounts.
(b) Retirement income account defined.
(c) Special deduction rule for self-employed ministers.

§ 1.403(b)–10 Miscellaneous provisions.

(a) Plan terminations and frozen plans.
(b) Contract exchanges and plan-to-plan transfers.
(c) Qualified domestic relations orders.
(d) Rollovers to a section 403(b) contract.
(e) Deemed IRAs.
(f) Defined benefit plans.
(g) Other rules relating to section 501(c)(3) organizations.

§ 1.403(b)–11 Applicable date.

(a) General rule.
(b) Collective bargaining agreements.
(c) Church conventions.
(d) Special rules for plans that exclude certain types of employees from elective deferrals.
(e) Special rules for plans that permit in-service distributions.
(f) Special rule for life insurance contracts.
(g) Special rule for contracts received in an exchange.

[T.D. 9340, 72 FR 41140, July 26, 2007]

§ 1.403(b)–1 General overview of taxability under an annuity contract purchased by a section 501(c)(3) organization or a public school.

Section 403(b) and §§ 1.403(b)–2 through 1.403(b)–10 provide rules for the Federal income tax treatment of an annuity purchased for an employee by an employer that is either a tax-exempt entity under section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) or a public school, or for a minister described in section 414(e)(5)(A). See section 403(a) (relating to qualified annuities) for rules regarding the taxation of an annuity purchased under a qualified annuity plan that meets the requirements of section 404(a)(2), and see section 403(c) (relating to nonqualified annuities) for rules regarding the taxation of other types of annuities.

[T.D. 9340, 72 FR 41141, July 26, 2007]

§ 1.403(b)–2 Definitions.

(a) *Application of definitions.* The definitions set forth in this section are applicable for purposes of § 1.403(b)–1, this section and §§ 1.403(b)–3 through 1.403(b)–11.

(b) *Definitions*—(1) *Accumulated benefit* means the total benefit to which a participant or beneficiary is entitled under a section 403(b) contract, including all contributions made to the contract and all earnings thereon.

(2) *Annuity contract* means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. See § 1.401(f)–1(d)(2) and (e) for the definition of an annuity, and see § 1.403(b)–8(c)(3) for a special rule for certain State plans. See also §§ 1.403(b)–8(d) and 1.403(b)–9(a) for additional rules regarding the treatment of custodial accounts and retirement income accounts as annuity contracts.

(3) *Beneficiary* means a person who is entitled to benefits in respect of a participant following the participant's death or an alternate payee pursuant to a qualified domestic relations order, as described in § 1.403(b)–10(c).

(4) *Catch-up* amount or *catch-up* limitation for a participant for a taxable year means a section 403(b) elective deferral permitted under section 414(v) (as described in § 1.403(b)–4(c)(2)) or section 402(g)(7) (as described in § 1.403(b)–4(c)(3)).

(5) *Church* means a church as defined in section 3121(w)(3)(A) and a qualified church-controlled organization as defined in section 3121(w)(3)(B).

(6) *Church-related organization* means a church or a convention or association of churches, including an organization described in section 414(e)(3)(A).

(7) *Elective deferral* means an elective deferral under § 1.402(g)–1 (with respect to an employer contribution to a section 403(b) contract) and any other amount that constitutes an elective deferral under section 402(g)(3).

(8) (i) *Eligible employer* means—

(A) A State, but only with respect to an employee of the State performing services for a public school;

(B) A section 501(c)(3) organization with respect to any employee of the section 501(c)(3) organization;

(C) Any employer of a minister described in section 414(e)(5)(A), but only with respect to the minister; or

(D) A minister described in section 414(e)(5)(A), but only with respect to a retirement income account established for the minister.

(ii) An entity is not an eligible employer under paragraph (a)(8)(i)(A) of this section if it treats itself as not being a State for any other purpose of the Internal Revenue Code, and a subsidiary or other affiliate of an eligible employer is not an eligible employer under paragraph (a)(8)(i) of this section if the subsidiary or other affiliate is not an entity described in paragraph (a)(8)(i) of this section.

(9) *Employee* means a common-law employee performing services for the employer, and does not include a former employee or an independent contractor. Subject to any rules in § 1.403(b)–1, this section, and §§ 1.403(b)–3 through 1.403(b)–11 that are specifically applicable to ministers, an employee also includes a minister described in section 414(e)(5)(A) when performing services in the exercise of his or her ministry.

(10) *Employee performing services for a public school* means an employee performing services as an employee for a public school of a State. This definition is not applicable unless the employee's compensation for performing services for a public school is paid by the State. Further, a person occupying an elective or appointive public office is not an employee performing services for a public school unless such office is one to which an individual is elected or appointed only if the individual has received training, or is experienced, in the field of education. The term *public office* includes any elective or appointive office of a State.

(11) *Includible compensation* means the employee's compensation received from an eligible employer that is includible in the participant's gross income for Federal income tax purposes

(computed without regard to section 911) for the most recent period that is a year of service. Includible compensation for a minister who is self-employed means the minister's earned income as defined in section 401(c)(2) (computed without regard to section 911) for the most recent period that is a year of service. Includible compensation does not include any compensation received during a period when the employer is not an eligible employer. Includible compensation also includes any elective deferral or other amount contributed or deferred by the eligible employer at the election of the employee that would be includible in the gross income of the employee but for the rules of sections 125, 132(f)(4), 402(e)(2), 402(h)(1)(B), 402(k), or 457(b). The amount of includible compensation is determined without regard to any community property laws. See section 415(c)(3)(A) through (D) for additional rules, and see §1.403(b)–4(d) for a special rule regarding former employees.

(12) *Participant* means an employee for whom a section 403(b) contract is currently being purchased, or an employee or former employee for whom a section 403(b) contract has previously been purchased and who has not received a distribution of his or her entire accumulated benefit under the contract.

(13) *Plan* means a plan as described in §1.403(b)–3(b)(3).

(14) *Public school* means a State-sponsored educational organization described in section 170(b)(1)(A)(ii) (relating to educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where educational activities are regularly carried on).

(15) *Retirement income account* means a defined contribution program established or maintained by a church-related organization to provide benefits under section 403(b) for its employees or their beneficiaries as described in §1.403(b)–9.

(16) *Section 403(b) contract; section 403(b) plan*—(i) *Section 403(b) contract* means a contract that satisfies the requirements of §1.403(b)–3. If for any taxable year an employer contributes to more than one section 403(b) contract for a participant or beneficiary, then, under section 403(b)(5), all such contracts are treated as one contract for purposes of section 403(b) and §1.403(b)–1, this section, and §§1.403(b)–3 through 1.403(b)–11. See also §1.403(b)–3(b)(1).

(ii) *Section 403(b) plan* means the plan of the employer under which the section 403(b) contracts for its employees are maintained.

(17) *Section 403(b) elective deferral; designated Roth contribution*—(i) *Section 403(b) elective deferral* means an elective deferral that is an employer contribution to a section 403(b) plan for an employee. See §1.403(b)–5(b) for additional rules with respect to a section 403(b) elective deferral.

(ii) *Designated Roth contribution* under a section 403(b) plan means a section 403(b) elective deferral that satisfies §1.403(b)–3(c).

(18) *Section 501(c)(3) organization* means an organization that is described in section 501(c)(3) (relating to certain religious, charitable, scientific, or other types of organizations) and exempt from tax under section 501(a).

(19) *Severance from employment* means that the employee ceases to be employed by the employer maintaining the plan. See §1.401(k)–1(d) for additional guidance concerning severance from employment. See also §1.403(b)–6(h) for a special rule under which severance from employment is determined by reference to employment with the eligible employer.

(20) *State* means a State, a political subdivision of a State, or any agency or instrumentality of a State. For this purpose, the District of Columbia is treated as a State. In addition, for purposes of determining whether an individual is an employee performing services for a public school, an Indian tribal government is treated as a State, as provided under section 7871(a)(6)(B). See also section 1450(b) of the Small Business Job Protection Act of 1996 (110 Stat. 1755, 1814) for special rules treating certain contracts purchased in a plan year beginning before January 1, 1995, that include contributions by an Indian tribal government as section 403(b) contracts, whether or not those

contributions are for employees performing services for a public school.

(21) *Year of service* means each full year during which an individual is a full-time employee of an eligible employer, plus fractional credit for each part of a year during which the individual is either a full-time employee of an eligible employer for a part of the year or a part-time employee of an eligible employer. See §1.403(b)–4(e) for rules for determining years of service.

[T.D. 9340, 72 FR 41141, July 26, 2007; 72 FR 54351, Sept. 25, 2007]

§ 1.403(b)–3 Exclusion for contributions to purchase section 403(b) contracts.

(a) *Exclusion for section 403(b) contracts.* Amounts contributed by an eligible employer for the purchase of an annuity contract for an employee are excluded from the gross income of the employee under section 403(b) only if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied. In addition, amounts contributed by an eligible employer for the purchase of an annuity contract for an employee pursuant to a cash or deferred election (as defined at §1.401(k)–1(a)(3)) are not includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election) if each of the requirements in paragraphs (a)(1) through (9) of this section is satisfied. However, the preceding two sentences generally do not apply to designated Roth contributions; see paragraph (c) of this section and §1.403(b)–7(e) for special taxation rules that apply with respect to designated Roth contributions under a section 403(b) plan.

(1) *Not a contract issued under qualified plan or eligible governmental plan.* The annuity contract is not purchased under a qualified plan (under section 401(a) or 403(a)) or an eligible governmental plan under section 457(b).

(2) *Nonforfeitability.* The rights of the employee under the annuity contract (disregarding rights to future premiums) are nonforfeitable. An employee's rights under a contract fail to be nonforfeitable unless the employee for whom the contract is purchased has at all times a fully vested and nonforfeitable right (as defined in regulations under section 411) to all benefits provided under the contract. See paragraph (d)(2) of this section for additional rules regarding the nonforfeitability requirement of this paragraph (a)(2).

(3) *Nondiscrimination.* In the case of an annuity contract purchased by an eligible employer other than a church, the contract is purchased under a plan that satisfies section 403(b)(12) (relating to nondiscrimination requirements, including universal availability). See §1.403(b)–5.

(4) *Limitations on elective deferrals.* In the case of an elective deferral, the contract satisfies section 401(a)(30) (relating to limitations on elective deferrals). A contract does not satisfy section 401(a)(30) as required under this paragraph (a)(4) unless the contract requires that all elective deferrals for an employee not exceed the limits of section 402(g)(1), including elective deferrals for the employee under the contract and any other elective deferrals under the plan under which the contract is purchased and under all other plans, contracts, or arrangements of the employer. See §1.401(a)–30.

(5) *Nontransferability.* The contract is not transferable. This paragraph (a)(5) does not apply to a contract issued before January 1, 1963. See section 401(g).

(6) *Minimum required distributions.* The contract satisfies the requirements of section 401(a)(9) (relating to minimum required distributions). See §1.403(b)–6(e).

(7) *Rollover distributions.* The contract provides that, if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, as defined in section 402(c)(8)(B), 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. See §1.403(b)–7(b)(2).

(8) *Limitation on incidental benefits.* The contract satisfies the incidental benefit requirements of section 401(a). See §1.403(b)–6(g).

(9) *Maximum annual additions.* The annual additions to the contract do not exceed the applicable limitations of section 415(c) (treating contributions

and other additions as annual additions). See paragraph (b) of this section and § 1.403(b)–4(b) and (f).

(b) *Application of requirements*—(1) Aggregation of contracts. In accordance with section 403(b)(5), for purposes of determining whether this section is satisfied, all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Additional aggregation rules apply under section 402(g) for purposes of satisfying paragraph (a)(4) of this section and under section 415 for purposes of satisfying paragraph (a)(9) of this section.

(2) *Disaggregation for excess annual additions.* In accordance with the last sentence of section 415(a)(2), if an excess annual addition is made to a contract that otherwise satisfies the requirements of this section, then the portion of the contract that includes such excess annual addition fails to be a section 403(b) contract (as further described in paragraph (d)(1) of this section) and the remaining portion of the contract is a section 403(b) contract. This paragraph (b)(2) is not satisfied unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for each such portion. Thus, the entire contract fails to be a section 403(b) contract if an excess annual addition is made and a separate account is not maintained with respect to the excess.

(3) *Plan in form and operation.* (i) A contract does not satisfy paragraph (a) of this section unless it is maintained pursuant to a plan. For this purpose, a plan is a written defined contribution plan, which, in both form and operation, satisfies the requirements of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11. For purposes of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11, the plan must contain all the material terms and conditions for eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefit distributions would be made. For purposes of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11, a plan may contain certain optional features that are consistent with but not required under section 403(b), such as hardship withdrawal distributions, loans, plan-to-plan or annuity contract-to-annuity contract transfers, and acceptance of rollovers to the plan. However, if a plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 403(b), this section, and §§ 1.403(b)–4 through 1.403(b)–11.

(ii) The plan may allocate responsibility for performing administrative functions, including functions to comply with the requirements of section 403(b) and other tax requirements. Any such allocation must identify responsibility for compliance with the requirements of the Internal Revenue Code that apply on the basis of the aggregated contracts issued to a participant under a plan, including loans under section 72(p) and the conditions for obtaining a hardship withdrawal under § 1.403(b)–6. A plan is permitted to assign such responsibilities to parties other than the eligible employer, but not to participants (other than employees of the employer a substantial portion of whose duties are administration of the plan), and may incorporate by reference other documents, including the insurance policy or custodial account, which thereupon become part of the plan.

(iii) This paragraph (b)(3) applies to contributions to an annuity contract by a church only if the annuity is part of a retirement income account, as defined in § 1.403(b)–9.

(4) *Exclusion limited for former employees*—(i) *General rule.* Except as provided in paragraph (b)(4)(ii) of this section and in § 1.403(b)–4(d), the exclusion from gross income provided by section 403(b) does not apply to contributions made for former employees. For this purpose, a contribution is not made for a former employee if the contribution is with respect to compensation that would otherwise be paid for a payroll period that begins before severance from employment.

(ii) *Exceptions.* The exclusion from gross income provided by section 403(b) applies to contributions made for former employees with respect to compensation described in § 1.415(c)–2(e)(3)(i) (relating to certain compensation paid by the later of 2½ months after severance from employment or the end of the limitation year that includes the date of severance from employment), and compensation described in § 1.415(c)–2(e)(4), § 1.415(c)–2(g)(4), or § 1.415(c)–2(g)(7) (relating to compensation paid to participants who are permanently and totally disabled or relating to qualified military service under section 414(u)).

(c) *Special rules for designated Roth section 403(b) contributions.* (1) The rules of § 1.401(k)–1(f)(1) and (2) for designated Roth contributions under a qualified cash or deferred arrangement apply to designated Roth contributions under a section 403(b) plan. Thus, a designated Roth contribution under a section 403(b) plan is a section 403(b) elective deferral that is designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the section 403(b) elective deferrals the employee is otherwise eligible to make under the plan; that is treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the cash or deferred election (such as by treating the contributions as wages subject to applicable withholding requirements); and that is maintained in a separate account (within the meaning of § 1.401(k)–1(f)(2)).

(2) A designated Roth contribution under a section 403(b) plan must satisfy the requirements applicable to section 403(b) elective deferrals. Thus, for example, designated Roth contributions under a section 403(b) plan must satisfy the requirements of § 1.403(b)–6(d). Similarly, a designated Roth account under a section 403(b) plan is subject to the rules of sections 401(a)(9)(A) and (B) and § 1.403(b)–6(e).

(d) *Effect of failure*—(1) *General rules.* (i) If a contract includes any amount that fails to satisfy the requirements of section 403(b), § 1.403(b)–1, § 1.403(b)–2, this section, or §§ 1.403(b)–4 through 1.403(b)–11, then, except as otherwise provided in paragraph (d)(2) of this section (relating to failure to satisfy nonforfeitability requirements) or § 1.403(b)–4(f) (relating to excess contributions under section 415 and excess deferrals under section 402(g)), the contract is not a section 403(b) contract. In addition, section 403(b)(5) and paragraph (b)(1) of this section provide that, for purposes of determining whether a contract satisfies section 403(b), all section 403(b) contracts purchased for an individual by an employer are treated as purchased under a single contract. Thus, except as provided in paragraph (b)(2) of this section or as otherwise provided in this paragraph (d), a failure to satisfy section 403(b) with respect to any contract issued to an individual by an employer adversely affects all contracts issued to that individual by that employer.

(ii) In accordance with paragraph (b)(3) of this section, a failure to operate in accordance with the terms of a plan adversely affects all of the contracts issued by the employer to the employee or employees with respect to whom the operational failure occurred. Such a failure does not adversely affect any other contract if the failure is neither a failure to satisfy the nondiscrimination requirements of § 1.403(b)–5 (a nondiscrimination failure) nor a failure of the employer to be an eligible employer as defined in § 1.403(b)–2 (an employer eligibility failure). However, any failure that is not an operational failure adversely affects all contracts issued under the plan, including: a failure to have contracts issued pursuant to a written defined contribution plan which, in form, satisfies the requirements of § 1.403(b)–1, § 1.403(b)–2, this section, and §§ 1.403(b)–4 through 1.403(b)–11 (a written plan failure); a nondiscrimination failure; or an employer eligibility failure.

(iii) See other applicable Internal Revenue Code provisions for the treatment of a contract that is not a section 403(b) contract, such as sections 61, 83, 402(b), and 403(c). Thus, for example, section 403(c) (relating to nonqualified annuities) applies if any annuity contract issued by an insurance company fails to satisfy section 403(b), based on the value of the contract at the time of the failure. However, see paragraph (d)(2) of this section for special rules with respect to the nonforfeitability requirement of paragraph (a)(2) of this section.

(2) *Failure to satisfy nonforfeitability requirement*—(i) *Treatment before contract becomes nonforfeitable.* If an annuity contract issued by an insurance company would qualify as a section 403(b) contract but for the failure to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section, then the contract is treated as a contract to which section 403(c) applies. See §1.403(b)–8(d)(4) for a rule under which a custodial account that fails to satisfy the nonforfeitability requirement of paragraph (a)(2) of this section is treated as a section 401(a) qualified plan for certain purposes.

(ii) *Treatment when contract becomes nonforfeitable*—(A) *In general.* Notwithstanding paragraph (d)(2)(i) of this section, on or after the date on which the participant's interest in a contract described in paragraph (d)(2)(i) of this section becomes nonforfeitable, the contract may be treated as a section 403(b) contract if no election has been made under section 83(b) with respect to the contract, the participant's interest in the contract has been subject to a substantial risk of forfeiture (as defined in section 83) before becoming nonforfeitable, each contribution under the contract that is subject to a different vesting schedule is maintained in a separate account, and the contract has at all times satisfied the requirements of paragraph (a) of this section other than the nonforfeitability requirement of paragraph (a)(2) of this section. Thus, for example, for the current year and each prior year, no contribution can have been made to the contract that would cause the contract to fail to be a section 403(b) contract as a result of contributions exceeding the limitations of section 415 (except to the extent permitted under paragraph (b)(2) of this section) or to fail to satisfy the nondiscrimination rules described in §1.403(b)–5. See also §1.403(b)–10(a)(1) for a special rule in connection with termination of a section 403(b) plan.

(B) *Partial vesting.* For purposes of applying this paragraph (d), if only a portion of a participant's interest in a contract becomes nonforfeitable in a year, then the portion that is nonforfeitable and the portion that fails to be nonforfeitable are each treated as separate contracts. In addition, for purposes of applying this paragraph (d), if a contribution is made to an annuity contract in excess of the limitations of section 415(c) and the excess is maintained in a separate account, then the portion of the contract that includes the excess contributions account and the remainder are each treated as separate contracts. Thus, if an annuity contract that includes an excess contributions account changes from forfeitable to nonforfeitable during a year, then the portion that is not attributable to the excess contributions account constitutes a section 403(b) contract (assuming it otherwise satisfies the requirements to be a section 403(b) contract) and is not included in gross income, and the portion that is attributable to the excess contributions account is included in gross income in accordance with section 403(c). See §1.403(b)–4(f) for additional rules.

[T.D. 9340, 72 FR 41141, July 26, 2007; 72 FR 54352, Sept. 25, 2007]

§1.403(b)–4 Contribution limitations.

(a) *Treatment of contributions in excess of limitations.* The exclusion provided under §1.403(b)–3(a) applies to a participant only if the amounts contributed by the employer for the purchase of an annuity contract for the participant do not exceed the applicable limit under sections 415 and 402(g), as described in this section. Under §1.403(b)–3(a)(4), a section 403(b) contract is required to include the limits on elective deferrals imposed by section 402(g), as described in paragraph (c) of this section. See paragraph (f) of this section for special rules concerning excess contributions and deferrals. Rollover contributions made to a section 403(b) contract, as described in §1.403(b)–10(d), are not taken into account for purposes of the limits imposed by section 415, §1.403(b)–3(a)(9), section 402(g), §1.403(b)–3(a)(4), and this section, but after-tax employee contributions are taken into account under section 415, §1.403(b)–3(a)(9), and paragraph (b) of this section.

(b) *Maximum annual contribution*—(1) *General rule.* In accordance with section 415(a)(2) and §1.403(b)–3(a)(9), the contributions for any participant under a section 403(b) contract (namely, employer nonelective contributions (including matching contributions), section 403(b) elective deferrals, and after-tax employee contributions) are not permitted to exceed the limitations imposed by section 415. Under section 415(c), contributions are permitted to be made for participants in a defined contribution plan, subject to the limitations set forth therein (which are generally the lesser of a dollar limit for a year or the participant's compensation for the year). For purposes of section 415, contributions made for a participant are aggregated to the extent applicable under sections 414(b), (c), (m), (n), and (o). For purposes of section 415(a)(2), §§1.403(b)–1 through 1.403(b)–3, this section, and §§1.403(b)–5 through 1.403(b)–11, a contribution means any annual addition, as defined in section 415(c).

(2) *Special rules.* See section 415(k)(4) for a special rule under which contributions to section 403(b) contracts are generally aggregated with contributions under other arrangements in applying section 415. For purposes of applying section 415(c)(1)(B) (relating to compensation) with respect to a section 403(b) contract, except as provided in section 415(c)(3)(C), a participant's includible compensation (as defined in §1.403(b)–2) is substituted for the participant's compensation, as described in section 415(c)(3)(E). Any age 50 catch-up contributions under paragraph (c)(2) of this section are disregarded in applying section 415.

(c) *Section 403(b) elective deferrals*—(1) *Basic limit under section 402(g)(1).* In accordance with section 402(g)(1)(A), the section 403(b) elective deferrals for any individual are included in the individual's gross income to the extent the amount of such deferrals, plus all other elective deferrals for the individual, for the taxable year exceeds the applicable dollar amount under section 402(g)(1)(B). The applicable annual dollar amount under section 402(g)(1)(B) is $15,000, adjusted for cost-of-living after 2006 in the manner described in section 402(g)(4). See §1.403(b)–5(b) for a universal availability rule that applies if any employee is permitted to have any section 403(b) elective deferrals made on his or her behalf.

(2) *Age 50 catch-up*—(i) *In general.* In accordance with section 414(v) and the regulations thereunder, a section 403(b) contract may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of additional age 50 catch-up contributions for a taxable year under section 414(v) is $5,000, adjusted for cost-of-living after 2006 in the manner described in section 414(v)(2)(C). For additional requirements, see regulations under section 414(v).

(ii) *Coordination with special section 403(b) catch-up.* In accordance with sections 414(v)(6)(A)(ii) and 402(g)(7)(A), the age 50 catch-up described in this paragraph (c)(2) may apply for any taxable year in which a participant also qualifies for the special section 403(b) catch-up under paragraph (c)(3) of this section.

(3) *Special section 403(b) catch-up for certain organizations*—(i) *Amount of the special section 403(b) catch-up.* In the case of a qualified employee of a qualified organization for whom the basic section 403(b) elective deferrals for any year are not less than the applicable dollar amount under section 402(g)(1)(B), the section 403(b) elective deferral limitation of section 402(g)(1) for the taxable year of the qualified employee is increased by the least of—

(A) $3,000;

(B) The excess of—

(*1*) $15,000, over

(*2*) The total elective deferrals described in section 402(g)(7)(A)(ii) made for the qualified employee by the qualified organization for prior years; or

(C) The excess of—

(*1*) $5,000 multiplied by the number of years of service of the employee with the qualified organization, over

(*2*) The total elective deferrals (as defined at §1.403(b)–2) made for the employee by the qualified organization for prior years.

(ii) Qualified organization. (A) For purposes of this paragraph (c)(3), *qualified organization* means an eligible employer that is—

(*1*) An educational organization described in section 170(b)(1)(A)(ii);

(*2*) A hospital;

(*3*) A health and welfare service agency (including a home health service agency);

(*4*) A church-related organization; or

(*5*) Any organization described in section 414(e)(3)(B)(ii).

(B) All entities that are in a church-related organization or an organization controlled by a church-related organization under section 414(e)(3)(B)(ii) are treated as a single qualified organization (so that years of service and any special section 403(b) catch-up elective deferrals previously made for a qualified employee for a church or other entity within a church-related organization or an organization controlled by the church-related organization are taken into account for purposes of applying this paragraph (c)(3) to the employee with respect to any other entity within the same church-related organization or organization controlled by a church-related organization).

(C) For purposes of this paragraph (c)(3)(ii), a *health and welfare service agency* means—

(*1*) An organization whose primary activity is to provide services that constitute medical care as defined in section 213(d)(1) (such as a hospice);

(*2*) A section 501(c)(3) organization whose primary activity is the prevention of cruelty to individuals or animals;

(*3*) An adoption agency; or

(*4*) An agency that provides substantial personal services to the needy as part of its primary activity (such as a section 501(c)(3) organization that either provides meals to needy individuals, is a home health service agency, provides services to help individuals who have substance abuse, or provides help to the disabled).

(iii) *Qualified employee.* For purposes of this paragraph (c)(3), *qualified employee* means an employee who has completed at least 15 years of service (as defined under paragraph (e) of this section) taking into account only employment with the qualified organization. Thus, an employee who has not completed at least 15 years of service (as defined under paragraph (e) of this section) taking into account only employment with the qualified organization is not a qualified employee.

(iv) *Coordination with age 50 catch-up.* In accordance with sections 402(g)(1)(C) and 402(g)(7), any catch-up amount contributed by an employee who is eligible for both an age 50 catch-up and a special section 403(b) catch-up is treated first as an amount contributed as a special section 403(b) catch-up to the extent a special section 403(b) catch-up is permitted, and then as an amount contributed as an age 50 catch-up (to the extent the catch-up amount exceeds the maximum special section 403(b) catch-up after taking into account sections 402(g) and 415(c), this paragraph (c)(3), and any limitations on the special section 403(b) catch-up that are imposed by the terms of the plan).

(4) *Coordination with designated Roth contributions.* See regulations under section 402A for rules for determining whether an elective deferral is a pre-tax elective deferral or a designated Roth contribution.

(5) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts illustrating application of the basic dollar limit.* Participant B, who is 45, is eligible to participate in a State university section 403(b) plan in 2006. B is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, B will receive includible compensation of $42,000 from the eligible employer. B desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000.

(ii) *Conclusion.* B is not eligible for the age 50 catch-up in 2006 because B is 45 in 2006. B is also not eligible for the special section 403(b) catch-up under paragraph (c)(3) of this section because B is not a qualified employee. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $15,000.

Example 2. (i) *Facts illustrating application of the includible compensation limitation.* The facts are the same as in *Example 1*, except B's includible compensation is $14,000.

(ii) *Conclusion.* Under section 415(c), contributions may not exceed 100 percent of includible compensation. Accordingly, the maximum section 403(b) elective deferral that B may elect for 2006 is $14,000.

Example 3. (i) *Facts illustrating application of the age 50 catch-up.* Participant C, who is 55, is eligible to participate in a State university section 403(b) plan in 2006. The plan permits section 403(b) elective deferrals, but no other employer contributions are made under the plan. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1) and (c)(3) of this section and the additional age 50 catch-up amount described in paragraph (c)(2) of this section. For 2006, C will receive includible compensation of $48,000 from the eligible employer. C desires to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000 and the additional dollar amount permitted under the age 50 catch-up is $5,000. C does not have 15 years of service and thus is not a qualified employee, as defined in paragraph (c)(3)(iii) of this section.

(ii) *Conclusion.* C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. C is not eligible for the special section 403(b) catch-up under paragraph (c)(3) of this section because C is not a qualified employee (as defined in paragraph (c)(3)(iii) of this section). Accordingly, the maximum section 403(b) elective deferral that C may elect for 2006 is $20,000 ($15,000 plus $5,000).

Example 4. (i) *Facts illustrating application of both the age 50 and the special section 403(b) catch-up.* The facts are the same as in *Example 3*, except that C is a qualified employee for purposes of the special section 403(b) catch-up provisions in paragraph (c)(3) of this section. For 2006, the maximum additional section 403(b) elective deferral for which C qualifies under the special section 403(b) catch-up under paragraph (c)(3) of this section is $3,000.

(ii) *Conclusion.* The maximum section 403(b) elective deferrals that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000.

Example 5. (i) *Facts illustrating calculation of years of service with a predecessor organization for purposes of the special section 403(b) catch-up.* Participant A is an employee of hospital H and is eligible to participate in a section 403(b) plan of H in 2006. A does not have 15 years of service with H, but A has previously made special section 403(b) catch-up deferrals to a section 403(b) plan maintained by hospital P which has since been acquired by H.

(ii) *Conclusion.* The special section 403(b) catch-up amount for which A qualifies under paragraph (c)(3) of this section must be calculated taking into account A's prior years of service and section 403(b) elective deferrals with the predecessor hospital if and only if A did not have any severance from service in connection with the acquisition.

Example 6. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 4*, except that the employer makes a nonelective contribution for each employee equal to 20 percent of C's compensation (which is $48,000). Thus, the employer makes a nonelective contribution for C for 2006 equal to $9,600. The plan provides that a participant is not permitted to make section 403(b) elective deferrals to the extent the section 403(b) elective deferrals would result in contributions in excess of the maximum permitted under section 415 and provides that contributions are reduced in the following order: the special section 403(b) catch-up elective deferrals under paragraph (c)(3) of this section are reduced first; the age 50 catch-up elective deferrals under paragraph (c)(2) of this section are reduced second; and then the basic section 403(b) elective deferrals under paragraph (c)(1) of this section are reduced. For 2006, the applicable dollar limit under section 415(c)(1)(A) is $44,000.

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 additional special section 403(b) catch-up amount for which C qualifies under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limit in paragraph (b) of this section would not be exceeded because the sum of the $9,600 nonelective contribution and the $23,000 section 403(b) elective deferrals does not exceed the lesser of $49,000 (which is the sum of $44,000 plus the $5,000 additional age 50 catch-up amount) or $53,000 (which is the sum of C's includible compensation for 2006 ($48,000) plus the $5,000 additional age 50 catch-up amount).

Example 7. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 6*, except that C's includible compensation for 2006 is $58,000 and the plan provides for a nonelective contribution equal to 50 percent of includible compensation, so that the employer nonelective contribution for C for 2006 is $29,000 (50 percent of $58,000).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for

2006 is $20,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount, because the sum of the employer's nonelective contribution of $29,000 plus a section 403(b) elective deferral in excess of $20,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount). (Note that a section 403(b) elective deferral in excess of $20,000 would also exceed the limitations of section 402(g) unless a special section 403(b) catch-up were permitted.)

Example 8. (i) *Facts further illustrating application of the age 50 catch-up and the section 415(c) dollar limitation.* The facts are the same as in *Example 7,* except that the plan provides for a nonelective contribution for C equal to $44,000 (which is the limit in section 415(c)(1)(A)).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $5,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(A) plus the additional age 50 catch-up amount ($5,000), because the sum of the employer's nonelective contribution of $44,000 plus a section 403(b) elective deferral in excess of $5,000 would exceed $49,000 (the sum of the $44,000 limit in section 415(c)(1)(A) plus the $5,000 additional age 50 catch-up amount).

Example 9. (i) *Facts illustrating application of the age 50 catch-up and the section 415(c) includible compensation limitation.* The facts are the same as in *Example 7,* except that C's includible compensation for 2006 is $28,000, so that the employer nonelective contribution for C for 2006 is $14,000 (50 percent of $28,000).

(ii) *Conclusion.* The maximum section 403(b) elective deferral that C may elect for 2006 is $19,000. A section 403(b) elective deferral in excess of this amount would exceed the sum of the limit in section 415(c)(1)(B) plus the additional age 50 catch-up amount, because C's includible compensation is $28,000 and the sum of the employer's nonelective contribution of $14,000 plus a section 403(b) elective deferral in excess of $19,000 would exceed $33,000 (which is the sum of 100 percent of C's includible compensation plus the $5,000 additional age 50 catch-up amount).

Example 10. (i) *Facts illustrating that section 403(b) elective deferrals cannot exceed compensation otherwise payable.* Employee D is age 60, has includible compensation of $14,000, and wishes to contribute section 403(b) elective deferrals of $20,000 for the year. No nonelective contributions are made for Employee D.

(ii) *Conclusion.* Because a contribution is a section 403(b) elective deferral only if it relates to an amount that would otherwise be included in the participant's compensation, the effective limitation on section 403(b) elective deferrals for a participant whose compensation is less than the basic dollar limit for section 403(b) elective deferrals is the participant's compensation. Thus, D cannot make section 403(b) elective deferrals in excess of D's actual compensation, which is $14,000, even though the basic dollar limit exceeds that amount.

Example 11. (i) *Facts illustrating calculation of the special section 403(b) catch-up.* For 2006, employee E, who is age 53, is eligible to participate in a section 403(b) plan of hospital H, which is a section 501(c)(3) organization. H's plan permits section 403(b) elective deferrals and provides for an employer contribution of 10 percent of a participant's compensation. The plan provides limitations on section 403(b) elective deferrals up to the maximum permitted under paragraphs (c)(1), (2), and (3) of this section. For 2006, E's includible compensation is $50,000. E wishes to elect to have the maximum section 403(b) elective deferral possible contributed in 2006. E has previously made $62,000 of section 403(b) elective deferrals under the plan, but has never made an election for a special section 403(b) catch-up elective deferral. For 2006, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is $15,000, the additional dollar amount permitted under the age 50 catch-up is $5,000, E's employer will make a nonelective contribution of $5,000 (10% of $50,000 compensation), and E is a qualified employee of a qualified employer as defined in paragraph (c)(3) of this section.

(ii) *Conclusion.* The maximum section 403(b) elective deferrals that E may elect under H's section 403(b) plan for 2006 is $23,000. This is the sum of the basic limit on section 403(b) elective deferrals for 2006 under paragraph (c)(1) of this section equal to $15,000, plus the $3,000 maximum additional special section 403(b) catch-up amount for which D qualifies in 2006 under paragraph (c)(3) of this section, plus the additional age 50 catch-up amount of $5,000. The limitation on the additional special section 403(b) catch-up amount is not less than $3,000 because the limitation at paragraph (c)(3)(i)(B) of this section is $15,000 ($15,000 minus zero) and the limitation at paragraph (c)(3)(i)(C) of this section is $13,000 ($5,000 times 15, minus $62,000 of total deferrals in prior years). These conclusions would be unaffected if H were an eligible governmental employer under section 457(b) that has a section 457(b) eligible governmental plan and E were in the past to have made annual deferrals to that plan, because contributions to a section 457(b) eligible governmental plan do not constitute elective deferrals; and these conclusions would also be the same if H had a section 401(k) plan and E were in the past to have made elective deferrals to that plan, assuming that those elective deferrals did not exceed $10,000 ($5,000 times 15, minus the sum of $62,000 plus $10,000, equals $3,000), so as to result in the limitation at paragraph (c)(3)(i)(C) of this section being less than $3,000.

Example 12. (i) *Facts illustrating calculation of the special section 403(b) catch-up in the next calendar year.* The facts are the same as in *Example 11*, except that, for 2007, E has includible compensation of $60,000. For 2007, E now has previously made $85,000 of section 403(b) elective deferrals ($62,000 deferred before 2006, plus the $15,000 in basic section 403(b) elective deferrals in 2006, the $3,000 maximum additional special section 403(b) catch-up amount in 2006, plus the $5,000 age 50 catch-up amount in 2006). However, the $5,000 age 50 catch-up amount deferred in 2006 is disregarded for purposes of applying the limitation at paragraph (c)(3)(i)(C) of this section to determine the special section 403(b) catch-up amount. Thus, for 2007, only $80,000 of section 403(b) elective deferrals are taken into account in applying the limitation at paragraph (c)(3)(i)(C) of this section. For 2007, the basic dollar limit for section 403(b) elective deferrals under paragraph (c)(1) of this section is assumed to be $16,000, the additional dollar amount permitted under the age 50 catch-up is assumed to be $5,000, and E's employer contributes $6,000 (10% of $60,000) as a non-elective contribution.

(ii) *Conclusion.* The maximum section 403(b) elective deferral that D may elect under H's section 403(b) plan for 2007 is $21,000. This is the sum of the basic limit on section 403(b) elective deferrals under paragraph (c)(1) of this section equal to $16,000, plus the additional age 50 catch-up amount of $5,000. E is not entitled to any additional special section 403(b) catch-up amount for 2007 under paragraph (c)(3) of this section due to the limitation at paragraph (c)(3)(i)(C) of this section (16 times $5,000 equals $80,000, minus D's total prior section 403(b) elective deferrals of $80,000 equals zero).

(d) *Employer contributions for former employees*—(1) *Includible compensation deemed to continue for nonelective contributions.* For purposes of applying paragraph (b) of this section, a former employee is deemed to have monthly includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of each of the next five taxable years. The amount of the monthly includible compensation is equal to one twelfth of the former employee's includible compensation during the former employee's most recent year of service. Accordingly, nonelective employer contributions for a former employee must not exceed the limitation of section 415(c)(1) up to the lesser of the dollar amount in section 415(c)(1)(A) or the former employee's annual includible compensation based on the former employee's average monthly compensation during his or her most recent year of service.

(2) *Examples.* The provisions of paragraph (d)(1) of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Private college M is a section 501(c)(3) organization operated on the basis of a June 30 fiscal year that maintains a section 403(b) plan for its employees. In 2004, M amends the plan to provide for a temporary early retirement incentive under which the college will make a nonelective contribution for any participant who satisfies certain minimum age and service conditions and who retires before June 30, 2006. The contribution will equal 110 percent of the participant's rate of pay for one year and will be payable over a period ending no later than the end of the fifth fiscal year that begins after retirement. It is assumed for purposes of this *Example 1* that, in accordance with §1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions and retire before June 30, 2006, do not discriminate in favor of former employees who are highly compensated employees. Employee A retires under the early retirement incentive on March 12, 2006, and A's annual includible compensation for the period from March 1, 2005, through February 28, 2006 (which is A's most recent one year of service) is $30,000. The applicable dollar limit under section 415(c)(1)(A) is assumed to be $44,000 for 2006 and $45,000 for 2007. The college contributes $30,000 for A for 2006 and $3,000 for A for 2007 (totaling $33,000 or 110 percent of $30,000). No other contributions are made to a section 403(b) contract for A for those years.

(ii) *Conclusion.* The contributions made for A do not exceed A's includible compensation for 2006 or 2007.

Example 2. (i) *Facts.* Private college N is a section 501(c)(3) organization that maintains a section 403(b) plan for its employees. The plan provides for N to make monthly nonelective contributions equal to 20 percent of the monthly includible compensation for each eligible employee. In addition, the plan provides for contributions to continue for 5 years following the retirement of any employee after age 64 and completion of at least 20 years of service (based on the employee's average annual rate of base salary in the preceding 3 calendar years ended before the date of retirement). It is assumed for purposes of this *Example 2* that, in accordance with

§ 1.401(a)(4)–10(b) and under the facts and circumstances, the post-retirement contributions made for participants who satisfy the minimum age and service conditions do not discriminate in favor of former employees who are highly compensated employees. Employee B retires on July 1, 2006, at age 64 after completion of 20 or more years of service. At that date, B's annual includible compensation for the most recently ended fiscal year of N is $72,000 and B's average monthly rate of base salary for 2003 through 2005 is $5,000. N contributes $1,200 per month (20 percent of 1/12th of $72,000) from January of 2006 through June of 2006 and contributes $1,000 (20 percent of $5,000) per month for B from July of 2006 through June of 2011. The applicable dollar limit under section 415(c)(1)(A) is $44,000 for 2006 through 2011. No other contributions are made to a section 403(b) contract for B for those years.

(ii) *Conclusion.* The contributions made for B do not exceed B's includible compensation for any of the years from 2006 through 2010.

Example 3. (i) *Facts.* A public university maintains a section 403(b) under which it contributes annually 10% of compensation for participants, including for the first 5 calendar years following the date on which the participant ceases to be an employee. The plan provides that if a participant who is a former employee dies during the first 5 calendar years following the date on which the participant ceases to be an employee, a contribution is made that is equal to the lesser of—

(A) The excess of the individual's includible compensation for that year over the contributions previously made for the individual for that year; or

(B) The total contributions that would have been made on the individual's behalf thereafter if he or she had survived to the end of the 5-year period.

(ii) Individual C's annual includible compensation is $72,000 (so that C's monthly includible compensation is $6,000). A $600 contribution is made for C for January of the first taxable year following retirement (10% of individual C's monthly includible compensation of $6,000). Individual C dies during February of that year. The university makes a contribution for individual C for February equal to $11,400 (C's monthly includible compensation for January and February, reduced by $600).

(iii) *Conclusion.* The contribution does not exceed the amount of individual C's includible compensation for the taxable year for purposes of section 415(c), but any additional contributions would exceed C's includible compensation for purposes of section 415(c).

(3) *Disabled employees.* See also section 415(c)(3)(C) which sets forth a special rule under which compensation may be treated as continuing for purposes of section 415 for certain former employees who are disabled.

(e) *Special rules for determining years of service*—(1) *In general.* For purposes of determining a participant's includible compensation under paragraph (b)(2) of this section and a participant's years of service under paragraphs (c)(3) (special section 403(b) catch-up for qualified employees of certain organizations) and (d) (employer contributions for former employees) of this section, an employee must be credited with a full year of service for each year during which the individual is a full-time employee of the eligible employer for the entire work period, and a fraction of a year for each part of a work period during which the individual is a full-time or part-time employee of the eligible employer. An individual's number of years of service equals the aggregate of the annual work periods during which the individual is employed by the eligible employer.

(2) *Work period.* A year of service is based on the employer's annual work period, not the employee's taxable year. For example, in determining whether a university professor is employed full time, the annual work period is the school's academic year. However, in no case may an employee accumulate more than one year of service in a twelve-month period.

(3) *Service with more than one eligible employer*—(i) *General rule.* With respect to any section 403(b) contract of an eligible employer, except as provided in paragraph (e)(3)(ii) of this section, any period during which an individual is not an employee of that eligible employer is disregarded for purposes of this paragraph (e).

(ii) *Special rule for church employees.* With respect to any section 403(b) contract of an eligible employer that is a church-related organization, any period during which an individual is an employee of that eligible employer and any other eligible employer that is a church-related organization that has an association (as defined in section 414(e)(3)(D)) with that eligible employer is taken into account on an aggregated basis, but any period during which an individual is not an employee of a church-related organization or is an employee of a church-related organization that does not have an association with that eligible employer is disregarded for purposes of this paragraph (e).

(4) *Full-time employee for full year.* Each annual work period during which an individual is employed full time by the eligible employer constitutes one year of service. In determining whether an individual is employed full-time, the amount of work which he or she actually performs is compared with the amount of work that is normally required of individuals performing similar services from which substantially all of their annual compensation is derived.

(5) *Other employees.* (i) An individual is treated as performing a fraction of a year of service for each annual work period during which he or she is a full-time employee for part of the annual work period and for each annual work period during which he or she is a part-time employee either for the entire annual work period or for a part of the annual work period.

(ii) In determining the fraction that represents the fractional year of service for an individual employed full time for part of an annual work period, the numerator is the period of time (such as weeks or months) during which the individual is a full-time employee during that annual work period, and the denominator is the period of time that is the annual work period.

(iii) In determining the fraction that represents the fractional year of service of an individual who is employed part time for the entire annual work period, the numerator is the amount of work performed by the individual, and the denominator is the amount of work normally required of individuals who perform similar services and who are employed full time for the entire annual work period.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of an annual work period, the fractional year of service that would apply if the individual were a part-time employee for a full annual work period is multiplied by the fractional year of service that would apply if the individual were a full-time employee for the part of an annual work period.

(6) *Work performed.* For purposes of this paragraph (e), in measuring the amount of work of an individual performing particular services, the work performed is determined based on the individual's hours of service (as defined under section 410(a)(3)(C)), except that a plan may use a different measure of work if appropriate under the facts and circumstances. For example, a plan may provide for a university professor's work to be measured by the number of courses taught during an annual work period in any case in which that individual's work assignment is generally based on a specified number of courses to be taught.

(7) *Most recent one-year period of service.* For purposes of paragraph (d) of this section, in the case of a part-time employee or a full-time employee who is employed for only part of the year determined on the basis of the employer's annual work period, the employee's most recent periods of service are aggregated to determine his or her most recent one-year period of service. In such a case, there is first taken into account his or her service during the annual work period for which the last year of service's includible compensation is being determined; then there is taken into account his or her service during his or her next preceding annual work period based on whole months; and so forth until the employee's service equals, in the aggregate, one year of service.

(8) *Less than one year of service considered as one year.* If, at the close of a taxable year, an employee has, after application of all of the other rules in this paragraph (e), some portion of one year of service (but has accumulated less than one year of service), the employee is deemed to have one year of service. Except as provided in the previous sentence, fractional years of service are not rounded up.

(9) *Examples.* The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual G is employed half-time in 2004 and 2005 as a clerk by H, a hospital which is a section 501(c)(3) organization. G earns $20,000 from H in each of those years, and retires on December 31, 2005.

(ii) *Conclusion.* For purposes of determining G's includible compensation during G's last year of service under paragraph (d) of this section, G's most recent periods of service are aggregated to determine G's most recent one-year period of service. In this case, since D worked half-time in 2004 and 2005, the compensation D earned in those two years are aggregated to produce D's includible compensation for D's last full year in service. Thus, in this case, the $20,000 that D earned in 2004 and 2005 for D's half-time work are aggregated, so that D has $40,000 of includible compensation for D's most recent one-year of service for purposes of applying paragraphs (b)(2), (c)(3), and (d) of this section.

Example 2. (i) *Facts.* Individual H is employed as a part-time professor by public University U during the first semester of its two-semester 2004–2005 academic year. While H teaches one course generally for 3 hours a week during the first semester of the academic year, U's full-time faculty members generally teach for 9 hours a week during the full academic year.

(ii) *Conclusion.* For purposes of calculating how much of a year of service H performs in the 2004–2005 academic year (before application of the special rules of paragraphs (e)(7) and (8) of this section concerning less than one year of service), paragraph (e)(5)(iv) of this section is applied as follows: since H teaches one course at U for 3 hours per week for 1 semester and other faculty members at U teach 9 hours per week for 2 semesters, H is considered to have completed $\frac{3}{18}$ or $\frac{1}{6}$ of a year of service during the 2004–2005 academic year, determined as follows:

(A) The fractional year of service if H were a part-time employee for a full year is 3/9 (number of hours employed divided by the usual number of hours of work required for that position).

(B) The fractional year of service if H were a full-time employee for half of a year is $\frac{1}{2}$ (one semester, divided by the usual 2-semester annual work period).

(C) These fractions are multiplied to obtain the fractional year of service: $\frac{3}{9}$ times $\frac{1}{2}$, or $\frac{3}{18}$, equals $\frac{1}{6}$ of a year of service.

(f) *Excess contributions or deferrals*—(1) *Inclusion in gross income.* Any contribution made for a participant to a section 403(b) contract for the taxable year that exceeds either the maximum annual contribution limit set forth in paragraph (b) of this section or the maximum annual section 403(b) elective deferral limit set forth in paragraph (c) of this section constitutes an excess contribution that is included in gross income for that taxable year. See §1.403(b)–3(d)(1)(iii) and (2)(i) for additional rules, including special rules relating to contracts that fail to be nonforfeitable. See also section 4973 for an excise tax applicable with respect to excess contributions to a custodial account and section 4979(f)(2)(B) for a special rule applicable if excess matching contributions, excess after-tax employee contributions, and excess section 403(b) elective deferrals do not exceed $100.

(2) *Separate account required for certain excess contributions; distribution of excess elective deferrals.* A contract to which a contribution is made that exceeds the maximum annual contribution limit set forth in paragraph (b) of this section is not a section 403(b) contract unless the excess contribution is held in a separate account which constitutes a separate account for purposes of section 72. See also §1.403(b)–3(a)(4) and paragraph (f)(4) of this section for additional rules with respect to the requirements of section 401(a)(30) and any excess deferral.

(3) *Ability to distribute excess contributions.* A contract does not fail to satisfy the requirements of §1.403(b)–3, the distribution rules of §1.403(b)–6 or 1.403(b)–9, or the funding rules of §1.403(b)–8 solely by reason of a distribution made from a separate account under paragraph (f)(2) of this section or made under paragraph (f)(4) of this section.

(4) *Excess section 403(b) elective deferrals.* A section 403(b) contract may provide that any excess deferral as a result of a failure to comply with the limitation under paragraph (c) of this section for a taxable year with respect to any section 403(b) elective deferral made for a participant by the employer will be distributed to the participant, with allocable net income, no later than April 15 of the following taxable year or otherwise in accordance with section 402(g). See section 402(g)(2)(A) for rules permitting the participant to allocate excess deferrals among the plans in which the participant has made elective deferrals, and see section 402(g)(2)(C) for special rules to determine the tax treatment of such a distribution.

(5) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. (i) *Facts.* Individual D's employer makes a $46,000 contribution for 2006 to an individual annuity insurance policy for Individual D that would otherwise be a section 403(b) contract. The contribution does not include any elective deferrals and the applicable limit under section 415(c) is $44,000 for 2006. The $2,000 section 415(c) excess is put into a separate account under the policy. Employer includes $2,000 in D's gross income as wages for 2006 and, to the extent of the amount held in the separate account for the section 415(c) excess contribution, does not treat the account as a contract to which section 403(b) applies.

(ii) *Conclusion.* The separate account for the section 415(c) excess contribution is a contract to which section 403(c) applies, but the excess contribution does not cause the rest of the contract to fail section 403(b).

Example 2. (i) *Facts.* Same facts as *Example 1*, except that the contribution is made to purchase mutual funds that are held in a custodial account, instead of an individual annuity insurance policy.

(ii) *Conclusion.* The conclusion is the same as in *Example 1*, except that the purchase constitutes a transfer described in section 83.

Example 3. (i) *Facts.* Same facts as *Example 1*, except that the amount held in the separate account for the section 415(c) excess contribution is subsequently distributed to D.

(ii) *Conclusion.* The distribution is included in gross income to the extent provided under section 72 relating to distributions from a section 403(c) contract.

Example 4. (i) *Facts.* Individual E makes section 403(b) elective deferrals totaling $15,500 for 2006, when E is age 45 and the applicable limit on section 403(b) elective deferrals is $15,000. On April 14, 2007, the plan refunds the $500 excess along with applicable earnings of $65.

(ii) *Conclusion.* The $565 payment constitutes a distribution of an excess deferral under paragraph (f)(4) of this section. Under section 402(g), the $500 excess deferral is included in E's gross income for 2006. The additional $65 is included in E's gross income for 2007 and, because the distribution is made by April 15, 2007 (as provided in section 402(g)(2)), the $65 is not subject to the additional 10 percent income tax on early distributions under section 72(t).

[T.D. 9340, 72 FR 41144, July 26, 2007, as amended by 72 FR 54352, Sept. 25, 2007; 75 FR 65566, Oct. 26, 2010]

§ 1.403(b)–5 Nondiscrimination rules.

(a) *Nondiscrimination rules for contributions other than section 403(b) elective deferrals*—(1) *General rule.* Under section 403(b)(12)(A)(i), employer contributions and after-tax employee contributions to a section 403(b) plan must satisfy all of the following requirements (the nondiscrimination requirements) in the same manner as a qualified plan under section 401(a):

(i) Section 401(a)(4) (relating to nondiscrimination in contributions and benefits), taking section 401(a)(5) into account.

(ii) Section 401(a)(17) (limiting the amount of compensation that can be taken into account).

(iii) Section 401(m) (relating to matching and after-tax employee contributions).

(iv) Section 410(b) (relating to minimum coverage).

(2) *Nonapplication to section 403(b) elective deferrals.* The requirements of this paragraph (a) do not apply to section 403(b) elective deferrals.

(3) *Compensation for testing.* Except as may otherwise be specifically permitted under the provisions referenced in paragraph (a)(1) of this section, compliance with those provisions is tested using compensation as defined in section 414(s) (and without regard to section 415(c)(3)(E)). In addition, for purposes of paragraph (a)(1) of this section, there may be excluded employees who are permitted to be excluded under paragraph (b)(4)(ii)(D) and (E) of this section. However, as provided in paragraph (b)(4)(i) of this section, the exclusion of any employee listed in paragraph (b)(4)(ii)(D) or (E) of this section is subject to the conditions applicable under section 410(b)(4).

(4) *Employer aggregation rules.* See regulations under section 414(b), (c), (m), and (o) for rules treating entities as a single employer for purposes of the nondiscrimination requirements.

(5) *Special rules for governmental plans.* Paragraphs (a)(1)(i), (iii), and (iv) of this section do not apply to a governmental plan as defined in section 414(d) (but contributions to a governmental plan must comply with paragraphs (a)(1)(ii) and (b) of this section).

(b) *Universal availability required for section 403(b) elective deferrals—(1) General rule.* Under section 403(b)(12)(A)(ii), all employees of the eligible employer must be permitted to have section 403(b) elective deferrals contributed on their behalf if any employee of the eligible employer may elect to have the organization make section 403(b) elective deferrals. Further, the employee's right to make elective deferrals also includes the right to designate section 403(b) elective deferrals as designated Roth contributions.

(2) *Effective opportunity required.* For purposes of paragraph (b)(1) of this section, an employee is not treated as being permitted to have section 403(b) elective deferrals contributed on the employee's behalf unless the employee is provided an effective opportunity that satisfies the requirements of this paragraph (b)(2). Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. A section 403(b) plan satisfies the effective opportunity requirement of this paragraph (b)(2) only if, at least once during each plan year, the plan provides an employee with an effective opportunity to make (or change) a cash or deferred election (as defined at §1.401(k)–1(a)(3)) between cash or a contribution to the plan. Further, an effective opportunity includes the right to have section 403(b) elective deferrals made on his or her behalf up to the lesser of the applicable limits in §1.403(b)–4(c) (including any permissible catch-up elective deferrals under §1.403(b)–4(c)(2) and (3)) or the applicable limits under the contract with the largest limitation, and applies to part-time employees as well as full-time employees. An effective opportunity is not considered to exist if there are any other rights or benefits (other than rights or benefits listed in §1.401(k)–1(e)(6)(i)(A), (B), or (D)) that are conditioned (directly or indirectly) upon a participant making or failing to make a cash or deferred election with respect to a contribution to a section 403(b) contract.

(3) *Special rules.* (i) In the case of a section 403(b) plan that covers the employees of more than one section 501(c)(3) organization, the universal availability requirement of this paragraph (b) applies separately to each common law entity (that is, applies separately to each section 501(c)(3) organization). In the case of a section 403(b) plan that covers the employees of more than one State entity, this requirement applies separately to each entity that is not part of a common payroll. An eligible employer may condition the employee's right to have section 403(b) elective deferrals made on his or her behalf on the employee electing a section 403(b) elective deferral of more than $200 for a year.

(ii) For purposes of this paragraph (b)(3), an employer that historically has treated one or more of its various geographically distinct units as separate for employee benefit purposes may treat each unit as a separate organization if the unit is operated independently on a day-to-day basis. Units are not geographically distinct if such units are located within the same Standard Metropolitan Statistical Area (SMSA).

(4) *Exclusions*—(i) *Exclusions for special types of employees.* A plan does not fail to satisfy the universal availability requirement of this paragraph (b) merely because it excludes one or more of the types of employees listed in paragraph (b)(4)(ii) of this section. However, the exclusion of any employee listed in paragraph (b)(4)(ii)(D) or (E) of this section is subject to the conditions applicable under section 410(b)(4). Thus, if any employee listed in paragraph (b)(4)(ii)(D) of this section has the right to have section 403(b) elective deferrals made on his or her behalf, then no employee listed in that paragraph (b)(4)(ii)(D) of this section may be excluded under this paragraph (b)(4) and, if any employee listed in paragraph (b)(4)(ii)(E) of this section has the right to have section 403(b) elective deferrals made on his or her behalf, then no employee listed in that paragraph (b)(4)(ii)(E) of this section may be excluded under this paragraph (b)(4).

(ii) *List of special types of excludible employees.* The following types of employees are listed in this paragraph (b)(4)(ii):

(A) Employees who are eligible under another section 403(b) plan, or a section 457(b) eligible governmental plan, of the employer which permits an amount to be contributed or deferred at the election of the employee.

(B) Employees who are eligible to make a cash or deferred election (as defined at §1.401(k)–1(a)(3)) under a section 401(k) plan of the employer.

(C) Employees who are non-resident aliens described in section 410(b)(3)(C).

(D) Subject to the conditions applicable under section 410(b)(4) (including section 410(b)(4)(B) permitting separate testing for employees not meeting minimum age and service requirements), employees who are students performing services described in section 3121(b)(10).

(E) Subject to the conditions applicable under section 410(b)(4), employees who normally work fewer than 20 hours per week (or such lower number of hours per week as may be set forth in the plan).

(iii) *Special rules.* (A) A section 403(b) plan is permitted to take into account coverage under another plan, as permitted in paragraphs (b)(4)(ii)(A) and (B) of this section, only if the rights to make elective deferrals with respect to that coverage would satisfy paragraphs (b)(2) and (4)(i) of this section if that coverage were provided under the section 403(b) plan.

(B) For purposes of paragraph (b)(4)(ii)(E) of this section, an employee normally works fewer than 20 hours per week if and only if—

(*1*) For the 12-month period beginning on the date the employee's employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours of service (as defined in section 410(a)(3)(C)) in such period; and

(*2*) For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period. (See, however, section 202(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829) Public Law 93–406, and regulations under section 410(a) of the Internal Revenue Code applicable with respect to plans that are subject to title I of ERISA.)

(c) *Plan required.* Contributions to an annuity contract do not satisfy the requirements of this section unless the contributions are made pursuant to a plan, as defined in §1.403(b)–3(b)(3), and the terms of the plan satisfy this section.

(d) *Church plans exception.* This section does not apply to a section 403(b) contract purchased by a church (as defined in §1.403(b)–2).

(e) *Other rules.* This section only reflects requirements of the Internal Revenue Code applicable for purposes of section 403(b) and does not include other requirements. Specifically, this section does not reflect the requirements of ERISA that may apply with respect to section 403(b) arrangements, such as the vesting requirements at 29 U.S.C. 1053.

[T.D. 9340, 72 FR 41144, July 26, 2007]

§ 1.403(b)–6 Timing of distributions and benefits.

(a) *Distributions generally.* This section provides special rules regarding the timing of distributions from, and the benefits that may be provided under, a section 403(b) contract, including limitations on when early distributions can be made (in paragraphs (b) through (d) of this section), required minimum distributions (in paragraph (e) of this section), and special rules relating to loans (in paragraph (f) of this section) and incidental benefits (in paragraph (g) of this section).

(b) *Distributions from contracts other than custodial accounts or amounts attributable to section 403(b) elective deferrals.* Except as provided in paragraph (c) of this section relating to distributions from custodial accounts, paragraph (d) of this section relating to distributions attributable to section 403(b) elective deferrals, §1.403(b)–4(f) (relating to correction of excess deferrals), or §1.403(b)–10(a) (relating to plan termination), a section 403(b) contract is permitted to distribute retirement benefits to the participant no earlier than upon the earlier of the participant's severance from employment or upon the prior occurrence of some event, such as after a fixed number of years, the attainment of a stated age, or disability. See §1.401–1(b)(1)(ii) for additional guidance. This paragraph (b) does not apply to after-tax employee contributions or earnings thereon.

(c) *Distributions from custodial accounts that are not attributable to section*

403(b) elective deferrals. Except as provided in § 1.403(b)–4(f) (relating to correction of excess deferrals) or § 1.403(b)–10(a) (relating to plan termination), distributions from a custodial account, as defined in § 1.403(b)–8(d)(2), may not be paid to a participant before the participant has a severance from employment, dies, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½. Any amounts transferred out of a custodial account to an annuity contract or retirement income account, including earnings thereon, continue to be subject to this paragraph (c). This paragraph (c) does not apply to distributions that are attributable to section 403(b) elective deferrals.

(d) *Distribution of section 403(b) elective deferrals*—(1) *Limitation on distributions*—(i) *General rule.* Except as provided in § 1.403(b)–4(f) (relating to correction of excess deferrals) or § 1.403(b)–10(a) (relating to plan termination), distributions of amounts attributable to section 403(b) elective deferrals may not be paid to a participant earlier than the earliest of the date on which the participant has a severance from employment, dies, has a hardship, becomes disabled (within the meaning of section 72(m)(7)), or attains age 59½.

(ii) *Special rule for pre-1989 section 403(b) elective deferrals.* For special rules relating to amounts held as of the close of the taxable year beginning before January 1, 1989 (which does not apply to earnings thereon), see section 1123(e)(3) of the Tax Reform Act of 1986 (100 Stat. 2085, 2475) Public Law 99–514, and section 1011A(c)(11) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342, 3476) Public Law 100–647.

(2) *Hardship rules.* A hardship distribution under this paragraph (d) has the same meaning as a distribution on account of hardship under § 1.401(k)–1(d)(3) and is subject to the rules and restrictions set forth in § 1.401(k)–1(d)(3) (including limiting the amount of a distribution in the case of hardship to the amount necessary to satisfy the hardship). In addition, a hardship distribution is limited to the aggregate dollar amount of the participant's section 403(b) elective deferrals under the contract (and may not include any income thereon), reduced by the aggregate dollar amount of the distributions previously made to the participant from the contract.

(3) *Failure to keep separate accounts.* If a section 403(b) contract includes both section 403(b) elective deferrals and other contributions and the section 403(b) elective deferrals are not maintained in a separate account, then distributions may not be made earlier than the later of—

(i) Any date permitted under paragraph (d)(1) of this section; and

(ii) Any date permitted under paragraph (b) or (c) of this section with respect to contributions that are not section 403(b) elective deferrals (whichever applies to the contributions that are not section 403(b) elective deferrals).

(e) *Minimum required distributions for eligible plans*—(1) *In general.* Under section 403(b)(10), a section 403(b) contract must meet the minimum distribution requirements of section 401(a)(9) (in both form and operation). See section 401(a)(9) for these requirements.

(2) *Treatment as IRAs.* For purposes of applying the distribution rules of section 401(a)(9) to section 403(b) contracts, the minimum distribution rules applicable to individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a) apply to section 403(b) contracts. Consequently, except as otherwise provided in this paragraph (e), the distribution rules in section 401(a)(9) are applied to section 403(b) contracts in accordance with the provisions in § 1.408–8 for purposes of determining required minimum distributions.

(3) *Required beginning date.* The required beginning date for purposes of section 403(b)(10) is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan. However, for any section 403(b) contract that is not part of a governmental plan or church plan, the required beginning date for a 5-percent owner is April 1 of the calendar year following the calendar year in which the employee attains age 70½.

(4) *Surviving spouse rule does not apply*. The special rule in §1.408–8, A–5 (relating to spousal beneficiaries), does not apply to a section 403(b) contract. Thus, the surviving spouse of a participant is not permitted to treat a section 403(b) contract as the spouse's own section 403(b) contract, even if the spouse is the sole beneficiary.

(5) *Retirement income accounts*. For purposes of §1.401(a)(9)–6, A–4 (relating to annuity contracts), annuity payments provided with respect to retirement income accounts do not fail to satisfy the requirements of section 401(a)(9) merely because the payments are not made under an annuity contract purchased from an insurance company, provided that the relationship between the annuity payments and the retirement income accounts is not inconsistent with any rules 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). See also §1.403(b)–9(a)(5) for additional rules relating to annuities payable from a retirement income account.

(6) *Special rules for benefits accruing before December 31, 1986*. (i) The distribution rules provided in section 401(a)(9) do not apply to the undistributed portion of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-'87 account balance). The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-'86 account balance), including earnings after December 31, 1986. Consequently, the post-'86 account balance includes earnings after December 31, 1986, on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986, and earnings thereon.

(ii) The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-'87 account balance and subsequent changes as set forth in paragraph (d)(6)(iii) of this section and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer or custodian does not keep such records, the entire account balance is treated as subject to section 401(a)(9).

(iii) In applying the distribution rules in section 401(a)(9), only the post-'86 account balance is used to calculate the required minimum distribution for a calendar year. The amount of any distribution from a contract is treated as being paid from the post-'86 account balance to the extent the distribution is required to satisfy the minimum distribution requirement with respect to that contract for a calendar year. Any amount distributed in a calendar year from a contract in excess of the required minimum distribution for a calendar year with respect to that contract is treated as paid from the pre-'87 account balance, if any, of that contract.

(iv) If an amount is distributed from the pre-'87 account balance and rolled over to another section 403(b) contract, the amount is treated as part of the post-'86 account balance in that second contract. However, if the pre-'87 account balance under a section 403(b) contract is directly transferred to another section 403(b) contract (as permitted under §1.403(b)–10(b)), the amount transferred retains its character as a pre-'87 account balance, provided the issuer of the transferee contract satisfies the recordkeeping requirements of paragraph (e)(6)(ii) of this section.

(v) The distinction between the pre-'87 account balance and the post-'86 account balance provided for under this paragraph (e)(6) of this section has no relevance for purposes of determining the portion of a distribution that is includible in income under section 72.

(vi) The pre-'87 account balance must be distributed in accordance with the incidental benefit requirement of §1.401–1(b)(1)(i). Distributions attributable to the pre-'87 account balance are treated as satisfying this requirement if all distributions from the section 403(b) contract (including distributions attributable to the post-'86 account balance) satisfy the requirements of §1.401–1(b)(1)(i) without regard to this section, and distributions attributable to the post-'86 account balance satisfy the rules of this paragraph (e) (without regard to this paragraph (e)(6)). Distributions attributable to the pre-'87 account balance are treated as satisfying the incidental benefit requirement if all distributions from the section 403(b) contract (including distributions attributable to both the pre-'87 account balance and the post-'86 account balance) satisfy the rules of this paragraph (e) (without regard to this paragraph (e)(6)).

(7) *Application to multiple contracts for an employee.* The required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, because, as provided in paragraph (e)(2) of this section, the distribution rules in section 401(a)(9) apply to section 403(b) contracts in accordance with the provisions in §1.408–8, the required minimum distribution from one section 403(b) contract of an employee is permitted to be distributed from another section 403(b) contract in order to satisfy section 401(a)(9). Thus, as provided in §1.408–8, A–9, with respect to IRAs, the required minimum distribution amount from each contract is then totaled and the total minimum distribution taken from any one or more of the individual section 403(b) contracts. However, consistent with the rules in §1.408–8, A–9, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts do not satisfy the minimum distribution requirements for IRAs, nor do distributions from IRAs satisfy the minimum distribution requirements for section 403(b) contracts.

(8) *Special rule for governmental plans.* A section 403(b) contract that is part of a governmental plan (within the meaning of section 414(d)) is treated as having complied with section 401(a)(9) for all years to which section 401(a)(9) applies to the contract, if the contract complies with a reasonable and good faith interpretation of section 401(a)(9).

(9) *Special rule for qualifying longevity annuity contracts.* The rules in A–17(b) of §1.401(a)(9)–6 (relating to limitations on premiums for a qualifying longevity annuity contract (QLAC), defined in A–17 of §1.401(a)(9)–6) and A–17(d)(1) of §1.401(a)(9)–6 (relating to reliance on representations with respect to a QLAC) apply to the purchase of a QLAC under a section 403(b) plan (rather than the rules in A–12(b) and (c) of §1.408–8).

(f) *Loans.* The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from an issuer of a section 403(b) contract to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 403(b) and §§1.403(b)–1 through 1.403(b)–5, this section, and §§1.403(b)–7 through 1.403(b)–11, depends on the facts and circumstances. Among the facts and circumstances are whether the loan has a fixed repayment schedule and bears a reasonable rate of interest, and whether there are repayment safeguards to which a prudent lender would adhere. Thus, for example, a loan must bear a reasonable rate of interest in order to be treated as not being a distribution. However, a plan loan offset is a distribution for purposes of this section. See §1.72(p)–1, Q&A–13. See also §1.403(b)–7(d) relating to the application of section 72(p) with respect to the taxation of a loan made under a section 403(b) contract. (Further, see section 408(b)(1) of title I of ERISA and 29 CFR 2550.408b–1 of the Department of Labor regulations concerning additional requirements applicable with respect to plans that are subject to title I of ERISA.)

(g) *Death benefits and other incidental benefits.* An annuity is not a section 403(b) contract if it fails to satisfy the incidental benefit requirement of §1.401–1(b)(1)(ii) (in form or in operation). For purposes of this paragraph (g), to the extent the incidental benefit requirement of §1.401–1(b)(1)(ii) requires a distribution of the participant's or beneficiary's accumulated benefit, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution requirements of section 401(a)(9). In addition, if a contract issued by an insurance company qualified to issue annuities in a State includes provisions under which, in the event a participant becomes disabled, benefits will be provided by the insurance carrier as if employer contributions were continued until benefit distribution commences, then that benefit is treated as an incidental benefit (as insurance for a deferred annuity benefit in the event of disability) that must satisfy the incidental benefit requirement of §1.401–1(b)(1)(ii) (taking into account any other incidental benefits provided under the plan). The rules of §1.402(a)–1(e) apply for purposes of determining when certain incidental benefits are treated as distributed and included in gross income. See §§1.72–15 and 1.72–16.

(h) *Special rule regarding severance from employment.* For purposes of this section, severance from employment occurs on any date on which an employee ceases to be an employee of an eligible employer, even though the employee may continue to be employed either by another entity that is treated as the same employer where either that other entity is not an entity that can be an eligible employer (such as transferring from a section 501(c)(3) organization to a for-profit subsidiary of the section 501(c)(3) organization) or in a capacity that is not employment with an eligible employer (for example, ceasing to be an employee performing services for a public school but continuing to work for the same State employer). Thus, this paragraph (h) does not apply if an employee transfers from one section 501(c)(3) organization to another section 501(c)(3) organization that is treated as the same employer or if an employee transfers from one public school to another public school of the same State employer.

(i) *Certain limitations do not apply to rollover contributions.* The limitations on distributions in paragraphs (b) through (d) of this section do not apply to amounts held in a separate account for eligible rollover distributions as described in §1.403(b)–10(d).

[T.D. 9340, 72 FR 41144, July 26, 2007, as amended by 72 FR 54352, Sept. 25, 2007; T.D. 9459, 74 FR 45994, Sept. 8, 2009; 75 FR 65566, Oct. 26, 2010; T.D. 9665, 79 FR 26843, May 12, 2014; T.D. 9673, 79 FR 37642, July 2, 2014]

§1.403(b)–7 Taxation of distributions and benefits.

(a) *General rules for when amounts are included in gross income.* Except as provided in this section (or in §1.403(b)–10(c) relating to payments pursuant to a qualified domestic relations order), amounts actually distributed from a section 403(b) contract are includible in the gross income of the recipient participant or beneficiary (in the year in which so distributed) under section 72 (relating to annuities). For an additional income tax that may apply to certain early distributions that are includible in gross income, see section 72(t).

(b) *Rollovers to individual retirement arrangements and other eligible retirement plans*—(1) *Timing of taxation of rollovers.* In accordance with sections 402(c), 403(b)(8), and 403(b)(10), a direct rollover in accordance with section 401(a)(31) is not includible in the gross income of a participant or beneficiary in the year rolled over. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is contributed to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the contribution to the eligible retirement plan of any property distributed. For this purpose, the rules of section 402(c)(2) through (7) and (c)(9) apply. Thus, to the extent that a portion of a distribution (including a distribution from a designated Roth account) would be excluded from gross income if it were not rolled over, if that portion of the distribution is to be rolled over into an eligible retirement plan that is not an IRA, the rollover must be accomplished through a direct rollover of the entire distribution to a plan qualified under section 401(a) or a section 403(b) plan and that plan must agree to separately account for the amount not includible in income (so that a 60-day rollover to a plan qualified under section 401(a) or another section 403(b) plan is not available for this portion of the distribution).

(2) *Requirement that contract provide rollover options for eligible rollover distributions.* As required in §1.403(b)–3(a)(7), an annuity contract is not a section 403(b) contract unless the contract provides that if the distributee of an eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in section 402(c)(8)(B)) 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 contract satisfies this requirement, the provisions of section 401(a)(31) apply to the annuity as though it were a plan qualified under section 401(a) unless otherwise provided in section 401(a)(31). Thus, the special rule in §1.401(k)–1(f)(3)(ii) with respect to distributions from a designated Roth account that are expected to total less than $200 during a year applies to designated Roth accounts under a section 403(b) plan. In applying the provisions of this paragraph (b)(2), the payor of the eligible rollover distribution from the contract is treated as the plan administrator.

(3) *Requirement that contract payor provide notice of rollover option to distributees.* To ensure that the distributee of an eligible rollover distribution from a section 403(b) contract has a meaningful right to elect a direct rollover, section 402(f) requires that the distributee be informed of the option. Thus, within a reasonable time period before making the initial 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 requirement, the plan timing rule provided in section 402(f)(1) and §1.402(f)–1 applies to section 403(b) contracts.

(4) *Mandatory withholding upon certain eligible rollover distributions from contracts.* If a distributee of an eligible rollover distribution from a section 403(b) contract 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 section 3405(c) and §31.3405(c)–1 of this chapter for provisions regarding the withholding requirements relating to eligible rollover distributions.

(5) *Automatic rollover for certain mandatory distributions under section 401(a)(31).* In accordance with section 403(b)(10), a section 403(b) plan is required to comply with section 401(a)(31) (including automatic rollover for certain mandatory distributions) in the same manner as a qualified plan.

(c) *Special rules.* See section 402(g)(2)(C) for special rules to determine the tax treatment of a distribution of excess deferrals, and see §1.401(m)–1(e)(3)(v) for the tax treatment of corrective distributions of after-tax employee contributions and matching contributions to comply with section 401(m). See sections 402(l) and 403(b)(2) for a special rule regarding distributions for certain retired public safety officers made from a governmental plan for the direct payment of certain premiums.

(d) *Amounts taxable under section 72(p)(1).* In accordance with section 72(p), the amount of any loan from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the contract under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and §1.72(p)–1. See generally §1.72(p)–1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from a section 403(b) contract to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. A deemed distribution is not an actual distribution for purposes of §1.403(b)–6, as provided at

§ 1.72(p)–1, Q&A–12 and Q&A–13. (Further, see section 408(b)(1) of title I of ERISA concerning the effect of noncompliance with title I loan requirements for plans that are subject to title I of ERISA.)

(e) *Special rules relating to distributions from a designated Roth account.* If an amount is distributed from a designated Roth account under a section 403(b) plan, the amount, if any, that is includible in gross income and the amount, if any, that may be rolled over to another section 403(b) plan is determined under § 1.402A–1. Thus, the designated Roth account is treated as a separate contract for purposes of section 72. For example, the rules of section 72(b) must be applied separately to annuity payments with respect to a designated Roth account under a section 403(b) plan and separately to annuity payments with respect to amounts attributable to any other contributions to the section 403(b) plan.

(f) *Aggregation of contracts.* In accordance with section 403(b)(5), the rules of this section are applied as if all annuity contracts for the employee by the employer are treated as a single contract.

(g) *Certain rules relating to employment taxes.* With respect to contributions under the Federal Insurance Contributions Act (FICA) under Chapter 21, see section 3121(a)(5)(D) for a special rule relating to section 403(b) contracts. With respect to income tax withholding on distributions from section 403(b) contracts, see section 3405 generally. However, see section 3401 for income tax withholding applicable to annuity contracts or custodial accounts that are not section 403(b) contracts or for cases in which an annuity contract or custodial account ceases to be a section 403(b) contract. See also § 1.72(p)–1, Q&A–15, and § 35.3405(c)–1, Q&A–11 of this chapter, for special rules relating to income tax withholding for loans made from certain employer plans, including section 403(b) contracts.

[T.D. 9340, 72 FR 41144, July 26, 2007, as amended by 75 FR 65566, Oct. 26, 2010]

§ 1.403(b)–8 Funding.

(a) *Investments.* Section 403(b) and § 1.403(b)–3(a) only apply to amounts held in an annuity contract (as defined in § 1.403(b)–2), including a custodial account that is treated as an annuity contract under paragraph (d) of this section, or a retirement income account that is treated as an annuity contract under § 1.403(b)–9.

(b) *Contributions to the plan.* Contributions to a section 403(b) plan must be transferred to the insurance company issuing the annuity contract (or the entity holding assets of any custodial or retirement income account that is treated as an annuity contract) within a period that is not longer than is reasonable for the proper administration of the plan. For purposes of this requirement, the plan may provide for section 403(b) elective deferrals for a participant under the plan to be transferred to the annuity contract within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for section 403(b) elective deferrals under the plan to be contributed within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(c) *Annuity contracts*—(1) *Generally.* As defined in § 1.403(b)–2, and except as otherwise permitted under this section, an annuity contract means a contract that is issued by an insurance company qualified to issue annuities in a State and that includes payment in the form of an annuity. This paragraph (c) sets forth additional rules regarding annuity contracts.

(2) *Certain insurance contracts.* Neither a life insurance contract, as defined in section 7702, an endowment contract, a health or accident insurance contract, nor a property, casualty, or liability insurance contract meets the definition of an annuity contract. See § 1.401(f)–4(e). If a contract issued by an insurance company qualified to issue annuities in a State provides death benefits as part of the contract, then that coverage is permitted, assuming that those death benefits do not cause the contract to fail to satisfy any requirement applicable to section 403(b) contracts, for example, assuming that those benefits satisfy the incidental benefit requirement of § 1.401–1(b)(1)(i), as required by § 1.403(b)–6(g).

(3) *Special rule for certain contracts.* This paragraph (c)(3) applies in the case of a contract issued under a State section 403(b) plan established on or before May 17, 1982, or for an employee who becomes covered for the first time under the plan after May 17, 1982, unless the Commissioner had before that date issued any written communication (either to the employer or financial institution) to the effect that the arrangement under which the contract was issued did not meet the requirements of section 403(b). The requirement that the contract be issued by an insurance company qualified to issue annuities in a State does not apply to a contract described in the preceding sentence if one of the following two conditions is satisfied and that condition has been satisfied continuously since May 17, 1982—

(i) Benefits under the contract are provided from a separately funded retirement reserve that is subject to supervision of the State insurance department; or

(ii) Benefits under the contract are provided from a fund that is separate from the fund used to provide statutory benefits payable under a state retirement system and that is part of a State teachers retirement system (including a state university retirement system) to purchase benefits that are unrelated to the basic benefits provided under the retirement system, and the death benefit provided under the contract does not at any time exceed the larger of the reserve or the contribution made for the employee.

(d) *Custodial accounts*—(1) *Treatment as a section 403(b) contract.* Under section 403(b)(7), a custodial account is treated as an annuity contract for purposes of §§1.403(b)–1 through 1.403(b)–7, this section and §§1.403(b)–9 through 1.403(b)–11. See section 403(b)(7)(B) for special rules regarding the tax treatment of custodial accounts and section 4973(c) for an excise tax that applies to excess contributions to a custodial account.

(2) *Custodial account defined.* A custodial account means a plan, or a separate account under a plan, in which an amount attributable to section 403(b) contributions (or amounts rolled over to a section 403(b) contract, as described in §1.403(b)–10(d)) is held by a bank or a person who satisfies the conditions in section 401(f)(2), if—

(i) All of the amounts held in the account are invested in stock of a regulated investment company (as defined in section 851(a) relating to mutual funds);

(ii) The requirements of §1.403(b)–6(c) (imposing restrictions on distributions with respect to a custodial account) are satisfied with respect to the amounts held in the account;

(iii) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (for which purpose, assets are treated as diverted to the employer if the employer borrows assets from the account); and

(iv) The account is not part of a retirement income account.

(3) *Effect of definition.* The requirement in paragraph (d)(2)(i) of this section is not satisfied if the account includes any assets other than stock of a regulated investment company.

(4) *Treatment of custodial account.* A custodial account is treated as a section 401 qualified plan solely for purposes of subchapter F of subtitle A and subtitle F of the Internal Revenue Code with respect to amounts received by it (and income from investment thereof). This treatment only applies to a custodial account that constitutes a section 403(b) contract under §§1.403(b)–1 through 1.403(b)–7, this section and §§1.403(b)–9 through 1.403(b)–11 or that would constitute a section 403(b) contract under §§1.403(b)–1 through 1.403(b)–7, this section and §§1.403(b)–9 through 1.403(b)–11 if the amounts held in the account were to satisfy the nonforfeitability requirement of §1.403(b)–3(a)(2).

(e) *Retirement income accounts.* See §1.403(b)–9 for special rules under which a retirement income account for employees of a church-related organization is treated as a section 403(b) contract for purposes of §§1.403(b)–1 through 1.403(b)–7, this section and §§1.403(b)–9 through 1.403(b)–11.

(f) *Combining assets.* To the extent permitted 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), trust assets held under a custodial account and trust assets held under a retirement income account, as described in §1.403(b)–9(a)(6), may be invested in a group trust with trust assets held under a qualified plan or individual retirement plan. For this purpose, a trust includes a custodial account that is treated as a trust under section 401(f).

[T.D. 9340, 72 FR 41144, July 26, 2007]

§ 1.403(b)–9 Special rules for church plans.

(a) *Retirement income accounts*—(1) *Treatment as a section 403(b) contract.* Under section 403(b)(9), a retirement income account for employees of a church-related organization (as defined in §1.403(b)–2) is treated as an annuity contract for purposes of §§1.403(b)–1 through 1.403(b)–8, this section, §1.403(b)–10 and §1.403(b)–11.

(2) *Retirement income account defined*—(i) *In general.* A retirement income account means a defined contribution program established or maintained by a church-related organization under which—

(A) There is separate accounting for the retirement income account's interest in the underlying assets (namely, there must be sufficient separate accounting in order for it to be possible at all times to determine the retirement income account's interest in the underlying assets and to distinguish that interest from any interest that is not part of the retirement income account);

(B) Investment performance is based on gains and losses on those assets; and

(C) The assets held in the account cannot be used for, or diverted to, purposes other than for the exclusive benefit of plan participants or their beneficiaries (and for this purpose, assets are treated as diverted to the employer if there is a loan or other extension of credit from assets in the account to the employer).

(ii) *Plan required.* A retirement income account must be maintained pursuant to a program which is a plan (as defined in §1.403(b)–3(b)(3)) and the plan document must state (or otherwise evidence in a similarly clear manner) the intent to constitute a retirement income account.

(3) *Ownership or use constitutes distribution.* Any asset of a retirement income account that is owned or used by a participant or beneficiary is treated as having been distributed to that participant or beneficiary. See §§1.403(b)–6 and 1.403(b)–7 for rules relating to distributions.

(4) *Coordination of retirement income account with custodial account rules.* A retirement income account that is treated as an annuity contract is not a custodial account (as defined in §1.403(b)–8(d)(2)), even if it is invested solely in stock of a regulated investment company.

(5) *Life annuities.* A retirement income account may distribute benefits in a form that includes a life annuity only if—

(i) The amount of the distribution form has an actuarial present value, at the annuity starting date, equal to the participant's or beneficiary's accumulated benefit, based on reasonable actuarial assumptions, including regarding interest and mortality; and

(ii) The plan sponsor guarantees benefits in the event that a payment is due that exceeds the participant's or beneficiary's accumulated benefit.

(6) *Combining retirement income account assets with other assets.* For purposes of §1.403(b)–8(f) relating to combining assets, retirement income account assets held in trust (including a custodial account that is treated as a trust under section 401(f)) are subject to the same rules regarding combining of assets as custodial account assets. In addition, retirement income account assets are permitted to be commingled in a common fund with amounts devoted exclusively to church purposes (such as a fund from which unfunded pension payments are made to former employees of the church). However, unless otherwise permitted by the Commissioner, no assets of the plan sponsor, other than retirement income account assets, may be combined with custodial account assets or any other assets permitted to be combined under §1.403(b)–8(f). This paragraph (a)(6) is subject to any additional rules issued

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).

(7) *Trust treated as tax exempt.* A trust (including a custodial account that is treated as a trust under section 401(f)) that includes no assets other than assets of a retirement income account is treated as an organization that is exempt from taxation under section 501(a).

(b) *No compensation limitation up to $10,000.* See section 415(c)(7) for special rules regarding certain annual additions not exceeding $10,000.

(c) *Special deduction rule for self-employed ministers.* See section 404(a)(10) for a special rule regarding the deductibility of a contribution made by a self-employed minister.

[T.D. 9340, 72 FR 41144, July 26, 2007]

§ 1.403(b)–10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans*—(1) *In general.* An employer is permitted to amend its section 403(b) plan to eliminate future contributions for existing participants or to limit participation to existing participants and employees (to the extent consistent with §1.403(b)–5). A section 403(b) plan is permitted to contain provisions that provide for plan termination and that allow accumulated benefits to be distributed on termination. However, in the case of a section 403(b) contract that is subject to the distribution restrictions in §1.403(b)–6(c) or (d) (relating to custodial accounts and section 403(b) elective deferrals), termination of the plan and the distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the same employer under section 414(b), (c), (m), or (o) on the date of the termination) does not make contributions to any section 403(b) contract that is not part of the plan during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the period beginning 12 months before the termination and ending 12 months after distribution of all assets from the terminated plan, fewer than 2 percent of the employees who were eligible under the section 403(b) plan as of the date of plan termination are eligible under the alternative section 403(b) contract, the alternative section 403(b) contract is disregarded. To the extent a contract fails to satisfy the nonforfeitability requirement of §1.403(b)–3(a)(2) at the date of plan termination, the contact is not, and cannot later become, a section 403(b) contract. In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. For this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution. The mere provision for, and making of, distributions to participants or beneficiaries upon plan termination does not cause a contract to cease to be a section 403(b) contract. See §1.403(b)–7 for rules regarding the tax treatment of distributions, including §1.403(b)–7(b)(1) under which an eligible rollover distribution is not included in gross income if paid in a direct rollover to an eligible retirement plan or if transferred to an eligible retirement plan within 60 days.

(2) *Employers that cease to be eligible employers.* An employer that ceases to be an eligible employer may no longer contribute to a section 403(b) contract for any subsequent period, and the contract will fail to satisfy §1.403(b)–3(a) if any further contributions are made with respect to a period after the employer ceases to be an eligible employer.

(b) *Contract exchanges and plan-to-plan transfers*—(1) *Contract exchanges and transfers*—(i) *General rule.* If the conditions in paragraph (b)(2) of this section are met, a section 403(b) contract held under a section 403(b) plan is permitted to be exchanged for another section 403(b) contract held under that section 403(b) plan. Further, if the conditions in paragraph (b)(3) of this section are met, a section 403(b) plan is permitted to provide for the transfer of its assets (including any assets held in a custodial account or retirement income account that are treated as section 403(b) contracts) to another section 403(b) plan. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive service credit and repayments under section 415) are met, a section 403(b) plan is permitted to provide for the transfer of its assets to a qualified plan under section 401(a). However, neither a qualified plan nor an eligible governmental plan under section 457(b) may transfer assets to a section 403(b) plan, and a section 403(b) plan may not accept such a transfer. In addition, a section 403(b) contract may not be exchanged for an annuity contract that is not a section 403(b) contract. Neither a plan-to-plan transfer nor a contract exchange permitted under this paragraph (b) is treated as a distribution for purposes of the distribution restrictions at §1.403(b)–6. Therefore, such a transfer or exchange may be made before severance from employment or another distribution event. Further, no amount is includible in gross income by reason of such a transfer or exchange.

(ii) *ERISA rules*. See §1.414(l)–1 for other rules that are applicable to section 403(b) plans that are subject to section 208 of the Employee Retirement Income Security Act of 1974 (88 Stat. 829, 865).

(2) *Requirements for contract exchange within the same plan*—(i) *General rule*. A section 403(b) contract of a participant or beneficiary may be exchanged under paragraph (b)(1) of this section for another section 403(b) contract of that participant or beneficiary under the same section 403(b) plan if each of the following conditions are met:

(A) The plan under which the contract is issued provides for the exchange.

(B) The participant or beneficiary has an accumulated benefit immediately after the exchange that is at least equal to the accumulated benefit of that participant or beneficiary immediately before the exchange (taking into account the accumulated benefit of that participant or beneficiary under both section 403(b) contracts immediately before the exchange).

(C) The other contract is subject to distribution restrictions with respect to the participant that are not less stringent than those imposed on the contract being exchanged, and the employer enters into an agreement with the issuer of the other contract under which the employer and the issuer will from time to time in the future provide each other with the following information:

(*1*) Information necessary for the resulting contract, or any other contract to which contributions have been made by the employer, to satisfy section 403(b), including information concerning the participant's employment and information that takes into account other section 403(b) contracts or qualified employer plans (such as whether a severance from employment has occurred for purposes of the distribution restrictions in §1.403(b)–6 and whether the hardship withdrawal rules of §1.403(b)–6(d)(2) are satisfied).

(*2*) Information necessary for the resulting contract, or any other contract to which contributions have been made by the employer, to satisfy other tax requirements (such as whether a plan loan satisfies the conditions in section 72(p)(2) so that the loan is not a deemed distribution under section 72(p)(1)).

(ii) *Accumulated benefit*. The condition in paragraph (b)(2)(i)(B) of this section is satisfied if the exchange would satisfy section 414(l)(1) if the exchange were a transfer of assets.

(iii) *Authority for future guidance*. Subject to such conditions as the Commissioner determines to be appropriate, the Commissioner may issue rules of general applicability, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), permitting an exchange of one section 403(b) contract for another section 403(b) contract for an exchange that does not satisfy paragraph (b)(2)(i)(C) of this section. Any such rules must require the resulting contract to set forth procedures that the Commissioner determines are reasonably designed to ensure compliance with those requirements of section 403(b) or other tax provisions that depend on either information concerning the participant's employment or information that takes into account other section 403(b) contracts or other employer plans (such as whether a severance from employment has occurred for purposes of the distribution restrictions in §1.403(b)–6, whether the hardship withdrawal rules of §1.403(b)–6(d)(2) are satisfied, and whether a plan loan constitutes a deemed distribution under section 72(p)).

(3) *Requirements for plan-to-plan transfers*—(i) *In general*. A plan-to-plan transfer under paragraph (b)(1) of this section from a section 403(b) plan to another section 403(b) plan is permitted if each of the following conditions are met—

(A) In the case of a transfer for a participant, the participant is an employee or former employee of the employer (or the business of the employer) for the receiving plan.

(B) In the case of a transfer for a beneficiary of a deceased participant, the participant was an employee or former employee of the employer (or business of the employer) for the receiving plan.

(C) The transferor plan provides for transfers.

(D) The receiving plan provides for the receipt of transfers.

(E) The participant or beneficiary whose assets are being transferred has an accumulated benefit immediately after the transfer that is at least equal to the accumulated benefit of that participant or beneficiary immediately before the transfer.

(F) The receiving plan provides that, to the extent any amount transferred is subject to any distribution restrictions under §1.403(b)–6, the receiving plan imposes restrictions on distributions to the participant or beneficiary whose assets are being transferred that are not less stringent than those imposed on the transferor plan.

(G) If a plan-to-plan transfer does not constitute a complete transfer of the participant's or beneficiary's interest in the section 403(b) plan, the transferee plan treats the amount transferred as a continuation of a pro rata portion of the participant's or beneficiary's interest in the section 403(b) plan (for example, a pro rata portion of the participant's or beneficiary's interest in any after-tax employee contributions).

(ii) *Accumulated benefit*. The condition in paragraph (b)(3)(i)(D) of this section is satisfied if the transfer would satisfy section 414(l)(1).

(4) *Purchases of permissive service credit by contract-to-plan transfers from a section 403(b) contract to a qualified plan*—(i) *General rule*. If the conditions in paragraph (b)(4)(ii) of this section are met, a section 403(b) plan may provide for the transfer of assets held in the plan to a qualified defined benefit plan that is a governmental plan (as defined in section 414(d)).

(ii) *Conditions for plan-to-plan transfers*. A transfer may be made under this paragraph (b)(4) only if the transfer is either—

(A) For the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(c) *Qualified domestic relations orders*. In accordance with the second sentence of section 414(p)(9), any distribution from an annuity contract under section 403(b) (including a distribution from a custodial account or retirement income account that is treated as a section 403(b) contract) pursuant to a qualified domestic relations order is treated in the same manner as a distribution from a plan to which section 401(a)(13) applies. Thus, for example, a section 403(b) plan does not fail to satisfy the distribution restrictions set forth in §1.403(b)–6(b), (c), or (d) merely as a result of distribution made pursuant to a qualified domestic relations order under section 414(p), so that such a distribution is permitted without regard to whether the employee from whose contract the distribution is made has had a severance from employment or another event permitting a distribution to be made under section 403(b). In the case of a plan that is subject to title I of ERISA, see also section 206(d)(3) of ERISA under which the prohibition against assignment or alienation of plan benefits under section 206(d)(1) of ERISA does not apply to an order that is determined to be a qualified domestic relations order.

(d) *Rollovers to a section 403(b) contract*—(1) *General rule*. A section 403(b) contract may accept a contribution that is an eligible rollover distribution (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)). Any amount contributed to a section 403(b) contract as an eligible rollover distribution is not taken into account for purposes of the limits in § 1.403(b)–4, but, except as otherwise specifically provided (for example, at § 1.403(b)–6(i)), is otherwise treated in the same manner as an amount held under a section 403(b) contract for purposes of §§ 1.403(b)–3 through 1.403(b)–9 and this section.

(2) *Special rules relating to after-tax employee contributions and designated Roth contributions.* A section 403(b) plan that receives an eligible rollover distribution that includes after-tax employee contributions or designated Roth contributions is required to obtain information regarding the employee's section 72 basis in the amount rolled over. A section 403(b) plan is permitted to receive an eligible rollover distribution that includes designated Roth contributions only if the plan permits employees to make elective deferrals that are designated Roth contributions.

(e) *Deemed IRAs.* See regulations under section 408(q) for special rules relating to deemed IRAs.

(f) *Defined benefit plans*—(1) *Defined benefit plans generally.* Except for a TEFRA church defined benefit plan as defined in paragraph (f)(2) of this section, section 403(b) does not apply to any contributions or accrual under a defined benefit plan.

(2) *TEFRA church defined benefit plans.* See section 251(e)(5) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97–248, for a provision permitting certain arrangements established by a church-related organization and in effect on September 3, 1982 (a TEFRA church defined benefit plan) to be treated as section 403(b) contract even though it is a defined benefit arrangement. In accordance with section 403(b)(1), for purposes of applying section 415 to a TEFRA church defined benefit plan, the accruals under the plan are limited to the maximum amount permitted under section 415(c) when expressed as an annual addition, and, for this purpose, the rules at § 1.402(b)–1(a)(2) for determining the present value of an accrual under a nonqualified defined benefit plan also apply for purposes of converting the accrual under a TEFRA church defined benefit plan to an annual addition. See section 415(b) for additional limits applicable to TEFRA church defined benefit plans.

(g) *Other rules relating to section 501(c)(3) organizations.* See section 501(c)(3) and regulations thereunder for the substantive standards for tax-exemption under that section, including the requirement that no part of the organization's net earnings inure to the benefit of any private shareholder or individual. See also sections 4941 (self dealing), 4945 (taxable expenditures), and 4958 (excess benefit transactions), and the regulations thereunder, for rules relating to excise taxes imposed on certain transactions involving organizations described in section 501(c)(3).

[T.D. 9340, 72 FR 41144, July 26, 2007, as amended by 75 FR 65566, Oct. 26, 2010]

§ 1.403(b)–11 Applicable dates.

(a) *General rule.* Except as otherwise provided in this section, §§ 1.403(b)–1 through 1.403(b)–10 apply for taxable years beginning after December 31, 2008.

(b) *Collective bargaining agreements.* In the case of a section 403(b) plan maintained pursuant to one or more collective bargaining agreements that have been ratified and in effect on July 26, 2007, §§ 1.403(b)–1 through 1.403(b)–10 do not apply before the earlier of—

(1) The date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after July 26, 2007); or

(2) July 26, 2010.

(c) *Church conventions; retirement income account.* (1) In the case of a section 403(b) plan maintained by a church-related organization for which the authority to amend the plan is held by a church convention (within the meaning of section 414(e)), §§ 1.403(b)–1 through 1.403(b)–10 do not apply before the first day of the first plan year that begins after December 31, 2009.

(2) In the case of a loan or other extension of credit to the employer that

was entered into under a retirement income account before July 26, 2007, the plan does not fail to satisfy §1.403(b)–9(a)(2)(i)(C) on account of the loan or other extension of credit if the plan takes reasonable steps to eliminate the loan or other extension of credit to the employer before the applicable date for §1.403(b)–9(a)(2) or as promptly as practical thereafter (including taking steps after July 26, 2007 and before the applicable date).

(d) *Special rules for plans that exclude certain types of employees from elective deferrals.* (1) If, on July 26, 2007, a plan excludes any of the following categories of employees, then the plan does not fail to satisfy §1.403(b)–5(b) as a result of that exclusion before the first day of the first taxable year that begins after December 31, 2009:

(i) Employees who make a one-time election to participate in a governmental plan described in section 414(d) that is not a section 403(b) plan.

(ii) Professors who are providing services on a temporary basis to another educational organization (as defined under section 170(b)(1)(A)(ii)) for up to one year and for whom section 403(b) contributions are being made at a rate no greater than the rate each such professor would receive under the section 403(b) plan of the original educational organization.

(iii) Employees who are affiliated with a religious order and who have taken a vow of poverty where the religious order provides for the support of such employees in their retirement from eligibility to make elective deferrals.

(2) If, on July 26, 2007, a plan excludes employees who are covered by a collective bargaining agreement from eligibility to make elective deferrals, the plan does not fail to satisfy §1.403(b)–5(b) (relating to universal availability) as a result of that exclusion before the later of—

(i) The first day of the first taxable year that begins after December 31, 2008; or

(ii) The earlier of—

(A) The date on which the related collective bargaining agreement terminates (determined without regard to any extension thereof after July 26, 2007); or

(B) July 26, 2010.

(3) In the case of a governmental plan (as defined in section 414(d)) for which the authority to amend the plan is held by a legislative body that meets in legislative session, the plan does not fail to satisfy §1.403(b)–5(b) as a result of any exclusion in paragraph (d)(1)(i), (d)(1)(ii),(d)(1)(iii), or (d)(2) of this section before the earlier of —

(i) The close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2009; or

(ii) January 1, 2011.

(e) *Special rules for plans that permit in-service distributions.* (1) Section 1.403(b)–6(b) does not apply to a contract issued by an insurance company before January 1, 2009.

(2) Any amendment to comply with the requirements of §1.403(b)–6 (disregarding paragraph (e)(1) of this section) that is adopted before January 1, 2009, or such later date as may be permitted under guidance issued 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), does not violate section 204(g) of the Employee Retirement Income Security Act of 1974 to the extent the amendment eliminates or reduces a right to receive benefit distributions during employment.

(f) *Special rule for life insurance contracts.* Section 1.403(b)–8(c)(2) does not apply to a contract issued before September 24, 2007.

(g) *Special rule for contracts received in an exchange.* Section 1.403(b)–10(b)(2) does not apply to a contract received in an exchange that occurred on or before September 24, 2007 if the exchange (including the contract received in the exchange) satisfies such rules as the Commissioner has prescribed in guidance of general applicability at the time of the exchange.

(h) *Special rule for coordination with regulations under section 415.* Section 1.403(b)–3(b)(4)(ii) is applicable for taxable years beginning on or after July 1, 2007.

(i) *Special rule for coordination with regulations under section 402A.* Sections 1.403(b)–3(c), 1.403(b)–7(e), and 1.403(b)–

10(d)(2) are applicable with respect to taxable years beginning on or after January 1, 2007.

[T.D. 9340, 72 FR 41144, July 26, 2007; 72 FR 54352, Sept. 25, 2007]

§ 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)–3. 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)–3. 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)–3(c) 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)–3, 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, as amended by T.D. 9340, 72 FR 41159, July 26, 2007]

§ 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 requirements 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
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

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
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
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 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.

(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]

§ 1.404(k)–3 Disallowance of deduction for reacquisition payments.

Q–1: Are payments to reacquire stock held by an ESOP applicable dividends that are deductible under section 404(k)(1)?

A–1: (a) Payments to reacquire stock held by an ESOP, including reacquisition payments that are used to make benefit distributions to participants or beneficiaries, are not deductible under section 404(k) because—

(1) Those payments do not constitute applicable dividends under section 404(k)(2); and

(2) The treatment of those payments as applicable dividends would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5).

(b) See also § 1.162(k)–1 concerning the disallowance of deductions for amounts paid or incurred by a corporation in connection with the reacquisition of its stock from an ESOP.

Q–2: What is the effective date of this section?

A–2: This section applies with respect to payments to reacquire stock that are made on or after August 30, 2006.

[T.D. 9282, 71 FR 51474, Aug. 30, 2006]

§ 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 commonlaw 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 commonlaw 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(l)(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. 781 (b)) or required to be registered under section 12(g) (1) of that Act (15 U.S.C. 781 (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. 781 (b)) or required to be registered under Section 12 (g) (1) of that Act (15 U.S.C. 781 (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 and for investments of accounts established under section 408(q) on or after August 1, 2003, 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.

(8) *Special rules for governmental units*—(i) *In general.* A governmental unit that seeks to qualify as a nonbank trustee of a deemed IRA that is part of its qualified employer plan must demonstrate to the satisfaction of the Commissioner that it is able to administer the trust in a manner that is consistent with the requirements of section 408. The demonstration must be made by written application to the Commissioner. Notwithstanding the requirement of paragraph (e)(1) of this section that a person must demonstrate by written application that the requirements of paragraphs (e)(2) through (e)(6) of this section will be met in order to qualify as a nonbank trustee, a governmental unit that maintains a plan qualified under section 401(a), 403(a), 403(b) or 457 need not demonstrate that all of these requirements will be met with respect to any individual retirement accounts maintained by that governmental unit pursuant to section 408(q). For example, a

governmental unit need not demonstrate that it satisfies the net worth requirements of paragraph (e)(3)(ii) of this section if it demonstrates instead that it possesses taxing authority under applicable law. The Commissioner, in his discretion, may exempt a governmental unit from certain other requirements upon a showing that the governmental unit is able to administer the deemed IRAs in the best interest of the participants. Moreover, in determining whether a governmental unit satisfies the other requirements of paragraphs (e)(2) through (e)(6) of this section, the Commissioner may apply the requirements in a manner that is consistent with the applicant's status as a governmental unit.

(ii) *Governmental unit.* For purposes of this special rule, the term *governmental unit* means a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state.

(iii) *Additional rules.* The Commissioner may in revenue rulings, notices, or other guidance of general applicability provide additional rules for governmental units seeking approval as nonbank trustees.

(iv) *Effective/applicability date.* This section is applicable for written applications made on or after June 18, 2007. The rules in this section also may be relied on for applications submitted on or after August 1, 2003 (or such earlier application as the Commissioner deems appropriate) and before June 18, 2007.

[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; T.D. 9142, 69 FR 43739, July 22, 2004; T.D. 9331, 72 FR 33388, June 18, 2007]

§ 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 taxfree 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.* The rules in this paragraph (c) apply for purposes of determining net income attributable to IRA contributions made before January 1, 2004, and returned pursuant to section 408(d)(4).

The rules in §1.408–11 apply for purposes of determining net income attributable to IRA contributions made on or after January 1, 2004, and returned pursuant to section 408(d)(4). 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, as amended by T.D. 9056, 68 FR 23588, May 5, 2003]

§ 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. However, for a distribution after December 31, 2008, the February 15 due date under section 6045 applies to the statement if the statement is furnished in a consolidated reporting statement under section 6045. *See* §§1.6045–1(k)(3), 1.6045–2(d)(2), 1.6045–3(e)(2), 1.6045–4(m)(3), and 1.6045–5(a)(3)(ii).

(e) *Effective date.* This section is effective for calendar years beginning after December 31, 1977.

[T.D. 7714, 45 FR 52798, Aug. 8, 1980, as amended by T.D. 9504, 75 FR 64084, Oct. 18, 2010]

§ 1.408–8 Distribution requirements for individual retirement plans.

The following questions and answers relate to the distribution rules for IRAs provided in sections 408(a)(6) and 408(b)(3).

Q–1. Is an IRA subject to the distribution rules provided in section 401(a)(9) for qualified plans?

A–1. (a) Yes, an IRA is subject to the required minimum distribution rules provided in section 401(a)(9). In order to satisfy section 401(a)(9) for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003, the rules of §§1.401(a)(9)–1 through 1.401(a)(9)–9 and 1.401(a)(9)–6 for defined contribution plans must be applied, except as otherwise provided in this section. For example, whether the 5-year rule or the life expectancy rule applies to distributions after death occurring before the IRA owner's required beginning date is determined in accordance with §1.401(a)(9)–3 and the rules of §1.401(a)(9)–4 apply for purposes of determining an IRA owner's designated beneficiary. Similarly, the amount of the minimum distribution required for each calendar year from an individual account is determined in accordance with §1.401(a)(9)–5. For purposes of this section, the term *IRA* means an individual retirement account or annuity described in section 408(a) or (b). The IRA owner is the individual for whom an IRA is originally established by contributions for the benefit of that individual and that individual's beneficiaries.

(b) For purposes of applying the required minimum distribution rules in §§1.401(a)(9)–1 through 1.401(a)(9)–9 and 1.401(a)(9)–6 for qualified plans, the IRA trustee, custodian, or issuer is treated as the plan administrator, and the IRA owner is substituted for the employee.

(c) See A–14 and A–15 of §1.408A–6 for rules under section 401(a)(9) that apply to a Roth IRA.

Q–2. Are IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE IRA (defined in section 408(p)) treated as IRAs for purposes of section 401(a)(9)?

A–2. Yes, IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE plan (defined in section 408(p)) are treated as IRAs, rather than employer plans, for purposes of section 401(a)(9) and are, therefore, subject to the distribution rules in this section.

Q–3. In the case of distributions from an IRA, what does the term *required beginning date* mean?

A–3. In the case of distributions from an IRA, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the individual attains age 70½.

Q–4. What portion of a distribution from an IRA is not eligible for rollover because the amount is a required minimum distribution?

A–4. The portion of a distribution that is a required minimum distribution from an IRA and thus not eligible for rollover is determined in the same manner as provided in A–7 of §1.402(c)–2 for distributions from qualified plans. For example, if a minimum distribution is required under section 401(a)(9) for a calendar year, an amount distributed during a calendar year from an IRA is treated as a required minimum distribution under section 401(a)(9) to the extent that the total required minimum distribution for the year under section 401(a)(9) for that IRA has not been satisfied. This requirement may be satisfied by a distribution from the IRA or, as permitted under A–9 of this section, from another IRA.

Q–5. May an individual's surviving spouse elect to treat such spouse's entire interest as a beneficiary in an individual's IRA upon the death of the individual (or the remaining part of such interest if distribution to the spouse has commenced) as the spouse's own account?

A–5. (a) The surviving spouse of an individual may elect, in the manner described in paragraph (b) of this A–5, to treat the spouse's entire interest as a beneficiary in an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA. This election is permitted to be made at any time after the individual's date of death. In order to make this election, the spouse must be the sole beneficiary of the IRA and have an unlimited right to withdraw amounts from the IRA. If a trust is named as beneficiary of the IRA, this requirement is not satisfied even if the spouse is the sole beneficiary of the trust. If the surviving spouse makes the election, the required minimum distribution for the calendar year of the election and each subsequent calendar year is determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B) with the surviving spouse as the deceased IRA owner's beneficiary. However, if the election is made in the calendar year containing the IRA owner's death, the spouse is not required to take a required minimum distribution as the IRA owner for that calendar year. Instead, the spouse is required to take a required minimum distribution for that year, determined with respect to the deceased IRA owner under the rules of A–4(a) of §1.401(a)(9)–5, to the extent such a distribution was not made to the IRA owner before death.

(b) The election described in paragraph (a) of this A–5 is made by the surviving spouse redesignating the account as an account in the name of the surviving spouse as IRA owner rather than as beneficiary. Alternatively, a surviving spouse eligible to make the election is deemed to have made the election if, at any time, either of the following occurs—

(1) Any amount in the IRA that would be required to be distributed to the surviving spouse as beneficiary under section 401(a)(9)(B) is not distributed within the time period required under section 401(a)(9)(B); or

(2) Any additional amount is contributed to the IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of section 401(a)(9)(A).

(c) The result of an election described in paragraph (b) of this A–5 is that the surviving spouse shall then be considered the IRA owner for whose benefit the trust is maintained for all purposes under the Internal Revenue Code (e.g., section 72(t)).

Q–6. How is the benefit determined for purposes of calculating the required minimum distribution from an IRA?

A–6. For purposes of determining the minimum distribution required to be made from an IRA in any calendar year, the account balance of the IRA as of December 31 of the calendar year immediately preceding the calendar year for which distributions are required to be made is substituted in A–3 of §1.401(a)(9)–5 for the account balance of the employee. Except as provided in A–7 and A–8 of this section, no adjustments are made for contributions or distributions after that date.

Q–7. What rules apply in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA?

A–7. If the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A–5 of this section. In the event of any other rollover to an IRA of an amount distributed by a qualified plan or another IRA, the rules in § 1.401(a)(9)–7 will apply for purposes of determining the account balance for the receiving IRA and the required minimum distribution from the receiving IRA. However, because the value of the account balance is determined as of December 31 of the year preceding the year for which the required minimum distribution is being determined and not as of a valuation date in the preceding year, the account balance of the receiving IRA is only adjusted if the amount is not received in the calendar year in which the amount rolled over is distributed. In that case, for purposes of determining the required minimum distribution for the calendar year in which such amount is actually received, the account balance of the receiving IRA as of December 31 of the preceding year must be adjusted by the amount received in accordance with A–2 of § 1.401(a)(9)–7.

Q–8. What rules apply in the case of a transfer (including a recharacterization) from one IRA to another?

A–8. (a) *General rule.* In the case of a trustee-to-trustee transfer from one IRA to another IRA that is not a distribution and rollover, the transfer is not treated as a distribution by the transferor IRA for purposes of section 401(a)(9). Accordingly, the minimum distribution requirement with respect to the transferor IRA must still be satisfied. Except as provided in paragraph (b) of this A–8 for recharacterizations, after the transfer the employee's account balance and the required minimum distribution under the transferee IRA are determined in the same manner as an account balance and required minimum distribution are determined under an IRA receiving a rollover contribution under A–7 of this section.

(b) *Recharacterizations.* If an amount is contributed to a Roth IRA that is a conversion contribution or failed conversion contribution and that amount (plus net income allocable to that amount) is transferred to another IRA (transferee IRA) in a subsequent year as a recharacterized contribution, the recharacterized contribution (plus allocable net income) must be added to the December 31 account balance of the transferee IRA for the year in which the conversion or failed conversion occurred.

Q–9. Is the required minimum distribution from one IRA of an owner permitted to be distributed from another IRA in order to satisfy section 401(a)(9)?

A–9. Yes, the required minimum distribution must be calculated separately for each IRA. The separately calculated amounts may then be totaled and the total distribution taken from any one or more of the individual's IRAs under the rules set forth in this A–9. Generally, only amounts in IRAs that an individual holds as the IRA owner may be aggregated. However, amounts in IRAs that an individual holds as a beneficiary of the same decedent and which are being distributed under the life expectancy rule in section 401(a)(9)(B)(iii) or (iv) may be aggregated, but such amounts may not be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts. Distributions from Roth IRAs (defined in section 408A) will not satisfy the distribution requirements applicable to IRAs or section 403(b) accounts or contracts and distributions from IRAs or section 403(b) contracts or accounts will not satisfy the distribution requirements from Roth IRAs.

Q–10. Is any reporting required by the trustee, custodian, or issuer of an IRA with respect to the minimum amount that is required to be distributed from that IRA?

A–10. Yes, the trustee, custodian, or issuer of an IRA is required to report information with respect to the minimum amount required to be distributed from the IRA for each calendar year to individuals or entities, at the time, and in the manner, 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) as well as the applicable Federal tax forms and accompanying instructions.

Q–11. Which amounts distributed from an IRA are taken into account in determining whether section 401(a)(9) is satisfied?

A–11. (a) *General rule.* Except as provided in paragraph (b) of this A–11, all amounts distributed from an IRA are taken into account in determining whether section 401(a)(9) is satisfied, regardless of whether the amount is includible in income.

(b) Amounts not taken into account. The following amounts are not taken into account in determining whether the required minimum amount with respect to an IRA for a calendar year has been distributed—

(1) Contributions returned pursuant to section 408(d)(4), together with the income allocable to these contributions;

(2) Contributions returned pursuant to section 408(d)(5);

(3) Corrective distributions of excess simplified employee pension contributions under section 408(k)(6)(C), together with the income allocable to these distributions; and

(4) 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–12. How does the special rule in A–3(d) of § 1.401(a)(9)–5 for a qualifying longevity annuity contract (QLAC) apply to an IRA?

A–12. (a) *General rule.* The special rule in A–3(d) of § 1.401(a)(9)–5 for a QLAC, defined in A–17 of § 1.401(a)(9)–6, applies to an IRA, subject to the exceptions set forth in this A–12. See A–14(d) of § 1.408A–6 for special rules relating to Roth IRAs.

(b) *Limitations on premiums*—(1) *In general.* In lieu of the limitations described in A–17(b) of § 1.401(a)(9)–6, the premiums paid with respect to the contract on a date are not permitted to exceed the lesser of the dollar limitation in paragraph (b)(2) of this A–12 or the percentage limitation in paragraph (b)(3) of this A–12.

(2) *Dollar limitation.* The dollar limitation is an amount equal to the excess of—

(i) $125,000 (as adjusted under A–17(d)(2) of § 1.401(a)(9)–6), over

(ii) The sum of—

(A) The premiums paid before that date with respect to the contract, and

(B) The premiums paid on or before that date with respect to any other contract that is intended to be a QLAC and that is purchased for the IRA owner under the IRA, or any other plan, annuity, or account described in section 401(a), 403(a), 403(b), or 408 or eligible governmental plan under section 457(b).

(3) *Percentage limitation.* The percentage limitation is an amount equal to the excess of—

(i) 25 percent of the total account balances of the IRAs (other than Roth IRAs) that an individual holds as the IRA owner (including the value of any QLAC held under those IRAs) as of December 31 of the calendar year immediately preceding the calendar year in which a premium is paid, over

(ii) The sum of—

(A) The premiums paid before that date with respect to the contract, and

(B) The premiums paid on or before that date with respect to any other contract that is intended to be a QLAC and that is held or was purchased for the individual under those IRAs.

(c) *Reliance on representations.* For purposes of the limitations described in paragraphs (b)(2) and (3) of this A–12, unless the trustee, custodian, or issuer of an IRA has actual knowledge to the contrary, the trustee, custodian, or issuer may rely on the IRA owner's representation (made in writing or such other form as may be prescribed by the Commissioner) of—

(1) The amount of the premiums described in paragraphs (b)(2)(ii)(B) and (b)(3)(ii)(B) of this A–12 that are not paid under the IRA, and

(2) The amount of the account balances described in paragraph (b)(3)(i) of this A–12 (other than the account balance under the IRA).

(d) *Permitted delay in setting beneficiary designation.* In case of a contract that is rolled over from a plan to an IRA before the required beginning date under the plan, the contract will not violate the rule in A–17(c)(2)(v) of § 1.401(a)(9)–6 that a non-spouse beneficiary must be irrevocably selected on or before the later of the date of purchase or the required beginning date under the IRA, provided that the contract requires a beneficiary to be irrevocably selected by the end of the year following the year of the rollover.

(e) *Roth IRAs*. A contract that is purchased under a Roth IRA is not treated as a contract that is intended to be a QLAC for purposes of applying the dollar and percentage limitation rules in paragraphs (b)(2)(ii)(B) and (b)(3)(ii)(B) of this A–12. See A–14(d) of §1.408A–6. If a QLAC is purchased or held under a plan, annuity, account, or traditional IRA, and that contract is later rolled over or converted to a Roth IRA, the contract is not treated as a contract that is intended to be a QLAC after the date of the rollover or conversion. Thus, premiums paid with respect to the contract will not be taken into account under paragraph (b)(2)(ii)(B) or paragraph (b)(3)(ii)(B) of this A–12 after the date of the rollover or conversion.

(f) *Effective/applicability date*. This A–12 applies to contracts purchased on or after July 2, 2014.

[T.D. 8987, 67 FR 19024, Apr. 17, 2002, as amended by T.D. 9130, 69 FR 33293, June 15, 2004; T.D. 9673, 79 FR 37642, July 2, 2014]

§1.408–11 Net income calculation for returned or recharacterized IRA contributions.

(a) *Net income calculation for returned IRA contributions*—(1) *General rule*. For purposes of returned contributions under section 408(d)(4), the net income attributable to a contribution made to an IRA is determined by allocating to the contribution a *pro rata* portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance.}}$$

(2) *Special rule*. If an IRA is established with a contribution and no other contributions, distributions or transfers are made to or from that IRA, then the subsequent distribution of the entire account balance of the IRA pursuant to section 408(d)(4) will satisfy the requirement of that Internal Revenue Code section that the return of a contribution be accompanied by the amount of net income attributable to the contribution.

(b) *Definitions*. For purposes of this section the following definitions apply:

(1) *Adjusted opening balance*. The term *adjusted opening balance* means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is distributed as a returned contribution pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made to the IRA during the computation period.

(2) *Adjusted closing balance*. The term *adjusted closing balance* means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including recharacterizations of contributions pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(3) *Computation period*. The term *computation period* means the period beginning immediately prior to the time that the contribution being returned was made to the IRA and ending immediately prior to the removal of the contribution. If more than one contribution was made as a regular contribution and is being returned from the IRA, the computation period begins immediately prior to the time the first contribution being returned was contributed.

(4) *Regular contribution*. The term *regular contribution* means an IRA contribution made by the IRA owner that is neither a trustee-to-trustee transfer from another IRA nor a rollover from another IRA or retirement plan.

(c) *Additional rules*. (1) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this section, notwithstanding A–3 of § 1.408A–5, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(2) In the case of an IRA that has received more than one regular contribution for a particular taxable year, the last regular contribution made to the IRA for the year is deemed to be the contribution that is distributed as a returned contribution under section 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution.

(3) In the case of an individual who owns multiple IRAs, the net income calculation is performed only on the IRA containing the contribution being returned, and that IRA is the IRA that must distribute the contribution.

(d) *Examples.* The following examples illustrate the net income calculation under section 408(d)(4) and this section:

Example 1. (i) On May 1, 2004, when her IRA is worth $4,800, Taxpayer A makes a $1,600 regular contribution to her IRA. Taxpayer A requests that $400 of the May 1, 2004, contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on February 1, 2005, when the IRA is worth $7,600, the IRA trustee distributes to Taxpayer A the $400 plus attributable net income. During this time, no other contributions have been made to the IRA and no distributions have been made.

(ii) The adjusted opening balance is $6,400 [$4,800 + $1,600] and the adjusted closing balance is $7,600. Thus, the net income attributable to the $400 May 1, 2004, contribution is $75 [$400 × ($7,600 − $6,400) ÷ $6,400]. Therefore, the total to be distributed on February 1, 2005, pursuant to § 408(d)(4) is $475.

Example 2. (i) Beginning in January 2004, Taxpayer B contributes $300 on the 15th of each month to an IRA for 2004, resulting in an excess regular contribution of $600 for that year. Taxpayer B requests that the $600 excess regular contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on March 1, 2005, when the IRA is worth $16,000, the IRA trustee distributes to Taxpayer B the $600 plus attributable net income. The excess regular contributions to be returned are deemed to be the last two made in 2004: the $300 December 15 contribution and the $300 November 15 contribution. On November 15 the IRA was worth $11,000 immediately prior to the contribution. No distributions or transfers have been made from the IRA and no contributions or transfers, other than the monthly contributions (including $300 in January and February 2005), have been made.

(ii) As of the beginning of the computation period (November 15), the adjusted opening balance is $12,200 [$11,000 + $300 + $300 + $300 + $300] and the adjusted closing balance is $16,000. Thus, the net income attributable to the excess regular contributions is $187 [$600 × ($16,000 − $12,200) ÷ $12,200]. Therefore, the total to be distributed as returned contributions on March 1, 2005, to correct the excess regular contribution is $787 [$600 + $187].

[T.D. 9056, 68 FR 23588, May 5, 2003]

§ 1.408(q)–1 Deemed IRAs in qualified employer plans.

(a) *In general.* Under section 408(q), a qualified employer plan may permit employees to make voluntary employee contributions to a separate account or annuity established under the plan. If the requirements of section 408(q) and this section are met, such account or annuity is treated in the same manner as an individual retirement plan under section 408 or 408A (and contributions to such an account or annuity are treated as contributions to an individual retirement plan and not to the qualified employer plan). The account or annuity is referred to as a deemed IRA.

(b) *Types of IRAs.* If the account or annuity meets the requirements applicable to traditional IRAs under section 408, the account or annuity is deemed to be a traditional IRA, and if the account or annuity meets the requirements applicable to Roth IRAs under section 408A, the account or annuity is deemed to be a Roth IRA. Simplified employee pensions (SEPs) under section 408(k) and SIMPLE IRAs under section 408(p) may not be used as deemed IRAs.

(c) *Separate entities.* Except as provided in paragraphs (d) and (g) of this section, the qualified employer plan and the deemed IRA are treated as separate entities under the Internal Revenue Code and are subject to the separate rules applicable to qualified employer plans and IRAs, respectively. Issues regarding eligibility, participation, disclosure, nondiscrimination, contributions, distributions, investments, and plan administration are generally to be resolved under the separate rules (if any) applicable to each entity under the Internal Revenue Code.

(d) *Exceptions*. The following exceptions to treatment of a deemed IRA and the qualified employer plan as separate entities apply:

(1) The plan document of the qualified employer plan must contain the deemed IRA provisions and a deemed IRA must be in effect at the time the deemed IRA contributions are accepted. Notwithstanding the preceding sentence, employers that provided deemed IRAs for plan years beginning before January 1, 2004, (but after December 31, 2002) are not required to have such provisions in their plan documents before the end of such plan years.

(2) The requirements of section 408(a)(5) regarding commingling of assets do not apply to deemed IRAs. Accordingly, the assets of a deemed IRA may be commingled for investment purposes with those of the qualified employer plan. However, the restrictions on the commingling of plan and IRA assets with other assets apply to the assets of the qualified employer plan and the deemed IRA.

(e) *Application of distribution rules*. (1) Rules applicable to distributions from qualified employer plans under the Internal Revenue Code and regulations do not apply to distributions from deemed IRAs. Instead, the rules applicable to distributions from IRAs apply to distributions from deemed IRAs. Also, any restrictions that a trustee, custodian, or insurance company is permitted to impose on distributions from traditional and Roth IRAs may be imposed on distributions from deemed IRAs (for example, early withdrawal penalties on annuities).

(2) The required minimum distribution rules of section 401(a)(9) must be met separately with respect to the qualified employer plan and the deemed IRA. The determination of whether a qualified employer plan satisfies the required minimum distribution rules of section 401(a)(9) is made without regard to whether a participant satisfies the required minimum distribution requirements with respect to the deemed IRA that is established under such plan.

(f) *Additional rules*—(1) *Trustee*. The trustee or custodian of an individual retirement account must be a bank, as required by section 408(a)(2), or, if the trustee is not a bank, as defined in section 408(n), the trustee must have received approval from the Commissioner to serve as a nonbank trustee or nonbank custodian pursuant to §1.408–2(e). For further guidance regarding governmental units serving as nonbank trustees of deemed IRAs established under section 408(q), see §1.408–2T(e)(8).

(2) *Trusts*. (i) General rule. Deemed IRAs that are individual retirement accounts may be held in separate individual trusts, a single trust separate from a trust maintained by the qualified employer plan, or in a single trust that includes the qualified employer plan. A deemed IRA trust must be created or organized in the United States for the exclusive benefit of the participants. If deemed IRAs are held in a single trust that includes the qualified employer plan, the trustee must maintain a separate account for each deemed IRA. In addition, the written governing instrument creating the trust must satisfy the requirements of section 408(a) (1), (2), (3), (4), and (6).

(ii) *Application of section 408(a)(3)*. If deemed IRAs are held in a single trust that includes the qualified employer plan, section 408(a)(3) is treated as satisfied if no part of the separate accounts of any of the deemed IRAs is invested in life insurance contracts, regardless of whether the separate account for the qualified employer plan invests in life insurance contracts.

(iii) *Separate accounts for traditional and Roth deemed IRAs*. The rules of section 408A(b) and the regulations thereunder, requiring each Roth IRA to be clearly designated as a Roth IRA, will not fail to be satisfied solely because Roth deemed IRAs and traditional deemed IRAs are held in a single trust, provided that the trustee maintains separate accounts for the Roth deemed IRAs and traditional deemed IRAs of each participant, and each of those accounts is clearly designated as such.

(3) *Annuity contracts.* Deemed IRAs that are individual retirement annuities may be held under a single annuity contract or under separate annuity contracts. However, the contract must be separate from any annuity contract or annuity contracts of the qualified employer plan. In addition, the contract must satisfy the requirements of section 408(b) and there must be separate accounting for the interest of each participant in those cases where the individual retirement annuities are held under a single annuity contract.

(4) *Deductibility.* The deductibility of voluntary employee contributions to a traditional deemed IRA is determined in the same manner as if they were made to any other traditional IRA. Thus, for example, taxpayers with compensation that exceeds the limits imposed by section 219(g) may not be able to make contributions to deemed IRAs, or the deductibility of such contributions may be limited in accordance with sections 408 and 219(g). However, section 219(f)(5), regarding the taxable year in which amounts paid by an employer to an individual retirement plan are includible in the employee's income, is not applicable to deemed IRAs.

(5) *Rollovers and transfers.* The same rules apply to rollovers and transfers to and from deemed IRAs as apply to rollovers and transfers to and from other IRAs. Thus, for example, the plan may provide that an employee may request and receive a distribution of his or her deemed IRA account balance and may roll it over to an eligible retirement plan in accordance with section 408(d)(3), regardless of whether that employee may receive a distribution of any other plan benefits.

(6) *Nondiscrimination.* The availability of a deemed IRA is not a benefit, right or feature of the qualified employer plan under § 1.401(a)(4)–4.

(7) *IRA assets and benefits not taken into account in determining benefits under or funding of qualified employer plan.* Neither the assets held in the deemed IRA portion of the qualified employer plan, nor any benefits attributable thereto, shall be taken into account for purposes of:

(i) Determining the benefits of employees and their beneficiaries under the plan (within the meaning of section 401(a)(2)); or

(ii) Determining the plan's assets or liabilities for purposes of section 404 or 412.

(g) *Disqualifying defects*—(1) *Single trust.* If the qualified employer plan fails to satisfy the qualification requirements applicable to it, either in form or operation, any deemed IRA that is an individual retirement account and that is included as part of the trust of that qualified employer plan does not satisfy section 408(q). Accordingly, any account maintained under such a plan as a deemed IRA ceases to be a deemed IRA at the time of the disqualifying event. In addition, the deemed IRA also ceases to satisfy the requirements of sections 408(a) and 408A. Also, if any one of the deemed IRAs fails to satisfy the applicable requirements of sections 408 or 408A, and the assets of that deemed IRA are included as part of the trust of the qualified employer plan, section 408(q) does not apply and the plan will fail to satisfy the plan's qualification requirements.

(2) *Separate trusts and annuities.* If the qualified employer plan fails to satisfy its qualification requirements, either in form or operation, but the assets of a deemed IRA are held in a separate trust (or where a deemed IRA is an individual retirement annuity), then the deemed IRA does not automatically fail to satisfy the applicable requirements of section 408 or 408A. Instead, its status as an IRA will be determined by considering whether the account or the annuity satisfies the applicable requirements of sections 408 and 408A (including, in the case of individual retirement accounts, the prohibition against the commingling of assets under section 408(a)(5)). Also, if a deemed IRA fails to satisfy the requirements of a qualified IRA and the assets of the deemed IRA are held in a separate trust (or where the deemed IRA is an individual retirement annuity), the qualified employer plan will not fail

the qualification requirements applicable to it under the Code solely because of the failure of the deemed IRA.

(h) *Definitions*. The following definitions apply for purposes of this section:

(1) *Qualified employer plan*. A *qualified employer plan* is a plan described in section 401(a), an annuity plan described in section 403(a), a section 403(b) plan, or a governmental plan under section 457(b).

(2) *Voluntary employee contribution*. A *voluntary employee contribution* is any contribution (other than a mandatory contribution within the meaning of section 411(c)(2)(C)) which is made by an individual as an employee under a qualified employer plan that allows employees to elect to make contributions to deemed IRAs and with respect to which the individual has designated the contribution as a contribution to which section 408(q) applies.

(3) *Employee*. An *employee* includes any individual who is an employee under the rules applicable to the qualified employer plan under which the deemed IRA is established.

(i) *Effective date*. This section applies to accounts or annuities established under section 408(q) on or after August 1, 2003.

[T.D. 9142, 69 FR 43739, July 22, 2004]

§ 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:

[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.

Q–14. What is the amount that is treated as a distribution, for purposes of determining income inclusion, when a conversion involves an annuity contract?

A–14. (a) *In general*—(1) *Distribution of Fair Market Value Upon Conversion*. Notwithstanding §1.408–4(e), when part or all of a traditional IRA that is an individual retirement annuity described in section 408(b) is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under § 1.408A–4, A–7, the amount that is treated as distributed is the fair market value of the annuity contract on the date the annuity contract is converted. Similarly, when a traditional IRA that is an individual retirement account described in section 408(a) holds an annuity contract as an account asset and the traditional IRA is converted to a Roth IRA, for purposes of determining the amount includible in gross income as a distribution under § 1.408A–4, A–7, the amount that is treated as distributed with respect to the annuity contract is the fair market value of the annuity contract on the date that the annuity contract is distributed or treated as distributed from the traditional IRA. The rules in this A–14 also apply to conversions from SIMPLE IRAs.

(2) *Annuity contract surrendered.* Paragraph (a)(1) of this paragraph A–14 does not apply to a conversion of a traditional IRA to the extent the conversion is accomplished by the complete surrender of an annuity contract for its cash value and the reinvestment of the cash proceeds in a Roth IRA, but only if the surrender extinguishes all benefits and other characteristics of the contract. In such a case, the cash from the surrendered contract is the amount reinvested in the Roth IRA.

(3) *Definitions.* The definitions set forth in § 1.408A–8 apply for purposes of this paragraph A–14.

(b) *Determination of fair market value*—(1) *Overview*—(i) *Use of alternative methods.* This paragraph (b) sets forth methods which may be used to determine the fair market value of an individual retirement annuity for purposes of paragraph (a)(1) of this paragraph A–14. However, if, because of the unusual nature of the contract, the value determined under one of these methods does not reflect the full value of the contract, that method may not be used.

(ii) *Additional guidance.* Additional guidance regarding the fair market value of an individual retirement annuity, including formulas to be used for determining fair market value, may be issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*)).

(2) *Gift tax method*—(i) *Cost of contract or comparable contract.* If with respect to an annuity, there is a comparable contract issued by the company which sold the annuity, the fair market value of the annuity may be established by the price of the comparable contract. If the conversion occurs soon after the annuity was sold, the comparable contract may be the annuity itself, and thus, the fair market value of the annuity may be established through the sale of the particular contract by the company (that is, the actual premiums paid for such contract).

(ii) *Use of reserves where no comparable contract available.* If with respect to an annuity, there is no comparable contract available in order to make the comparison described in paragraph (b)(2)(i) of this paragraph A–14, the fair market value may be established through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date.

(3) *Accumulation method.* As an alternative to the gift tax method described in paragraph (b)(2) of this paragraph A–14, this paragraph (b)(3) provides a method that may be used for an annuity contract which has not been annuitized. The fair market value of such an annuity contract is permitted to be determined using the methodology provided in § 1.401(a)(9)–6, A–12, with the following modifications:

(i) All front-end loads and other non-recurring charges assessed in the twelve months immediately preceding the conversion must be added to the account value.

(ii) Future distributions are not to be assumed in the determination of the actuarial present value of additional benefits.

(iii) The exclusions provided under § 1.401(a)(9)–6, A–12(c)(1) and (c)(2), are not to be taken into account.

(c) *Effective/applicability date.* The provisions of this paragraph A–14 are applicable to any conversion in which an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. However, for annuity contracts distributed or treated as distributed from a traditional IRA on or before December 31, 2008, taxpayers may instead apply the valuation methods in §1.408A–4T (as it appeared in the April 1, 2008, edition of 26 CFR part 1) and Revenue Procedure 2006–13 (2006–1 CB 315) (See §601.601(d)(2)(ii)(*b*)).

[T.D. 8816, 64 FR 5603, Feb. 4, 1999, as amended by T.D. 9220, 70 FR 48871, Aug. 22, 2005; T.D. 9418, 73 FR 43862, July 29, 2008]

§ 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)(1) If paragraph (b) of this A–2 does not apply, then, for purposes of determining net income attributable to IRA contributions, the net income attributable to the amount of a contribution is determined by allocating to the contribution a *pro rata* portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance.}}$$

(2) For purposes of this paragraph (c), the following definitions apply:

(i) The term *adjusted opening balance* means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is being recharacterized pursuant to section 408A(d)(6) and any other recharacterizations) made to the IRA during the computation period.

(ii) The term *adjusted closing balance* means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including contributions returned pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(iii) The term *computation period* means the period beginning immediately prior to the time the particular contribution being recharacterized is made to the IRA and ending immediately prior to the recharacterizing transfer of the contribution. If a series of regular contributions was made to the IRA, and consecutive contributions in that series are being recharacterized, the computation period begins immediately prior to the time the first of the regular contributions being recharacterized was made.

(3) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this paragraph (c), notwithstanding A–3 of this section, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(4) In the case of an individual with multiple IRAs, the net income calculation is performed only on the IRA containing the particular contribution to be recharacterized, and that IRA is the IRA from which the recharacterizing transfer must be made.

(5) In the case of multiple contributions made to an IRA for a particular year that are eligible for recharacterization, the IRA owner can choose (by date and by dollar amount, not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized.

(6) The following examples illustrate the net income calculation under section 408A(d)(6) and this paragraph:

Example 1. (i) On March 1, 2004, when her Roth IRA is worth $80,000, Taxpayer A makes a $160,000 conversion contribution to the Roth IRA. Subsequently, Taxpayer A discovers that she was ineligible to make a Roth conversion contribution in 2004 and so she requests that the $160,000 be recharacterized to a traditional IRA pursuant to section 408A(d)(6). Pursuant to this request, on March 1, 2005, when the IRA is worth $225,000, the Roth IRA trustee transfers to a traditional IRA the $160,000 plus allocable net income. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) The adjusted opening balance is $240,000 [$80,000 + $160,000] and the adjusted closing balance is $225,000. Thus the net income allocable to the $160,000 is − $10,000 [$160,000 × ($225,000 − $240,000) ÷ $240,000]. Therefore, in order to recharacterize the March 1, 2004, $160,000 conversion contribution on March 1, 2005, the Roth IRA trustee must transfer from Taxpayer A's Roth IRA to her traditional IRA $150,000 [$160,000 − $10,000].

Example 2. (i) On April 1, 2004, when her traditional IRA is worth $100,000, Taxpayer B converts the entire amount, consisting of 100 shares of stock in ABC Corp. and 100 shares of stock in XYZ Corp., by transferring the shares to a Roth IRA. At the time of the conversion, the 100 shares of stock in ABC Corp. are worth $50,000 and the 100 shares of stock in XYZ Corp. are also worth $50,000. Taxpayer B decides that she would like to recharacterize the ABC Corp. shares back to a traditional IRA. However, B may choose only by dollar amount the contribution or portion thereof that is to be recharacterized. On the date of transfer, November 1, 2004, the 100 shares of stock in ABC Corp. are worth $40,000 and the 100 shares of stock in XYZ Corp. are worth $70,000. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) If B requests that $50,000 (which was the value of the ABC Corp. shares at the time of conversion) be recharacterized, the net income allocable to the $50,000 is $5,000 [$50,000 × ($110,000 − $100,000) ÷ $100,000]. Therefore, in order to recharacterize $50,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of $55,000 [$50,000 + $5,000].

(iii) If, on the other hand, B requests that $40,000 (which was the value of the ABC Corp. shares on November 1) be recharacterized, the net income allocable to the $40,000 is $4,000 [$40,000 × ($110,000 − $100,000) ÷ $100,000]. Therefore, in order to recharacterize $40,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of $44,000 [$40,000 + $4,000].

(iv) Regardless of the amount of the contribution recharacterized, the determination of that amount (or of the net income allocable thereto) is not affected by whether the recharacterization is accomplished by the transfer of shares of ABC Corp. or of shares of XYZ Corp.

(7) This paragraph (c) applies for purposes of determining net income attributable to IRA contributions, made on or after January 1, 2004. For purposes of determining net income attributable to IRA contributions made before January 1, 2004, *see* paragraph (c) of this A–2 of §1.408A–5 (as it appeared in the April 1, 2003, edition of 26 CFR part 1).

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, as amended by T.D. 9056, 68 FR 23589, May 5, 2003]

§ 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.

(d) The special rules in A–3 of §1.401(a)(9)–5 and A–12 of §1.408–8 for a qualifying longevity annuity contract (QLAC), defined in A–17 of §1.401(a)(9)–6, do not apply to a Roth IRA.

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, as amended by T.D. 9673, 79 FR 37643, July 2, 2014]

§ 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]

§ 1.408A–10 Coordination between designated Roth accounts and Roth IRAs.

Q–1. Can an eligible rollover distribution, within the meaning of section 402(c)(4), from a designated Roth account, as defined in A–1 of §1.402A–1, be rolled over to a Roth IRA?

A–1. Yes. An eligible rollover distribution, within the meaning of section 402(c)(4), from a designated Roth account may be rolled over to a Roth IRA. For purposes of this section, a designated Roth account means a designated Roth account as defined in A–1 of §1.402A–1.

Q–2. Can an eligible rollover distribution from a designated Roth account be rolled over to a Roth IRA even if the distributee is not otherwise eligible to make regular or conversion contributions to a Roth IRA?

A–2. Yes. An individual may establish a Roth IRA and roll over an eligible rollover distribution from a designated Roth account to that Roth IRA even if such individual is not eligible to make regular contributions or conversion contributions (as described in section 408A(c)(2) and (d)(3), respectively) because of the modified adjusted gross income limits in section 408A(b)(3).

Q–3. For purposes of the ordering rules on distributions from Roth IRAs, what portion of a distribution from a rollover contribution from a designated Roth account is treated as contributions?

A–3. (a) Under section 408A(d)(4), distributions from Roth IRAs are deemed to consist first of regular contributions, then of conversion contributions, and finally, of earnings. For purposes of section 408A(d)(4), the amount of a rollover contribution that is treated as a regular contribution is the portion of the distribution that is treated as investment in the contract under A–6 of §1.402A–1, and the remainder of the rollover contribution is treated as earnings. Thus, the entire amount of any qualified distribution from a designated Roth account that is rolled over into a Roth IRA is treated as a regular contribution to the Roth IRA. Accordingly, a subsequent distribution from the Roth IRA in the amount of that rollover contribution is not includible in gross income under the rules of A–8 of §1.408A–6.

(b) If the entire account balance of a designated Roth account is distributed to an employee and only a portion of the distribution is rolled over to a Roth IRA within the 60-day period described in section 402(c)(3), and at the time of the distribution, the investment in the contract exceeds the balance in the designated Roth account, the portion of investment in the contract that exceeds the amount used to determine the taxable amount of the distribution is treated as a regular contribution for purposes of section 408A(d)(4).

Q–4. In the case of a rollover from a designated Roth account to a Roth IRA, when does the 5-taxable-year period (described in section 408A(d)(2)(B) and A–1 of §1.408A–6) for determining qualified distributions from a Roth IRA begin?

A–4. (a) The 5-taxable-year period for determining a qualified distribution from a Roth IRA (described in section 408A(d)(2)(B) and A–1 of §1.408A–6) begins with the earlier of the taxable year described in A–2 of §1.408A–6 or the taxable year in which a rollover contribution from a designated Roth account is made to a Roth IRA. The 5-taxable-year period described in this A–4 and the 5-taxable-year period of participation described in A–4 of §1.402A–1 are determined independently.

(b) The following examples illustrate the application of this A–4:

Example 1. Employee D began making designated Roth contributions under his employer's 401(k) plan in 2006. Employee D, who is over age 59½, takes a distribution from D's designated Roth account in 2008, prior to the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account. The distribution is an eligible rollover distribution and D rolls it over in accordance with sections 402(c) and 402A(c)(3) to D's Roth IRA, which was established in 2003. Any subsequent distribution from the Roth IRA of the amount rolled in, plus earnings thereon, would not be includible in gross income (because it would be a qualified distribution within the meaning of section 408A(d)(2)).

Example 2. The facts are the same as in *Example 1*, except that the Roth IRA is D's first Roth IRA and is established with the rollover in 2008, which is the only contribution made to the Roth IRA. If a distribution is made from the Roth IRA prior to the end of the 5-taxable-year period used to determine qualified distributions from a Roth IRA (which begins in 2008, the year of the rollover which established the Roth IRA) the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the portion of the rollover contribution that consisted of investment in the contract is includible in D's gross income.

Example 3. The facts are the same as in *Example 2*, except that the distribution from the designated Roth account and the rollover to the Roth IRA occur in 2011 (after the end of the 5-taxable-year period of participation used to determine qualified distributions from a designated Roth account). If a distribution is made from the Roth IRA prior to the expiration of the 5-taxable-year period used to determine qualified distributions from a Roth IRA, the distribution would not be a qualified distribution within the meaning of section 408A(d)(2), and any amount of the distribution that exceeded the amount rolled in is includible in D's gross income.

Q–5. Can amounts distributed from a Roth IRA be rolled over to a designated Roth account as defined in A–1 of § 1.402A–1?

A–5. No. Amounts distributed from a Roth IRA may be rolled over or transferred only to another Roth IRA and are not permitted to be rolled over to a designated Roth account under a section 401(a) or section 403(b) plan. The same rule applies even if all the amounts in the Roth IRA are attributable to a rollover distribution from a designated Roth account in a plan.

Q–6. When is this § 1.408A–10 applicable?

A–6. The rules of this § 1.408A–10 apply for taxable years beginning on or after January 1, 2006.

[T.D. 9324, 72 FR 21115, Apr. 30, 2007]

§ 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]

§ 1.409A–0 Table of contents.

This section lists captions contained in §§ 1.409A–1, 1.409A–2, 1.409A–3, 1.409A–4, 1.409A–5 and 1.409A–6.

§ 1.409A–1 Definitions and covered plans.

§ 1.409A–2 Deferral elections.

(11) Initial deferral election with respect to certain separation pay.
(12) Initial deferral election with respect to certain commissions.
(i) Sales commission compensation.
(ii) Investment commission compensation.
(iii) Commission compensation and related persons.
(13) Initial deferral election with respect to compensation paid for final payroll period.
(i) In general.
(ii) Transition rule.
(14) Elections to annualize recurring part-year compensation.
(15) USERRA rights.
(b) Subsequent changes in time and form of payment.
(1) In general.
(2) Definition of payments for purposes of subsequent changes in the time and form of payment.
(i) In general.
(ii) Life annuities.
(A) In general.
(B) Certain features disregarded.
(C) Subsidized joint and survivor annuities.
(D) Actuarial assumptions and methods.
(iii) Installment payments.
(iv) Transition rule.
(3) Beneficiaries.
(4) Domestic relations orders.
(5) Coordination with prohibition against acceleration of payments.
(6) Application to multiple payment events.
(7) Delay of payments under certain circumstances.
(i) Payments subject to section 162(m).
(ii) Payments that would violate Federal securities laws or other applicable law.
(iii) Other events and conditions.
(8) USERRA rights.
(9) Examples.
(c) Special rules for certain resident aliens.

§ 1.409A–3 Permissible payments

(a) In general.
(b) Designation of payment upon a permissible payment event.
(c) Designation of alternative specified dates or payment schedules based upon date of permissible event.
(d) When a payment is treated as made upon the designated payment date.
(e) Designation of time and form of payment with respect to earnings.
(f) Substitutions.
(g) Disputed payments and refusals to pay.
(h) Special rule for certain resident aliens.
(i) Definitions and special rules.
(1) Specified time or fixed schedule.
(i) In general.
(ii) Payment schedules with formula and fixed limitations.
(A) Individual limitations.
(B) Limitations on aggregate payments to all participants in substantially identical plans.
(iii) Payment schedules determined by timing of payments received by the service recipient.
(iv) Reimbursement or in-kind benefit plans.
(A) General rule.
(B) Medical reimbursement arrangements.
(v) Tax gross-up payments.
(vi) Examples.
(2) Separation from service—required delay in payment to a specified employee pursuant to a separation from service.
(i) In general.
(ii) Application of payment rules to delayed payments.
(3) Unforeseeable emergency.
(i) Definition.
(ii) Amount of payment permitted upon an unforeseeable emergency.
(iii) Payments due to an unforeseeable emergency.
(4) Disability.
(i) In general.
(ii) Limited plan definition of disability.
(iii) Determination of disability.
(5) Change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation.
(i) In general.
(ii) Identification of relevant corporation.
(A) In general.
(B) Majority shareholder.
(C) Example.
(iii) Attribution of stock ownership.
(iv) Special rules for certain delayed payments pursuant to a change in control event.
(A) Certain transaction-based compensation.
(B) Certain nonvested compensation.
(v) Change in the ownership of a corporation.
(A) In general.
(B) Persons acting as a group.
(vi) Change in the effective control of a corporation.
(A) In general.
(B) Multiple change in control events.
(C) Acquisition of additional control.
(D) Persons acting as a group.
(vii) Change in the ownership of a substantial portion of a corporation's assets.
(A) In general.
(B) Transfers to a related person.
(C) Persons acting as a group.
(6) Certain back-to-back arrangements.
(i) In general.
(ii) Example.
(j) Prohibition on acceleration of payments.
(1) In general.
(2) Application to multiple payment events.
(3) Beneficiaries.

(4) Exceptions.
(i) In general.
(ii) Domestic relations order.
(iii) Conflicts of interest.
(A) Compliance with ethics agreements with the Federal government.
(B) Compliance with ethics laws or conflicts of interest laws.
(iv) Section 457 plans.
(v) Limited cashouts.
(vi) Payment of employment taxes.
(vii) Payment upon income inclusion under section 409A.
(viii) Cancellation of deferrals following an unforeseeable emergency or hardship distribution.
(ix) Plan terminations and liquidations.
(x) Certain distributions to avoid a nonallocation year under section 409(p).
(xi) Payment of state, local, or foreign taxes.
(xii) Cancellation of deferral elections due to disability.
(xiii) Certain offsets.
(xiv) Bona fide disputes as to a right to a payment.
(5) Nonqualified deferred compensation plans linked to qualified employer plans or certain other arrangements.
(6) Changes in elections under a cafeteria plan.

§ 1.409A–4 Calculation of income inclusion. [Reserved]

§ 1.409A–5 Funding. [Reserved]

§ 1.409A–6 Application of section 409A and effective dates.

(a) Statutory application and effective dates
(1) Application to amounts deferred.
(i) In general.
(ii) Collectively bargained plans.
(2) Identification of date of deferral for statutory effective date purposes.
(3) Calculation of amount of compensation deferred for statutory effective date purposes.
(i) Nonaccount balance plans.
(ii) Account balance plans.
(iii) Equity-based compensation plans.
(iv) Earnings.
(v) Definition of plan.
(4) Material modifications.
(i) In general.
(ii) Adoptions of new plans.
(iii) Suspension or termination of a plan.
(iv) Changes to investment measures—account balance plans.
(v) Stock rights.
(vi) Rescission of modifications.
(vii) Definition of plan.
(b) Regulatory applicability date.

[T.D. 9321, 72 FR 19276, Apr. 17, 2007]

§ 1.409A–1 Definitions and covered plans.

(a) *Nonqualified deferred compensation plan*—(1) *In general*. Except as otherwise provided in this paragraph (a), the term *nonqualified deferred compensation plan* means any plan (within the meaning of paragraph (c) of this section) that provides for the deferral of compensation (within the meaning of paragraph (b) of this section). Whether a plan provides for the deferral of compensation generally is determined at the time the service provider obtains a legally binding right to the compensation under the plan, and is not affected by any retroactive change to the plan to characterize the right as one that does not provide for the deferral of compensation. For example, amounts deferred under a nonqualified deferred compensation plan do not become an excluded death benefit if the plan is amended so that the amounts are payable only upon the death of the service provider. If a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A and the regulations thereunder.

(2) *Qualified employer plans*. The term *nonqualified deferred compensation plan* does not include a qualified employer plan. The term *qualified employer plan* means any of the following plans:

(i) Any plan described in section 401(a) and a trust exempt from tax under section 501(a) or that is described in section 402(d).

(ii) Any annuity plan described in section 403(a).

(iii) Any annuity contract described in section 403(b).

(iv) Any simplified employee pension (within the meaning of section 408(k)).

(v) Any simple retirement account (within the meaning of section 408(p)).

(vi) Any plan under which an active participant makes deductible contributions to a trust described in section 501(c)(18).

(vii) Any eligible deferred compensation plan (within the meaning of section 457(b)).

(viii) Any plan described in section 415(m).

(ix) Any plan described in §1022(i)(2) of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829, 942) (Sept. 2, 1974) (ERISA).

(3) *Certain foreign plans*—(i) *Participation addressed by treaty.* With respect to an individual for a taxable year, the term *nonqualified deferred compensation plan* does not include any scheme, trust, arrangement, or plan maintained with respect to such individual, to the extent contributions made by or on behalf of such individual to such scheme, trust, arrangement, or plan, or credited allocations, accrued benefits, earnings, or other amounts constituting income, of such individual under such scheme, trust, arrangement, or plan, are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention, or other bilateral or multilateral agreement, to which the United States is a party.

(ii) *Participation by nonresident aliens, certain resident aliens, and bona fide residents of possessions.* With respect to an alien individual for a taxable year during which such individual is a nonresident alien, a resident alien classified as a resident alien solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or a bona fide resident of a possession (within the meaning of section 937(a)), the term *nonqualified deferred compensation plan* does not include any broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section).

(iii) *Participation by U.S. citizens and lawful permanent residents.* With respect to an individual for a given taxable year during which such individual is a U.S. citizen or a resident alien classified as a resident alien under section 7701(b)(1)(A)(i), other than an individual who is also a bona fide resident of a possession (within the meaning of section 937(a)), the term *nonqualified deferred compensation plan* does not include a broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section), but only with respect to a plan, or a portion of a plan where such portion may be distinguished, providing for nonelective deferrals of modified foreign earned income, and earnings with respect to such nonelective deferrals, and only to the extent that the amounts deferred under all such plans of the service recipient, or all portions of such plans, in which the service provider participates in such taxable year, do not exceed the applicable limits under section 415(b) (applied to nonaccount balance plans as defined in paragraph (c)(2)(i)(C) of this section) and section 415(c) (applied to account balance plans as defined in paragraph (c)(2)(i)(A) of this section) that would be applicable if such plans were plans subject to section 415 and the modified foreign earned income of such individual were treated as compensation for purposes of applying section 415(b) and (c). For purposes of this paragraph (a)(3)(iii), the term *modified foreign earned income* means foreign earned income as defined in section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B). The provisions of this paragraph (a)(3)(iii) do not apply to any individual with respect to any taxable year in which the individual is simultaneously eligible to participate in a broad-based foreign retirement plan and a qualified employer plan described in paragraph (a)(2) of this section. For purposes of this paragraph (a)(3)(iii), an individual is eligible to participate in a qualified employer plan if under the terms of the plan and without further amendment or action by the plan sponsor, the individual is eligible to make or receive contributions or accrue benefits under the plan (regardless of whether the individual has elected to participate in the plan).

(iv) *Plans subject to a totalization agreement and similar plans.* The term *nonqualified deferred compensation plan* does not include any social security system of a jurisdiction to the extent that benefits provided under or contributions made to the system are subject to an agreement entered into pursuant to section 233 of the Social Security Act (42 U.S.C. 433) with any foreign jurisdiction. In addition, the term *nonqualified deferred compensation plan* does not include a social security system of a foreign jurisdiction to the extent that benefits are provided under or contributions are made to a government-mandated plan as part of that foreign jurisdiction's social security system.

(v) *Broad-based foreign retirement plan.* The term *broad-based foreign retirement plan* means a scheme, trust, arrangement, or plan (regardless of whether sponsored by a U.S. person) that is written and that, in the case of an employer-maintained plan, satisfies the following conditions:

(A) The plan is nondiscriminatory insofar as the employees who, under the terms of the plan (alone or in combination with other comparable plans) and without further amendment or action by the employer, are eligible to make or receive contributions or accrue benefits under the plan other than earnings (regardless of whether the employee has elected to participate in the plan), are a wide range of employees, substantially all of whom are nonresident aliens, resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or bona fide residents of a possession (within the meaning of section 937(a)), including rank and file employees.

(B) The plan (alone or in combination with other comparable plans) actually provides significant benefits for a substantial majority of such covered employees.

(C) The benefits actually provided under the plan to such covered employees are nondiscriminatory.

(D) The plan contains provisions or is the subject of tax law provisions or other legal restrictions that generally discourage employees from using plan benefits for purposes other than retirement or restrict access to plan benefits before separation from service, including (but not limited to), restricting in-service distributions except in events similar to an unforeseeable emergency (as defined in §1.409A–3(i)(3)(i)) or hardship (as defined for purposes of section 401(k)(2)(B)(i)(IV)), or for educational purposes or the purchase of a primary residence.

(4) *Section 457 plans.* A nonqualified deferred compensation plan under section 457(f) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The rules of section 409A apply to nonqualified deferred compensation plans separately and in addition to any requirements applicable to such plans under section 457(f). In addition, nonelective deferred compensation of non-employees described in section 457(e)(12) and a grandfathered plan or arrangement described in §1.457–2(k)(4) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The term *nonqualified deferred compensation plan* does not include a length of service award to a bona fide volunteer under section 457(e)(11)(A)(ii). For purposes of the application of section 409A to a plan to which section 457 applies, a payment under the plan generally means the provision of cash or property to the service provider, provided that for purposes of the application of the short-term deferral rule set forth in paragraph (b)(4) of this section, the inclusion in income of an amount under section 457(f) is treated as a payment of the amount.

(5) *Certain welfare benefits.* The term *nonqualified deferred compensation plan* does not include a plan, or a portion of a plan, to the extent that the plan provides bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefits. For these purposes, the terms ''disability pay'' and ''death benefits'' have the same meanings as provided in §31.3121(v)(2)–1(b)(4)(iv)(C) of this chapter, provided that for purposes of this paragraph, such disability pay and death benefits may be provided through insurance and the lifetime benefits payable under the plan are not treated as including the value of any taxable term life insurance coverage or taxable disability insurance coverage provided under the plan. The term *nonqualified deferred compensation plan* also does not include any Archer Medical Savings Account as described in section 220, any Health Savings Account as described in section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of section 105 and section 106 such that the benefits or reimbursements provided

under such arrangement are not includible in income.

(b) *Deferral of compensation*—(1) *In general.* Except as otherwise provided in paragraphs (b)(3) through (b)(12) of this section, a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. Such compensation is deferred compensation for purposes of section 409A, this section and §§1.409A–2 through 1.409A–6. A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in section 125). A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, a service provider will be considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance depends on all the relevant facts and circumstances. However, where the service provider to whom the compensation may be paid has effective control of the person retaining the discretion to reduce or eliminate the compensation, or has effective control over any portion of the compensation of the person retaining the discretion to reduce or eliminate the compensation, or is a member of the family (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family) of the person retaining the discretion to reduce or eliminate the compensation, the discretion to reduce or eliminate the compensation will not be treated as having substantive significance. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under another plan (including a plan that is qualified under section 401(a)), or because benefits are reduced due to actual or notional investment losses, or, in a final average pay plan, subsequent decreases in compensation.

(2) *Earnings.* References to the deferral of compensation or deferred compensation include references to earnings. When the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. A plan may provide that the time and form of payment of earnings is treated separately from the time and form of payment of the underlying compensation, so that, provided that the rules of section 409A are otherwise met, a plan may provide that earnings will be paid at a separate time or in a separate form from the payment of the underlying compensation. For the application of the deferral election rules to current payments of earnings and dividend equivalents, see §1.409A–3(e).

(3) *Compensation payable pursuant to the service recipient's customary payment timing arrangement.* A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or

with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b) or if no such payroll period exists, a period not longer than the earlier of the normal timing arrangement under which the service provider normally compensates non-employee service providers or 30 days after the end of the service provider's taxable year.

(4) *Short-term deferrals*—(i) *In general.* A deferral of compensation does not occur under a plan with respect to any payment (as defined in §1.409A–2(b)(2)) that is not a deferred payment, provided that the service provider actually or constructively receives such payment on or before the last day of the applicable 2½ month period. The following rules apply for purposes of this paragraph (b)(4)(i):

(A) The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

(B) A payment is treated as actually or constructively received if the payment is includible in income, including if the payment is includible in income under section 83, the economic benefit doctrine, section 402(b), or section 457(f).

(C) A right to a payment that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the payment.

(D) A payment is a deferred payment if it is made pursuant to a provision of a plan that provides for the payment to be made or completed on or after any date, or upon or after the occurrence of any event, that will or may occur later than the end of the applicable 2½ month period, such as a separation from service, death, disability, change in control event, specified time or schedule of payment, or unforeseeable emergency, regardless of whether an amount is actually paid as a result of the occurrence of such a payment date or event during the applicable 2½ month period. If a plan provides that the service provider or service recipient may make an election under the plan (including an election under §1.409A–2(a)(4)) of a different payment date, schedule, or event, such right is disregarded for this purpose. In such cases, whether a plan provides for a deferred payment is determined based on the payment date, schedule, or event that would apply if no such election were made, except that if the plan would not provide for a deferred payment absent such an election, and the service provider or service recipient makes such an election, whether the plan provides for a deferred payment is determined based upon the payment date, schedule, or event that the service provider or service recipient in fact elected.

(E) A stock right provides for a deferred payment if such right includes any provision pursuant to which the holder of the stock right will or may have the right to exercise the stock right after the applicable 2½ month period.

(F) This paragraph (b)(4)(i) is applied separately to each payment (as defined in §1.409A–2(b)(2)) required to be made under a plan.

(G) If a plan provides for a deferred payment with respect to part of a payment (for example a life annuity or a series of installment amounts treated as a single payment), the plan provides for a deferred payment with respect to the entire payment.

(ii) *Certain delayed payments.* A payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the applicable 2½ month period and, as of the date upon which the legally binding right to the compensation arose, such impracticability was unforeseeable, or the taxpayer establishes that making the payment by the end of the applicable 2½ month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect. For purposes of this paragraph (b)(4)(ii), an action or failure to act of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event. In addition, a payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that the service recipient reasonably anticipated that the service recipient's deduction with respect to such payment otherwise would not be permitted by application of section 162(m), and, as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of section 162(m) at the time of the payment, and provided further that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that, if the payment were made on such date, the service recipient's deduction with respect to such payment would no longer be restricted due to the application of section 162(m). For additional rules applicable to certain transaction-based compensation, see § 1.409A–3(i)(5)(iv)(A).

(iii) *Examples*. The following examples illustrate the provisions of this paragraph (b)(4). In these examples, except as otherwise noted, each employee and each employer has a calendar year taxable year and each employee is an individual who is employed by the specified employer.

Example 1. On November 1, 2008, Employer Z awards a bonus to Employee A such that Employee A has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2009.

Example 2. Employer Y has a taxable year ending August 31. On November 1, 2008, Employer Y awards a bonus to Employee B so that Employee B has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee B on or before November 15, 2009.

Example 3. On November 1, 2008, Employer X awards a bonus to Employee C such that Employee C has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee C will forfeit the bonus unless Employee C continues performing services through December 31, 2010. The right to the payment is subject to a substantial risk of forfeiture through December 31, 2010. Employee C has the right to make a written election not later than December 31, 2009, to receive the bonus on or after December 31, 2015, but Employee C does not make such election. The bonus plan does not provide for a default payment date or a deferred payment in the absence of an election by Employee C. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee C on or before March 15, 2011.

Example 4. On November 1, 2008, Employer W awards a bonus to Employee D such that Employee D has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, the bonus will be determined based on services performed during the period from January 1, 2009 through December 31, 2010. The bonus is scheduled to be paid as a lump sum payment on February 15, 2011. Under the bonus plan, Employee D will forfeit the bonus unless Employee D continues performing services through the scheduled payment date (February 15, 2011). Provided that at all times before the scheduled payment date Employee D is required to continue to perform services to retain the right to the bonus, and the bonus is paid on or before March 15, 2012, the bonus plan will not be considered to have provided for a deferral of compensation.

Example 5. On November 1, 2008, Employer V awards a bonus to Employee E such that Employee E has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee E will forfeit the bonus unless Employee E continues performing services through December 31, 2010. Under the bonus plan, the bonus is scheduled to be paid as a lump sum payment on July 1, 2011. By specifying a payment date after the applicable 2½ month period, the bonus plan provides for a deferred payment. The bonus plan provides for a deferral of compensation, and will not qualify as a short-term deferral regardless of whether the bonus is paid or made available on or before March 15, 2011 (and generally any payment before June 1, 2011 would constitute an impermissible acceleration of a payment).

Example 6. On November 1, 2008, Employer U awards a bonus to Employee F such that Employee F has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan provides for a lump sum payment upon Employee F's separation from service. Because the separation from service is an event that may occur after the applicable 2½ month period, the bonus plan provides for a deferred payment and therefore provides for a deferral of compensation. Accordingly, the bonus plan will not qualify as a short-term deferral regardless of whether Employee F separates from service and the bonus is paid or made available on or before March 15, 2009.

Example 7. On November 1, 2008, Employer T grants Employee G a legally binding right to the payment of a life annuity with the first annuity payment on November 1, 2013, provided that Employee G continues performing services for Employer T continuously through November 1, 2013. Because the life annuity is treated as a single payment, and because all payments of the life annuity may not occur during the applicable 2½ month period, the plan provides for a deferred payment and none of the amounts payable under the annuity will qualify as a short-term deferral, so that section 409A applies to all amounts that are payable under the plan.

Example 8. On November 1, 2008, Employer S grants Employee H a stock right providing for an exercise price less than the fair market value of the underlying stock on November 1, 2008. The stock right is subject to a substantial risk of forfeiture requiring services through November 1, 2010. The stock right becomes exercisable when the substantial risk of forfeiture lapses and expires on November 1, 2013. Employee H continues providing services through November 1, 2010, at which time the substantial risk of forfeiture lapses. The stock right provides for a deferred payment and will not qualify as a short-term deferral regardless of whether Employee H exercises the stock right on or before March 15, 2011.

(5) *Stock options, stock appreciation rights, and other equity-based compensation*—(i) *Stock rights*—(A) *Nonstatutory stock options not providing for the deferral of compensation.* An option to purchase service recipient stock does not provide for a deferral of compensation if—

(*1*) The exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option;

(*2*) The transfer or exercise of the option is subject to taxation under section 83 and §1.83–7; and

(*3*) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:

(*i*) The exercise or disposition of the option under §1.83–7.

(*ii*) The time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in §1.83–3(b)).

(B) *Stock appreciation rights not providing for the deferral of compensation.* A right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of exercise of such right (a stock appreciation right) does not provide for a deferral of compensation if—

(*1*) Compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the stock appreciation right is exercised over an amount specified on the date of grant of the stock appreciation right (the stock appreciation right exercise price), with respect to a number of shares fixed on or before the date of grant of the right;

(*2*) The stock appreciation right exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the right is granted; and

(*3*) The stock appreciation right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the stock appreciation right.

(C) *Stock rights that may provide for the deferral of compensation.* An option to purchase stock other than service recipient stock, or a stock appreciation right with respect to stock other than service recipient stock, generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of an option to purchase service recipient stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423), the exercise price is or could become less than the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date of grant, the grant of the option generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of a stock appreciation right with respect to service recipient stock, the compensation payable under the stock appreciation right is or could be any amount greater than, with respect to a predetermined number of shares, the excess of the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the stock appreciation right is exercised over the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date of grant of the stock appreciation right, the grant of the stock appreciation right generally will provide for a deferral of compensation within the meaning of this paragraph (b).

(D) *Feature for the deferral of compensation.* To the extent a stock right provides a right other than the right to receive cash or stock on the date of exercise and such additional right would otherwise allow compensation to be deferred beyond the date of exercise, the entire arrangement (including the underlying stock right) provides for the deferral of compensation. For purposes of this paragraph (b)(5)(i), neither the right to receive substantially nonvested stock (as defined in §1.83–3(b)) upon the exercise of a stock right, nor the right to pay the exercise price with previously acquired shares, constitutes a feature for the deferral of compensation.

(E) *Rights to dividends.* For purposes of this paragraph (b)(5)(i), the right, directly or indirectly contingent upon the exercise of a stock right, to receive an amount equal to all or part of the dividends or other distributions (other than stock dividends described in paragraph (b)(5)(v)(H) of this section) declared and paid on the number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right (generally causing such stock right to be subject to section 409A). A plan providing a right to dividends or other distributions declared and paid on the number of shares underlying a stock right, the payment of which is not contingent upon, or otherwise payable on, the exercise of the stock right, may provide for a deferral of compensation, but the existence of the right to receive such an amount will not be treated as a reduction to the exercise price of (or an increase to the compensation payable under) the stock right. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon the exercise of a stock right will not cause the related stock right to fail to satisfy the requirements of the exclusion from the definition of a deferral of compensation provided in paragraphs (b)(5)(i)(A) and (B) of this section.

(ii) *Statutory stock options.* The grant of an incentive stock option as described in section 422, or the grant of an option under an employee stock purchase plan described in section 423 (including the grant of an option with an exercise price discounted in accordance with section 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation. However, the exclusion for statutory stock options under this paragraph (b)(5)(ii) does not apply to a modification, extension, or renewal of a statutory option that is treated as the grant of a new option that is not a statutory option. See §1.424–1(e). In such event, the option is treated for purposes of this paragraph (b) as if it had been a nonstatutory stock option from the date of the original grant. Accordingly, if such modification, extension, or renewal of the stock option would have been treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant under paragraph (b)(5)(v) of this section, the modification, extension, or renewal of the stock option is treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant for purposes of this paragraph (b)(5).

(iii) *Service recipient stock*—(A) *In general.* Except as otherwise provided in paragraphs (b)(5)(iii)(B), (C), and (D) of this section, the term *service recipient stock* means a class of stock that, as of the date of grant, is common stock for purposes of section 305 and the regulations thereunder of a corporation that is an eligible issuer of service recipient stock (as defined in paragraph (b)(5)(iii)(E) of this section). Notwithstanding the foregoing, the term *service recipient stock* does not include a class of stock that has any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer. The term *service recipient stock* also does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a put or call right that is not a lapse restriction as defined in §1.83–3(i), if the stock price under such right or obligation is based on a measure other than the fair market value (disregarding lapse restrictions as defined in §1.83–3(i)) of the equity interest in the corporation represented by the stock.

(B) *American depositary receipts.* An American depositary receipt or American depositary share may constitute service recipient stock, to the extent that the stock traded on a foreign securities market to which the American depositary receipt or American depositary share relates qualifies as service recipient stock.

(C) *Mutual company units.* Mutual company units may constitute service recipient stock. For this purpose, the term *mutual company unit* means a fixed percentage of the overall value of a non-stock mutual company or association. For purposes of determining the value of the mutual company unit, the unit may be valued in accordance with the rules set forth in paragraph (b)(5)(iv)(B) of this section governing valuation of service recipient stock the shares of which are not traded on an established securities market, applied as if the mutual company were a stock corporation with one class of common stock and the number of shares of such stock determined according to such fixed percentage. For example, an appreciation right based on the appreciation of 10 mutual company units, where each unit is defined as one percent of the overall value of the mutual company, would be valued as if the appreciation right were based upon 10 shares of a corporation, with 100 shares of common stock (and no other class of stock), the shares of which are not readily tradable on an established securities market.

(D) *Other entities.* An interest in an entity other than a corporation or nonstock mutual company or association may constitute service recipient stock to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(E) *Eligible issuer of service recipient stock*—(*1*) *In general.* The term *eligible issuer of service recipient stock* means only the corporation for which the service provider provides direct services on the date of grant of the stock right (if the entity receiving such services is a corporation), and any corporation in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right. For this purpose, the term *controlling interest* has the same meaning as provided in §1.414(c)–2(b)(2)(i), provided that the language "at least 50 percent" is used instead of "at least 80 percent" each place it appears in §1.414(c)–2(b)(2)(i). In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the term *controlling interest* has the same meaning as provided in §1.414(c)–2(b)(2)(i), provided that the language "at least 20 percent" is used instead of "at least 80 percent" each place it appears in §1.414(c)–2(b)(2)(i). For purposes of determining ownership of an interest in an organization, the rules of §§1.414(c)–3 and 1.414(c)–4 apply. The determination of whether a grant is based on legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of section 409A. For example, stock of a corporation that owns an interest in a joint venture involving an operating business, used with respect to stock rights granted to service providers of the joint venture who are former service providers of such corporation, generally will constitute use of service recipient stock based upon legitimate business criteria, and therefore could constitute service recipient stock with respect to such service providers if the corporation owns at least 20 percent of the joint venture and the other requirements of this paragraph (b)(5)(iii) are met. Similarly, the legitimate business criteria requirement generally would be met if the corporate venturer issued such a right to an employee of the joint venture who it reasonably expected would in the future become an employee of the corporate venturer. However, where a service provider has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient joint venture, a stock right issued to that employee on the investor corporation's stock generally would not be based upon legitimate business criteria. Similarly, where a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity for which the service provider performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation's stock to the service provider.

(*2*) *Investment vehicles.* Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(*1*) of this section, except as to a service provider providing services directly to such corporation, for purposes of this paragraph (b)(5), an eligible issuer of service recipient stock does not include any corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's minority ownership interests in entities other than the service recipient.

(*3*) *Corporate structures established or transactions undertaken for purposes of avoiding coverage under section 409A.* Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(*1*) of this section, an eligible issuer of service recipient stock does not include any corporation within a group of entities treated as a single service recipient if a purpose of the establishment of the structure of the ownership, or a purpose of a significant transaction between or among two or more entities comprising a single service recipient, is to provide deferred compensation not subject to the application of section 409A. If an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, it is presumed that such structure was established for purposes of avoiding the application of section 409A if any stock rights are issued with respect to such entity.

(*4*) *Substitutions and assumptions by reason of a corporate transaction.* If the requirements of paragraph (b)(5)(v)(D) of this section are met such that the substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right, or the assumption of an outstanding stock right pursuant to a corporate transaction, would not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§1.409A–2 through 1.409A–6, the stock underlying the stock right that replaced the stock right that is substituted or assumed will be treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock rights if such underlying stock otherwise satisfies the requirements of paragraph (b)(5)(iii)(A) of this section. For example, if by reason of a spinoff transaction (under which the stock of a subsidiary corporation is distributed to the stockholders of a distributing corporation), a stock option to purchase distributing corporation stock is replaced with a stock option to purchase distributing corporation stock and a stock option to purchase the spun off subsidiary corporation's stock (each otherwise satisfying the requirements of paragraph (b)(5)(iii)(A) of this section), and where such substitution is not treated as a modification of the original stock option pursuant to paragraph (b)(5)(v)(D) of this section, both the distributing corporation stock and the subsidiary corporation stock are treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock options.

(iv) *Determination of the fair market value of service recipient stock*—(A) *Stock readily tradable on an established securities market*. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or any other reasonable method using actual transactions in such stock as reported by such market. The determination of fair market value also may be determined using an average selling price during a specified period that is within 30 days before or 30 days after the applicable valuation date, provided that the program under which the stock right is granted, including a program with a single participant, must irrevocably specify the commitment to grant the stock right with an exercise price set using such an average selling price before the beginning of the specified period. For this purpose, the term *average selling price* refers to the arithmetic mean of such selling prices on all trading days during the specified period, or the average of such prices over the specified period weighted based on the volume of trading of such stock on each trading day during such specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock right, the number and class of shares of stock that are subject to the stock right, and the method for determining the exercise price including the period over which the averaging will occur, before the beginning of the specified averaging period. Notwithstanding the forgoing provisions of this paragraph (b)(5)(iv)(A), where applicable foreign law requires that a compensatory stock right be priced based upon a specific price averaging method and period, a stock right granted in accordance with such applicable foreign law will be treated as meeting the requirements of this paragraph (b)(5)(iv)(A), provided that the averaging period does not exceed 30 days.

(B) *Stock not readily tradable on an established securities market*—(*1*) *In general*. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(*2*) *Presumption of reasonableness.* For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(*i*) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(*ii*) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83–3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83–5, provided that such stock is valued in the same manner for purposes of any transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of §1.424–1(d)), other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(*2*)(*ii*) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(*iii*) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(*1*) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83–3(i)), and provided that this paragraph (b)(5)(iv)(B)(*2*)(*iii*) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A–3(i)(5)(v) or §1.409A–3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(*2*)(*iii*), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons'' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(*3*) *Use of alternative methods.* For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

(v) *Modifications, extensions, substitutions, and assumptions of stock rights*—(A) *Treatment of modified and extended stock rights.* A modification of the terms of a stock right within the meaning of paragraph (b)(5)(v)(B) of this section is considered to be the grant of a new stock right. The new stock right may or may not constitute a deferral of compensation under paragraph (b)(5)(i) of this section, determined at the date of grant of the new stock right. If there is an extension of a stock right (within the meaning of paragraph (b)(5)(v)(C) of this section), the stock right is treated as having had an additional deferral feature from the original date of grant of the stock right, and therefore will be treated as a plan providing for the deferral of compensation from the original grant date for purposes of this paragraph (b).

(B) *Modification in general.* Except as otherwise provided in paragraph (b)(5)(v) of this section, the term *modification* means any change in the terms of the stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right regardless of whether the holder in fact benefits from the change in terms. A change in the terms of the stock right shortening the period during which the stock right is exercisable is not a modification. It is not a modification to add a feature providing the ability to tender previously acquired stock for the stock purchasable under the stock right, or to withhold or have withheld shares of stock to facilitate the payment of the exercise price or the employment taxes or required withholding taxes resulting from the exercise of the stock right. In addition, it is not a modification for the grantor to exercise discretion specifically reserved under a stock right with respect to the transferability of the stock right.

(C) *Extensions*—(*1*) *In general.* An extension of a stock right refers to the provision to the holder of an additional period of time within which to exercise the stock right beyond the time originally prescribed under the terms of the stock right, the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation not permitted in paragraph (b)(5)(i)(A)(*3*) of this section (in the case of a stock option) or not permitted in paragraph (b)(5)(i)(B)(*3*) of this section (in the case of a stock appreciation right) to the terms of the stock right, other than at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), and includes a renewal of such right that has such effect. It is not an extension if the exercise period of a stock right is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms under any circumstances or the 10th anniversary of the original date of grant of the stock right. If the exercise period of a stock right is extended at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), it is not an extension of the original stock right. Instead, in such a case, the original stock right is treated as modified rather than extended and a new stock right is treated as having been granted for purposes of this section. In addition, it is not an extension of a stock right if the expiration of the stock right is tolled while the holder cannot exercise the stock right because such an exercise would violate an applicable Federal, state, local, or foreign law, or would jeopardize the ability of the service recipient to continue as a going concern, provided that the period during which the stock right may be exercised is not extended more than 30 days after the exercise of the stock right first would no longer violate an applicable Federal, state, local, and foreign laws or would first no longer jeopardize the ability of the service recipient to continue as a going concern. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(*2*) *Certain extensions before April 10, 2007.* An extension of a stock right before April 10, 2007 solely in order to provide the holder of such stock right an additional period of time beyond the time originally prescribed under the terms of such stock right within which to exercise the stock right is disregarded for purposes of applying the rules contained in paragraph (b)(5)(v)(C)(*1*) of this section. For purposes of applying the rules contained in paragraph (b)(5)(v)(C)(*1*) of this section on and after April 10, 2007, such a stock right is treated as having specified at the date of grant the time within which to exercise such stock right that was prescribed under the terms of such stock right in effect on April 10, 2007. Nothing in this paragraph (b)(5)(v)(C)(*2*) affects any other action treated as the extension of a stock right, including the addition of a deferral feature.

(*3*) *Examples.* The following examples illustrate the provisions of this paragraph (b)(5)(v)(C). In the examples, each employee is an individual employed by the specified employer, and each employee and each employer has a calendar year taxable year.

Example 1. On July 1, 2009, Employer Z grants Employee A a nonstatutory stock option that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(A) of this section. The terms of the nonstatutory stock option provide that the exercise period of the stock option expires on the earlier of July 1, 2019, or 3 months after Employee A's separation from service. On

July 1, 2011, Employee A separates from service. On the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2013. Because the exercise period of the stock right is not extended beyond July 1, 2019, the change is not an extension for purposes of this paragraph (b)(5)(v)(C).

Example 2. The facts are the same as in *Example 1* except that Employee A separates from service on July 1, 2018, and on the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2020. As of July 1, 2018, the fair market value of the underlying stock exceeds the exercise price. Because the exercise period of the stock right is extended beyond July 1, 2019, the change is an extension for purposes of this paragraph (b)(5)(v)(C).

Example 3. The facts are the same as in *Example 2* except that as of July 1, 2018, the fair market value of the underlying stock is less than the exercise price of the option. Because the exercise period of the stock right is extended at a time when the fair market value of the underlying stock is less than the exercise price, the change is not an extension for purposes of this paragraph (b)(5)(v)(C) and the change is treated as a modification of the option, resulting in the extension of the exercise period being treated as the grant of a new option on July 1, 2018.

Example 4. On July 1, 2009, Employer Y grants to Employee B a stock appreciation right with respect to 200 shares of Employer Y common stock that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(B) of this section. Upon exercise of the stock appreciation right, Employee B is entitled to receive the excess of the fair market value of a share of Employer Y common stock on the date of exercise over $100 (the fair market value of a share of Employer Y common stock on July 1, 2009), multiplied by the number of shares with respect to which Employee B is exercising the right. The exercise period of the right expires on the earlier of July 1, 2019, or 3 months after Employee B separates from service. Employee B cannot exercise the stock appreciation right with respect to more than 100 shares unless Employee B continues to be employed by Employer Y through June 30, 2014. On July 1, 2011, when the fair market value of a share of Employer Y common stock is $200, Employee B and Employer Y amend the stock appreciation right to provide that the right will be exercisable only during calendar year 2018, except that before January 1, 2017, Employee B may elect to designate calendar year 2023 or any subsequent calendar year before 2033 as the year in which the right will be exercisable. The amendment constitutes an extension of the stock appreciation right under paragraph (b)(5)(v)(C)(*1*) of this section. Under paragraph (b)(5)(v)(A) of this section, the stock appreciation right is treated as having had an additional deferral feature from the original date of grant (July 1, 2009) of the right, and therefore is treated as a plan providing for the deferral of compensation from that date. During the period from July 1, 2009, through June 30, 2011, the provisions of the stock appreciation right relating to the time and form of payment did not satisfy the requirements of §1.409A–3(a). Therefore, the stock appreciation right provides for a deferral of compensation that does not comply with section 409A.

(D) *Substitutions and assumptions of stock rights by reason of a corporate transaction.* If the requirements of §1.424–1 (without regard to the requirement described in §1.424–1(a)(2) that an eligible corporation be the employer of the optionee) would be met if the stock right were a statutory option, the substitution of a new stock right pursuant to a corporate transaction (as defined in §1.424–1(a)(3)) for an outstanding stock right or the assumption of an outstanding stock right pursuant to a corporate transaction will not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§1.409A–2 through 1.409A–6. For purposes of the preceding sentence, the requirement of §1.424–1(a)(5)(iii) will be deemed to be satisfied if the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately before the substitution or assumption. In the case of a transaction described in section 355 in which the stock of the distributing corporation and the stock distributed in the transaction are both readily tradable on an established securities market immediately after the transaction, for purposes of this paragraph (b)(5)(v), the requirements of §1.424–1(a)(5) related to the fair market value of the stock may be satisfied by—

(*1*) Using the last sale before or the first sale after the specified date as of which such valuation is being made, the closing price on the last trading day before or the trading day of a specified date, the arithmetic mean of the high and low prices on the last trading day before or the trading day of such specified date, or any other reasonable method using actual transactions in such stock as reported by such market on a specified date, for the stock of the distributing corporation and the stock distributed in the transaction, provided the specified date is designated before such specified date, and such specified date is not more than 60 days after the transaction;

(*2*) Using the arithmetic mean of such market prices on trading days during a specified period designated before the beginning of such specified period, where such specified period is not longer than 30 days and ends no later than 60 days after the transaction; or

(*3*) Using an average of such prices during such prespecified period weighted based on the volume of trading of such stock on each trading day during such prespecified period.

(E) *Acceleration of date when exercisable.* Although with respect to a stock right not immediately exercisable in full, a change in the terms of the right solely to accelerate or delay, within the original term of the stock right, the time at which the stock right (or any portion of such stock right) may be exercised is not a modification for purposes of this section, with respect to a stock right subject to section 409A, such an acceleration may constitute an impermissible acceleration of a payment date under § 1.409A–3(j) or a subsequent deferral under § 1.409A–2(b).

(F) *Discretionary added benefits.* If a change to a stock right provides, either by its terms or in substance, that the holder may receive an additional benefit under the stock right at the future discretion of the grantor, and the addition of such benefit would constitute a modification or extension, then the addition of such discretion is a modification or extension at the time that the stock right is changed to provide such discretion.

(G) *Change in underlying stock increasing value.* A change in the terms of the stock subject to a stock right that increases the value of the stock is a modification of such stock right, except to the extent that a new stock right is substituted for such stock right by reason of the change in the terms of the stock in accordance with paragraph (b)(5)(v)(D) of this section.

(H) *Change in the number of shares purchasable.* If a stock right is amended solely to increase the number of shares subject to the stock right, the increase is not considered a modification of the stock right but is treated as the grant of a new additional stock right to which the additional shares are subject. Notwithstanding the previous sentence, if the exercise price and number of shares subject to a stock right are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or decrease) on a pro rata basis the number of shares owned by each shareholder of the class of stock subject to the stock right, then there is no modification of the stock right if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the stock right is not less than the aggregate exercise price before the stock split or stock dividend.

(I) *Rescission of changes.* A change to the terms of a stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the right) is not considered a modification or extension of the stock right to the extent the change in the terms of the stock right is rescinded by the earlier of the date the stock right is exercised or the last day of the service provider's taxable year during which such change occurred. Thus, for example, if the terms of a stock right granted to an individual employee with a calendar year taxable year are changed on March 1 in a manner that would result in an extension of the stock right, and the change is rescinded on November 1 of the same year, and the stock right is not exercised before the change is rescinded, the stock right is not considered extended under this paragraph (b)(5)(v).

(J) *Successive modifications and extensions.* The rules of this paragraph (b)(5)(v) apply as well to successive modifications and extensions.

(K) *Modifications and extensions in effect on October 23, 2004.* For purposes of the application of section 409A and these regulations to a stock right, if a legally binding right to a modification or extension of such stock right existed on October 23, 2004, such modification or extension is disregarded, and the stock right is treated as if granted with the terms and conditions in effect on October 23, 2004.

(vi) *Meaning and use of certain terms*—(A) *Option*. The term *option* means 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 (b)(5)(vi)(D) of this section, such individual being under no obligation to purchase. While no particular form of words is necessary, the option must express an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open. The term *option* includes a warrant that meets the requirements of this paragraph (b)(5)(vi)(A). An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. An option must be in writing (in paper or electronic form) provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(B) *Date of grant of option*. (*1*) The language the *date of grant of the option*, and similar phrases, refer to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. A corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated. Ordinarily, if the corporate action provides for an immediate offer of stock for sale to a service provider, or provides for a particular date on which such offer is to be made, the date of the granting of the option is the date of such corporate action if the offer is to be made immediately, or the date provided 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 service provider will be taken into account as indicating that the corporation provided that the offer was to be made at the subsequent date on which such notice is given.

(*2*) If the corporation imposes a condition on the granting of an option (as distinguished from a condition governing the exercise of the option), such condition generally will be given effect in accordance with the intent of the corporation. However, if the grant of an option is subject to approval by stockholders, the date of grant of the option will be determined as if the option had not been subject to such approval. A condition that does not require corporate action, such as the approval of, or registration with, some regulatory or government 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 has been satisfied.

(*3*) In general, a condition imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 2008, Corporation A grants to X, an employee, an option to purchase 5,000 shares of the corporation's common stock, exercisable by X on or after June 1, 2009, provided X is employed by the corporation on June 1, 2009, 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, 2008, and will be treated as outstanding as of such date.

(C) *Stock*. The term *stock* means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term stock 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 for this purpose, provided such stock otherwise possesses the rights and characteristics of capital stock.

(D) *Exercise price.* The term *exercise price* means the consideration in cash or property that, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term *exercise price* does not include any amounts paid as interest under a deferred payment plan or treated as interest.

(E) *Exercise.* The term *exercise,* when used in reference to an option, means the act of acceptance by the holder of the option 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 exercise price does not constitute an exercise of the option unless the holder of the option is subject to personal liability on such promise. An agreement or undertaking by the service provider to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the service provider.

(F) *Transfer.* The term *transfer,* when used in reference to the transfer to an individual of a share of stock pursuant to the exercise of an 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. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to acquire the share at the share's fair market value at the time of the sale.

(G) *Readily tradable.* For purposes of this section and §§1.409A–2 through 1.409A–6, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

(H) *Application to stock appreciation rights.* For purposes of this section and §§1.409A–2 through 1.409A–6, the definitions provided in paragraphs (b)(5)(vi)(A) through (G) of this section may be applied by analogy to the issuance of, exercise of, or payment upon the exercise of, a stock appreciation right.

(6) *Restricted property, section 402(b) trusts, and section 403(c) annuities*—(i) *In general.* If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested (as defined in §1.83–3(b)), or is includible in income solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c). In addition, for purposes of this paragraph (b), a right to compensation income that will be required to be included in income under section 402(b)(4)(A) is not a deferral of compensation.

(ii) *Promises to transfer property.* A plan under which a service provider obtains a legally binding right to receive property in a future taxable year where the property will be substantially vested (as defined in §1.83–3(b)) at the time of transfer of the property may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. A legally binding right to receive property in a future taxable year where the property will be substantially nonvested (as defined in §1.83–3(b)) at the time of transfer of the property will not provide for the deferral of compensation and, accordingly, will not constitute a nonqualified deferred compensation plan unless offered in conjunction with another legally binding right that constitutes a deferral of compensation.

(7) *Arrangements between partnerships and partners.* [Reserved]

(8) *Certain foreign plans*—(i) *Plans with respect to compensation covered by treaty or other international agreement.* A plan in which a service provider participates

does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the compensation under the plan would have been excluded from gross income for Federal income tax purposes under the provisions of any bilateral income tax convention or other bilateral or multilateral agreement to which the United States is a party if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture.

(ii) *Plans with respect to certain other compensation.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that compensation under the plan would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture, due to one of the following:

(A) The service provider was a nonresident alien at such time and the compensation would not have been includible in gross income under section 872.

(B) The service provider was a qualified individual (as defined in section 911(d)(1)) at such time, the compensation would have been foreign earned income within the meaning of section 911(b)(1) (without regard to section 911(b)(1)(B)(iv)) if paid at such time, and the amount of such compensation was equal to or less than the excess (if any) of the maximum exclusion amount under section 911(b)(2)(D) for such taxable year over the amount of foreign earned income actually excluded from gross income by such qualified individual for such taxable year under section 911(a)(1).

(C) The compensation would have been excludible from gross income under section 893.

(D) The compensation would have been excludible from gross income under section 931 or section 933.

(iii) *Tax equalization agreements.* A tax equalization agreement does not provide for a deferral of compensation if payments made under such tax equalization agreement are made no later than the end of the second taxable year of the service provider beginning after the taxable year of the service provider in which the service provider's U.S. Federal income tax return is required to be filed (including any extensions) for the year to which the compensation subject to the tax equalization payment relates, or, if later, the second taxable year of the service provider beginning after the latest such taxable year in which the service provider's foreign tax return or payment is required to be filed or made for the year to which the compensation subject to the tax equalization payment relates. Where such payments arise due to an audit, litigation or similar proceeding, the right to the payments will not be treated as resulting in a deferral of compensation if the payments are scheduled and made in accordance with the provisions of §1.409A–3(i)(1)(v) (timing of tax gross-up payments). For purposes of this paragraph (b)(8)(iii), the term *tax equalization agreement* refers to an agreement, method, program, or other arrangement that provides payments intended to compensate the service provider for some or all of the excess of the taxes actually imposed by a foreign jurisdiction on the compensation paid by the service recipient to the service provider over the taxes that would be imposed if the compensation were subject solely to United States Federal, state, and local income tax, or some or all of the excess of the United States Federal, state, and local income tax actually imposed on the compensation paid by the service to the service provider over the taxes that would be imposed if the compensation were subject solely to taxes in the foreign jurisdiction, provided that the payment made under such agreement, method, program, or other arrangement may not exceed such excess and the amount necessary to compensate for the additional taxes on the amount paid under the agreement, method, program, or other arrangement.

(iv) *Certain limited deferrals of a nonresident alien.* With respect to a nonresident alien, a foreign plan does not provide for a deferral of compensation if the amounts deferred under the foreign plan based upon services performed by the nonresident alien in the United States (including amounts deferred based upon service credits or compensation received due to services performed in the United States) do not exceed the applicable dollar amount under section 402(g)(1)(B) for the taxable year. If the amounts deferred under the foreign plan based upon the services performed by the nonresident alien in the United States exceed the applicable dollar amount, an amount of such deferrals equal to such amount is treated as not deferred under a nonqualified deferred compensation plan. For purposes of this paragraph (b)(8)(iv), the term *foreign plan* means a plan that, together with all substantially similar plans, is maintained by a service recipient for a substantial number of participants, substantially all of whom are nonresident aliens or resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)).

(v) *Additional foreign plans.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(vi) *Earnings.* Earnings on compensation excluded from the definition of deferral of compensation pursuant to this paragraph (b)(8) are also not treated as a deferral of compensation.

(9) *Separation pay plans*—(i) *In general.* A plan that otherwise provides for a deferral of compensation under this paragraph (b) does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation from service. However, paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section provide rules concerning the extent to which certain separation pay plans do not provide for the deferral of compensation. The exceptions contained in paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section may be used in combination, such that compensation under a plan that would be excepted under one of those paragraphs may be treated as excepted under another of those paragraphs, so that other compensation under a plan may be treated as excepted under the first of such paragraphs. Notwithstanding any other provision of this paragraph (b)(9), any payment or benefit, or entitlement to a payment or benefit, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a separate nonqualified deferred compensation plan constitutes a payment or a deferral of compensation under the separate nonqualified deferred compensation plan, and does not constitute a payment or deferral of compensation under a separation pay plan. If a service provider receives a payment at separation from service and also has a legally binding right to an amount of deferred compensation that would be forfeited upon the separation from service, whether the payment acts as an acceleration of vesting and substitute payment for the amount of deferred compensation forfeited, or whether the deferred compensation is treated as forfeited and the amount paid is treated as a separate payment of current compensation, is determined based on the facts and circumstances, provided that, where the separation from service is voluntary, it is presumed that the payment results from an acceleration of vesting followed by a payment of the deferred compensation that is subject to section 409A. Accordingly, any change in the payment schedule to accelerate or defer the payments would be subject to the rules of section 409A. The presumption that a right to a payment is not a new right, but is instead a right substituted for a pre-existing forfeited right, may be rebutted by demonstrating that the service provider would have obtained the right to the payment regardless of the forfeiture of the nonvested right. A factor indicating that the service provider would have obtained a right to a payment regardless of the forfeiture of the nonvested right is that the amount to which the service provider obtains a right is materially less than an amount

equal to the present value of the forfeited amount multiplied by a fraction, the numerator of which is the period of service the service provider actually completed, and the denominator of which is the full period of service the service provider would have been required to complete to receive the full amount of the payment. For example, where a service provider is entitled to a future payment only if the service provider completes three years of service and at the time of termination the service provider has completed one year of service, the presumption could be rebutted if the payment to the service provider is materially less than the present value of one-third of the nonvested amount. Another such factor is that the payment to the service provider is of a type customarily made to service providers who separate from service with the service recipient and do not forfeit nonvested rights to deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims).

(ii) *Collectively bargained separation pay plans.* A separation pay plan does not provide for a deferral of compensation to the extent the plan is a collectively bargained separation pay plan that provides for separation pay only upon an involuntary separation from service or pursuant to a window program. Only the portion of the separation pay plan attributable to employees covered by a bona fide collective bargaining agreement is considered to be provided under a collectively bargained separation pay plan. A collectively bargained separation pay plan is a separation pay plan that meets the following conditions:

(A) The separation pay plan is contained within an agreement that the Secretary of Labor determines to be a collective bargaining agreement.

(B) The separation pay provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and one or more employers, and the agreement between employee representatives and one or more employers satisfies section 7701(a)(46).

(C) The circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay to be provided under the agreement.

(iii) *Separation pay due to involuntary separation from service or participation in a window program.* A separation pay plan that is not described in paragraph (b)(9)(ii) of this section and that provides for separation pay only upon an involuntary separation from service (as defined in paragraph (n) of this section) or pursuant to a window program does not provide for a deferral of compensation to the extent that the separation pay, or portion of the separation pay, provided under the plan meets the following requirements:

(A) The separation pay (other than amounts described in paragraphs (b)(9)(iv) and (v) of this section) does not exceed two times the lesser of—

(*1*) The sum of the service provider's annualized compensation based upon the annual rate of pay for services provided to the service recipient for the taxable year of the service provider preceding the taxable year of the service provider in which the service provider has a separation from service with such service recipient (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service); or

(*2*) The maximum amount that may be taken into account under a qualified plan pursuant to section 401(a)(17) for the year in which the service provider has a separation from service.

(B) The plan provides that the separation pay described in paragraph (b)(9)(iii)(A) of this section must be paid no later than the last day of the second taxable year of the service provider following the taxable year of the service provider in which occurs the separation from service.

(iv) *Foreign separation pay plans.* A separation pay plan (including a plan providing payments upon a voluntary separation from service) does not provide for deferred compensation to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(v) *Reimbursements and certain other separation payments*—(A) *In general.* To the extent a separation pay plan (including a plan providing payments upon a voluntary separation from service) entitles a service provider to payment by the service recipient of reimbursements that are not otherwise excludible from gross income for expenses that the service provider could otherwise deduct under section 162 or section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient, such plan does not provide for a deferral of compensation to the extent such rights apply during a limited period of time (regardless of whether such rights extend beyond the limited period of time). For purposes of this paragraph (b)(9)(v)(A), the reimbursement of reasonable moving expenses includes the reimbursement of all or part of any loss the service provider actually incurs due to the sale of a primary residence in connection with a separation from service.

(B) *Medical benefits.* To the extent a separation pay plan (including a plan providing payments due to a voluntary separation from service) entitles a service provider to reimbursement by the service recipient of payments of medical expenses incurred and paid by the service provider but not reimbursed by a person other than the service recipient and allowable as a deduction under section 213 (disregarding the requirement of section 213(a) that the deduction is available only to the extent that such expenses exceed 7.5 percent of adjusted gross income), such plan does not provide for a deferral of compensation to the extent such rights apply during the period of time during which the service provider would be entitled (or would, but for such plan, be entitled) to continuation coverage under a group health plan of the service recipient under section 4980B (COBRA) if the service provider elected such coverage and paid the applicable premiums.

(C) *In-kind benefits and direct service recipient payments.* A service provider's entitlement to in-kind benefits from the service recipient, or a payment by the service recipient directly to the person providing the goods or services to the service provider, is treated as not providing for a deferral of compensation for purposes of this paragraph (b), if a right to reimbursement by the service recipient for a payment for such benefits, goods, or services by the service provider would not be treated as providing for a deferral of compensation under this paragraph (b)(9)(v).

(D) *Limited payments.* If not otherwise excluded, a taxpayer may treat a right or rights under a separation pay plan to a payment or payments as not providing for a deferral of compensation to the extent such payments in the aggregate do not exceed the applicable dollar amount under section 402(g)(1)(B) for the year of the separation from service.

(E) *Limited period of time.* For purposes of paragraphs (b)(9)(v)(A) and (C) of this section, a limited period of time in which expenses may be incurred, or in which in-kind benefits may be provided by the service recipient or a third party that the service recipient will pay, does not include periods beyond the last day of the second taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred, provided that the period during which the reimbursements for such expenses must be paid may not extend beyond the third taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred.

(vi) *Window programs—definition.* The term *window program* refers to a program established by a service recipient in connection with an impending separation from service to provide separation pay, where such program is made available by the service recipient for a limited period of time (no longer than 12 months) to service providers who separate from service during that period or to service providers who separate from service during that period under specified circumstances. A program will not be considered a window program if a service recipient establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(10) *Certain indemnification and liability insurance plans.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the plan provides (to the extent permissible under applicable law), for the indemnification of, or the purchase of an insurance policy providing for payments of, all or part of the expenses incurred or damages paid or payable by a service provider with respect to a bona fide claim against the service provider or service recipient, including amounts paid or payable by the service provider upon the settlement of a bona fide claim against the service provider or service recipient, where such claim is based on actions or failures to act by the service provider in his or her capacity as a service provider of the service recipient.

(11) *Legal settlements.* An agreement to which a service provider is a party does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the agreement provides for amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reimbursements or payments of reasonable attorneys fees or other reasonable expenses incurred by the service provider related to such bona fide legal claims, regardless of whether such settlements, awards, or reimbursement or payment of expenses pursuant to such claims are treated as compensation or wages for Federal tax purposes. Whether the execution of a waiver of any or all of such types of claims indicates that the amounts are paid as an award or settlement of an actual bona fide claim for damages under applicable law is determined based on the facts and circumstances. This paragraph (b)(11) does not apply to any deferred amounts that did not arise as a result of an actual bona fide claim for damages under applicable law, such as amounts that would have been deferred or paid regardless of the existence of such claim, even if such amounts are paid or modified as part of a settlement or award resolving an actual bona fide claim. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(12) *Certain educational benefits.* A plan in which a service provider participates does not provide for a deferral of compensation to the extent the plan provides for taxable educational benefits. For purposes of this paragraph (b)(12), the term *educational benefits* refers solely to benefits provided to a service provider, consisting solely of educational assistance for the education of the service provider, as defined in section 127(c) and the accompanying regulations, and does not refer to any benefits provided for the education of any other person, including any spouse, child, or other family member of the service provider.

(c) *Plan*—(1) *In general.* The term *plan* includes any agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method, program, or other arrangement may constitute a plan regardless of whether it is an employee benefit plan under section 3(3) of ERISA, as amended (29 U.S.C. 1002(3)). The requirements of section 409A are applied as if a separate plan or plans is maintained for each service provider. For purposes of determining the terms of a plan, general provisions of the plan that purport to nullify noncompliant plan terms, or to supply any specific plan terms required by this section, § 1.409A–2 or § 1.409A–3, are disregarded.

(2) *Plan aggregation rules*—(i) *In general*. Except as otherwise provided, the following rules apply with respect to the application of this section and §§ 1.409A–2 through 1.409A–6 to deferrals of compensation with respect to a service provider:

(A) All deferrals of compensation at the election of that service provider under all plans of the service recipient that are account balance plans, except to the extent that the plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph, the term *account balance plan* means—

(*1*) An agreement, method, program, or other arrangement that is an account balance plan as defined in § 31.3121(v)(2)–1(c)(1)(ii)(A) of this chapter, including mandatorily bifurcating the agreement, method, program, or other arrangement in accordance with the rules provided in § 31.3121(v)–1(c)(1)(iii)(B) of this chapter; or

(*2*) An agreement, method, program, or other arrangement that would be described in paragraph (c)(2)(i)(A)(*1*) of this section if the service provider were an employee.

(B) All deferrals of compensation other than at the election of that service provider, including deferrals reflecting matching by the service recipient with respect to amounts a service provider elects to defer, under all plans of the service recipient that are account balance plans, except to the extent the plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph (c)(2)(i)(B), the term ''account balance plan'' has the same meaning as provided in paragraph (c)(2)(i)(A) of this section.

(C) All deferrals of compensation with respect to that service provider under all plans of the service recipient that are nonaccount balance plans, except to the extent such plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph (c)(2)(i)(C), the term *nonaccount balance plan* means—

(*1*) An agreement, method, program, or other arrangement that is a nonaccount balance plan as defined in § 31.3121(v)(2)–1(c)(2)(i) of this chapter, including mandatorily bifurcating the agreement, method, program, or other arrangement in accordance with the rules provided in § 31.3121(v)–1(c)(1)(iii)(B) of this chapter; or

(*2*) An agreement, method, program, or other arrangement that would be described in paragraph (c)(2)(i)(C)(*1*) of this section if the service provider were an employee.

(D) All deferrals of compensation with respect to that service provider under all separation pay plans (as defined in paragraph (m) of this section) of the service recipient to the extent an amount deferred under the plans is not described in paragraph (c)(2)(i)(E) of this section and is payable solely upon an involuntary separation from service within the meaning of paragraph (n) of this section or as a result of participation in a window program, are treated as deferred under a single plan.

(E) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent such amounts deferred consist of rights to in-kind benefits or reimbursements of expenses, such as membership fees, or expenses related to aircraft or vehicle usage, to the extent that the right to the in-kind benefit or reimbursement, separately or in the aggregate, does not constitute a substantial portion of either the overall compensation earned by the service provider for performing services for the service recipient or the overall compensation received due to a separation from service, are treated as deferred under a single plan.

(F) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent that the taxation of such compensation is governed by §1.61–22 or §1.7872–15 (split-dollar life insurance arrangements), or the taxation of such compensation would be governed by §1.61–22 or §1.7872–15 but for the operation of §1.61–22(j) (effective date provisions), are treated as deferred under a single plan.

(G) All deferrals of compensation with respect to that service provider under all agreements, methods, programs, or other arrangements of the service recipient to the extent the deferrals under the agreements, methods, programs, or other arrangements are deferrals of amounts that would be treated as modified foreign earned income (meaning foreign earned income as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) if paid to the service provider at the time the amount is first deferred, and provided further that substantially all the participants in such agreements, methods, programs, or other arrangements and any substantially similar agreements, methods, programs, or other arrangements are nonresident aliens and that the service provider does not participate in a substantially identical agreement, method, program, or other arrangement that does not meet the requirements of this paragraph (c)(2)(i)(G) (a domestic arrangement), are treated as deferred under a single plan.

(H) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent such plans are stock rights (as defined in paragraph (l) of this section) subject to section 409A, are treated as deferred under a single plan.

(I) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent such plans are not described in paragraph (c)(2)(i)(A), (B), (C), (D), (E), (F), (G), or (H) of this section are treated as deferred under a single plan.

(ii) *Dual status.* Agreements, methods, programs, and other arrangements in which a service provider participates are not aggregated with other agreements, methods, programs, and other arrangements to the extent the service provider participates in one set of agreements, methods, programs, and other arrangements due to status as an employee of the service recipient (employee arrangements) and another set of agreements, methods, programs, and other arrangements due to status as an independent contractor of the service recipient (independent contractor arrangements). For example, where a service provider deferred amounts under an independent contractor arrangement while providing services as an independent contractor, and then becomes eligible for and defers amounts under a separate employee arrangement after being hired as an employee, the two arrangements will not be aggregated for purposes of this paragraph (c)(2). Where an employee also is a member of the board of directors of the service recipient (or a similar position with respect to a non-corporate service recipient), the arrangements under which the employee participates as a director (director arrangements) are not aggregated with employee arrangements, provided that the director arrangements are substantially similar to arrangements provided to service providers providing services only as directors (or similar positions with respect to non-corporate service recipients). For example, an employee director who participates in an employee arrangement and a director arrangement generally may treat the two arrangements as separate plans, provided that the director arrangement is substantially similar to arrangements providing benefits to non-employee directors. To the extent a plan in which an employee director participates is not substantially similar to arrangements in which non-employee directors participate, such plan is treated as an employee plan for purposes of this paragraph (c)(2). Director plans and independent contractor plans are aggregated for purposes of this paragraph (c)(2).

(3) *Establishment of plan*—(i) *In general*. A plan does not satisfy the requirements of section 409A and this section and §§1.409A–2 through 1.409A–3 and §§1.409A–5 through 1.409A–6, unless the plan is established and maintained by a service recipient in accordance with the requirements of this section, §§1.409A–2 through 1.409A–3 and §§1.409A–5 through 1.409A–6. For purposes of this paragraph (c)(3), a plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. The material terms of the plan may be set forth in writing in one or more documents. For purposes of this paragraph (c)(3)(i), a plan will be deemed to be set forth in writing if it is set forth in any other form that is approved by the Commissioner. The material terms of the plan include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time and form of payment. Notwithstanding the foregoing, a plan will be deemed to be established as of the date the participant obtains a legally binding right to a deferral of compensation, provided that the plan is otherwise established under the rules of this paragraph (c)(3)(i) by the end of the taxable year of the service provider in which the legally binding right arises, or with respect to an amount not payable in the year immediately following the taxable year of the service provider in which the legally binding right arises (the subsequent year), the 15th day of the third month of the subsequent year.

(ii) *Initial deferral election provisions*. If a plan provides a service provider or a service recipient with an initial deferral election, the plan satisfies the requirements of this paragraph (c)(3) if the plan sets forth in writing, on or before the date the applicable election is required to be irrevocable to satisfy the requirements of §1.409A–2(a), the conditions under which such election may be made.

(iii) *Subsequent deferral election provisions*. If a plan permits a subsequent deferral election described in §1.409A–2(b), the plan satisfies the requirements of this paragraph (c)(3) if the plan sets forth in writing, on or before the date the election is required to be irrevocable to meet the requirements of §1.409A–2(b), the conditions under which such election may be made.

(iv) *Payment accelerations*. Except as explicitly provided in §1.409A–3, a plan is not required to set forth in writing the conditions under which a payment may be accelerated if such acceleration is permitted under §1.409A–3(j)(4).

(v) *Six-month delay for specified employees*. A plan must provide that distributions to a specified employee may not be made before the date that is six months after the date of separation from service or, if earlier, the date of death (the six-month delay rule). The six-month delay rule, required for payments due to the separation from service of a specified employee, must be written in the plan. A plan does not fail to be established and maintained merely because it does not contain the six-month delay rule when the service provider who has a right to compensation deferred under such plan is not a specified employee. However, such provision must be set forth in writing on or before the date such service provider first becomes a specified employee. In general, this means the provision must be set forth in writing on or before the specified employee effective date (as defined in paragraph (i)(3) of this section) for the first list of specified employees that includes such service provider.

(vi) *Plan amendments*. In the case of an amendment that increases the amount deferred under a nonqualified deferred compensation plan, the plan is not considered established with respect to the additional amount deferred until the plan, as amended, is established in accordance with paragraph (c)(3)(i) of this section.

(vii) *Transition rule for written plan requirement*. For purposes of this paragraph (c)(3), a legally enforceable unwritten plan that was adopted and effective before December 31, 2007, is treated as established under this section as of the later of the date on which it was adopted or became effective, provided that the material terms of the plan are set forth in writing on or before December 31, 2007.

(viii) *Plan aggregation rules.* The plan aggregation rules of paragraph (c)(2)(i) of this section do not apply to the written plan requirements of this paragraph (c)(3). Accordingly, deferrals of compensation under an agreement, method, program, or other arrangement that fails to meet the requirements of section 409A solely due to a failure to meet the written plan requirements of this paragraph (c)(3) are not aggregated with deferrals of compensation under other agreements, methods, programs, or other arrangements that meet such requirements.

(d) *Substantial risk of forfeiture*—(1) *In general.* Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this paragraph (d), a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering). For purposes of this paragraph (d), if a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services. Except as provided with respect to certain transaction-based compensation under §1.409A–3(i)(5)(iv), the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. For this purpose, compensation that the service provider would receive for continuing to perform services regardless of whether the service provider elected to receive the amount that is subject to a substantial risk of forfeiture is not taken into account in determining whether the present value of the right to the amount subject to a substantial risk of forfeiture is materially greater than the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. But, for example, where a bonus plan provides an election between a cash payment or restricted stock units with a present value that is materially greater (disregarding the risk of forfeiture) than the present value of such cash payment and that will be forfeited absent continued services for a period of years, the right to the restricted stock units generally will be treated as subject to a substantial risk of forfeiture.

(2) *Stock rights.* A stock right is not subject to a substantial risk of forfeiture at the earlier of the first date the holder may exercise the stock right and receive cash or property that is substantially vested (as defined in §1.83–3(b)) or the first date that the stock right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture. Accordingly, a stock option that the service provider may exercise immediately and receive substantially vested stock is

not subject to a substantial risk of forfeiture, even if the stock option automatically terminates upon the service provider's separation from service.

(3) *Enforcement of forfeiture condition*—(i) *In general.* In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted by a service recipient to a service provider that owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient (where the service provider's ownership is determined with application of the attribution rules under section 318 if the service recipient is a corporation, or if the service recipient is an entity that is not a corporation, with application by analogy of the attribution rules under section 318), all relevant facts and circumstances will be taken into account in determining whether the probability of the service recipient enforcing such condition is substantial, including—

(A) The service provider's relationship to other equity holders and the extent of their control, potential control and possible loss of control of the service recipient;

(B) The position of the service provider in the service recipient and the extent to which the service provider is subordinate to other service providers;

(C) The service provider's relationship to the officers and directors of the service recipient (or similar positions with respect to a noncorporate service recipient);

(D) The person or persons who must approve the service provider's discharge; and

(E) Past actions of the service recipient in enforcing the restrictions.

(ii) *Examples.* The following examples illustrate the rules of paragraph (d)(3)(i) of this section:

Example 1. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation. If the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture.

Example 2. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider, who is president of the corporation, also owns 4 percent of the voting power of all the stock of a corporation. If the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(e) *Performance-based compensation*—(1) *In general.* The term *performance-based compensation* means compensation the amount of which, or the entitlement to which, is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 consecutive months. Organizational or individual performance criteria are considered preestablished if established in writing by not later than 90 days after the commencement of the period of service to which the criteria relates, provided that the outcome is substantially uncertain at the time the criteria are established. Performance-based compensation may include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Performance-based compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established. In addition, except as provided in paragraph (e)(3) of this section, compensation is not performance-based compensation merely because the amount of such compensation is determined by reference to the value of the service recipient or the stock of the service recipient. Where a portion of an amount of compensation would qualify as performance-based compensation if the portion were the sole amount available under the plan, that portion of the award will not fail to qualify as performance-based compensation if that portion is designated separately or otherwise separately identifiable under the terms of the plan, and the amount of each portion is determined independently of the other. Compensation may be performance-based compensation where the amount will be paid regardless of satisfaction of the performance criteria due to the service provider's death, disability, or a change in control event (as defined in §1.409A–3(i)(5)(i)), provided that a payment made under such circumstances without regard to the satisfaction of the performance criteria will not constitute performance-based compensation. For purposes of this paragraph (e)(1), a disability refers to any medically determinable physical or mental impairment resulting in the service provider's inability to perform the duties of his or her position or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months.

(2) *Payments based upon subjective performance criteria.* The term *performance-based compensation* includes payments based upon subjective performance criteria, provided that—

(i) The subjective performance criteria are bona fide and relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and

(ii) The determination that any subjective performance criteria have been met is not made by the participant service provider or a family member of the participant service provider (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or a person under the effective control of the participant service provider or such a family member, and no amount of the compensation of the person making such determination is effectively controlled in whole or in part by the service provider or such a family member.

(3) *Equity-based compensation.* Compensation is performance-based compensation if it is based solely on an increase in the value of the service recipient, or a share of stock in the service recipient, after the date of a grant or award. However, compensation payable for a service period that is equal to the value of a predetermined number of shares of stock, and is variable only to the extent that the value of such shares appreciates or depreciates, generally will not be performance-based compensation. Notwithstanding the foregoing, the attainment of a prescribed value for the service recipient (or a portion thereof), or a share of stock in the service recipient, may be used as a preestablished organizational criterion for purposes of providing performance-based compensation, provided that the other requirements of paragraph (e)(1) of this section are satisfied. In addition, an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is subject to a condition that would cause the award to otherwise qualify as performance-based compensation, such as a performance-based vesting condition. A provision that allows a service provider to defer compensation that would be realized upon the exercise of a stock right generally constitutes an additional deferral feature for purposes of the definition of a deferral of compensation under paragraph (b)(5) of this section.

(f) *Service provider*—(1) *In general.* The term *service provider* includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in section 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation (as defined in section 448(d)(2)), and noncorporate entity that would be a qualified personal service corporation if it were a corporation, for any taxable year in which such individual, corporation, subchapter S corporation, partnership, or other entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting. The term *service provider* generally includes a person who has separated from service (a former service provider).

(2) *Independent contractors*—(i) *In general.* Except as otherwise provided in paragraph (f)(2)(iv) of this section, section 409A does not apply to an amount deferred under a plan between a service provider and service recipient with respect to a particular trade or business in which the service provider participates, including earnings credited to such deferred amount, if during the service provider's taxable year in which the service provider obtains a legally binding right to the payment of the amount deferred each of the following applies:

(A) The service provider is actively engaged in the trade or business of providing services, other than as an employee or as a member of the board of directors of a corporation (or similar position with respect to an entity that is not a corporation).

(B) The service provider provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another (as defined in paragraph (f)(2)(ii) of this section).

(C) The service provider is not related to the service recipient, applying the definition of related person contained in paragraph (f)(2)(ii) of this section subject to the modification that the language "20 percent" is not used instead of "50 percent" each place "50 percent" appears in sections 267(b) and 707(b)(1).

(ii) *Related person.* For purposes of this paragraph (f)(2), a person is related to another person if the persons bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or the persons are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)). In addition, an individual is related to an entity if the individual is an officer of an entity that is a corporation, or holds a position substantially similar to an officer of a corporation with an entity that is not a corporation.

(iii) *Significant services.* Whether a service provider is providing significant services depends on the facts and circumstances of each case. However, for purposes of paragraph (f)(2)(i) of this section, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year, if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services. In addition, in the case of a service provider who has been providing services in a trade or business for a period of not less than three consecutive years, for purposes of paragraph (f)(2)(i) of this section, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year if in each of the prior three taxable years the revenues generated from the services provided to any service recipient or group of related service recipients during such prior taxable years did not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services and, at the time an amount is deferred, the service provider does not know or have reason to anticipate that the revenues generated from the services provided to any service recipient or group of related service recipients during the current year will exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services.

(iv) *Management services.* This paragraph (f)(2) does not apply to a service provider to the extent the service provider provides management services to a service recipient. For purposes of this paragraph (f)(2)(iv), the term *management services* means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or a real estate investment trust.

(v) *Services provided to related persons.* Section 409A does not apply to an amount deferred under a plan that is a bona fide agreement, method, program, or other arrangement between a service provider and a related service recipient arising in the ordinary course of a particular trade or business in which the service provider is engaged to the extent that—

(A) The service provider provides services to the service recipient as an independent contractor;

(B) During the service provider's taxable year in which the amount is deferred, the service provider qualifies for the safe harbor provided in paragraph (f)(2)(iii) of this section with respect to such trade or business; and

(C) Such agreement, method, program, or other arrangement and the practices thereunder (including billing and collection practices), are substantially similar to the agreements, methods, programs, or other arrangements and practices applicable to one or more unrelated service recipients to whom the service provider provides substantial services and that produce a majority of the total revenue that the service provider earns from the trade or business of providing such services during the taxable year.

(g) *Service recipient.* Except as otherwise specifically provided in these regulations, the term *service recipient* means the person for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under section 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under section 414(c) (employees of partnerships, proprietorships, etc., under common control). For example, if the service provider is an employee, the service recipient generally is the employer (including all persons treated as a single employer under section 414(b) or (c)). Notwithstanding the foregoing, section 409A applies to a plan that provides for the deferral of compensation, even if the payment of the compensation is not made by the person for whom services are performed.

(h) *Separation from service*—(1) *Employees*—(i) *In general.* An employee separates from service with the employer if the employee dies, retires, or otherwise has a termination of employment with the employer. However, for purposes of this paragraph (h)(1), the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract. For purposes of this paragraph (h)(1), a leave of absence constitutes a bona fide leave of absence only if there is a reasonable expectation that the employee will return to perform services for the employer. If the period of leave exceeds six months and the individual does not retain a right to reemployment under an applicable statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such six-month period. Notwithstanding the foregoing, where a leave of absence is due to any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months, where such impairment causes the employee to be unable to perform the duties of his or her position of employment or any substantially similar position of employment, a 29-month period of absence may be substituted for such six-month period.

(ii) *Termination of employment.* Whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer less than 36 months). Facts and circumstances to be considered in making this determination include, but are not limited to, whether the employee continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), whether similarly situated service providers have been treated consistently, and whether the employee is permitted, and realistically available, to perform services for other service recipients in the same line of business. An employee is presumed to have separated from service where the level of bona fide services performed decreases to a level equal to 20 percent or less of the average level of services performed by the employee during the immediately preceding 36-month period. An employee will be presumed not to have separated from service where the level of bona fide services performed continues at a level that is 50 percent or more of the average level of service performed by the employee during the immediately preceding 36-month period. No presumption applies to a decrease in the level of bona fide services performed to a level that is more than 20 percent and less than 50 percent of the average level of bona fide services performed during the immediately preceding 36-month period. The presumption is rebuttable by demonstrating that the employer and the employee reasonably anticipated that as of a certain date the level of bona fide services would be reduced permanently to a level less than or equal to 20 percent of the average level of bona fide services provided during the immediately preceding 36-month period or full period of services provided to the employer if the employee has been providing services to the service recipient for a period of less than 36 months (or that the level of bona fide services would not be so reduced). For example, an employee may demonstrate that the employer and employee reasonably anticipated that the employee would cease providing services, but that, after the original cessation of services, business circumstances such as termination of the employee's replacement caused the employee to return to employment. Although the employee's return to employment may cause the employee to be presumed to have continued in employment because the employee is providing services at a rate equal to the rate at which the employee was providing services before the termination of employment, the facts and circumstances in this case would demonstrate that at the time the employee originally ceased to provide services, the employee and the service recipient reasonably anticipated that the employee would not provide services in the future. Notwithstanding the foregoing provisions of this paragraph (h)(1)(ii), a plan may treat another level of reasonably anticipated permanent reduction in the level of bona fide services as a separation from service, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of bona fide services must be greater than 20 percent but less that 50 percent of the average level of bona fide services provided in the immediately preceding 36 months. The plan must specify the definition of separation from service on or before the date on which a separation from service is designated as a time of payment of the applicable amount deferred, and once designated, any change to the definition of separation from service with respect to such amount deferred will be subject to the rules regarding subsequent deferrals and the acceleration of payments. For purposes of this paragraph (h)(1)(ii), for periods during which an employee is on a paid bona fide leave of absence (as defined in paragraph (h)(1)(i) of this section) and has not otherwise terminated employment pursuant to paragraph (h)(1)(i) of this section, the employee is treated as providing bona fide services at a level equal to the level of services that the employee would have been required to perform to receive the compensation paid with respect to such leave of absence. Periods during which an employee is on an unpaid bona fide leave of absence (as defined in paragraph (h)(1)(i) of this section) and has not otherwise terminated employment pursuant to paragraph (h)(1)(i) of this section, are disregarded for purposes of this paragraph (h)(1)(ii) (including for purposes of determining the applicable 36-month (or shorter) period).

(2) *Independent contractors*—(i) *In general*. An independent contractor is considered to have a separation from service with the service recipient upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a service recipient is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to contract again for the services provided under the expired contract, and neither the service recipient nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a service recipient is considered to intend to contract again for the services provided under an expired contract if the service recipient's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule*. Notwithstanding paragraph (h)(2)(i) of this section, a plan is considered to satisfy the requirement described in §1.409A–3(a)(1) with respect to an amount payable upon a separation from service if, with respect to amounts payable to a service provider who is an independent contractor, the plan provides that—

(A) No amount will be paid to the service provider before a date at least 12 months after the day on which the contract expires under which the service provider performs services for the service recipient (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the service provider on that date will be paid to the service provider if, after the expiration of the contract (or contracts) and before that date, the service provider performs services for the service recipient as an independent contractor or an employee.

(3) *Definition of service recipient and employer*. For purposes of this paragraph (h), the term *service recipient* or *employer* means the service recipient as defined in paragraph (g) of this section, provided that in applying section 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), the language ''at least 50 percent'' is used instead of ''at least 80 percent'' each place it appears in section 1563(a)(1), (2), and (3), and in applying §1.414(c)–2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), ''at least 50 percent'' is used instead of ''at least 80 percent'' each place it appears in §1.414(c)–2. A plan may provide with respect to a deferral of compensation under the plan that in applying sections 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), another defined percentage greater than 50 percent, but not greater than 80 percent, is used instead of ''at least 80 percent'' at each place it appears in sections 1563(a)(1), (2), and (3), and in applying §1.414(c)–2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), another defined percentage greater than 50 percent, but not greater than 80 percent, is used instead of ''at least 80 percent'' at each place it appears in §1.414(c)–2. In addition, where the use of such definition of service recipient for purposes of determining a separation from service is based upon legitimate business criteria, the plan may provide that for purposes of a deferral of compensation under the plan

that in applying sections 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), the language ''at least 20 percent'' or another defined percentage not less than 20 percent but not greater than 50 percent is used instead of ''at least 80 percent'' at each place it appears in sections 1563(a)(1), (2), and (3), and in applying § 1.414(c)–2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), the language ''at least 20 percent'' or another defined percentage not less than 20 percent but not greater than 50 percent is used instead of ''at least 80 percent'' at each place it appears in § 1.414(c)–2. Where a definition of service recipient or employer other than the definition provided in the first sentence of this paragraph (h)(3) (the 50 percent standard) is used, the plan must designate in writing the alternate definition no later than the last date at which the time and form of payment of the applicable amount deferred must be elected in accordance with § 1.409A–2(a), and any change in the definition for such amounts deferred will constitute a change in the time and form of payment subject to the rules governing subsequent deferral elections under § 1.409A–2(b) and the acceleration of payments under § 1.409A–3(j).

(4) *Asset purchase transactions.* Where as part of a sale or other disposition of assets by one service recipient (seller) to an unrelated service recipient (buyer), a service provider of the seller would otherwise experience a separation from service with the seller, the seller and the buyer may retain the discretion to specify, and may specify, whether a service provider providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction has experienced a separation from service for purposes of this paragraph (h), provided that the asset purchase transaction results from bona fide, arm's length negotiations, all service providers providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any nonqualified deferred compensation plan, and such treatment is specified in writing no later than the closing date of the asset purchase transaction. For purposes of this paragraph (h)(4), references to a sale or other disposition of assets, or an asset purchase transaction, refer only to a transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business. For purposes of this paragraph (h)(4), whether a service recipient is related to another service recipient is determined under the rules provided in paragraph (f)(2)(ii) of this section.

(5) *Dual status.* If a service provider provides services both as an employee of a service recipient and as an independent contractor of a service recipient, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service. If a service provider ceases providing services as an independent contractor and begins providing services as an employee, or ceases providing services as an employee and begins providing services as an independent contractor, the service provider will not be considered to have a separation from service until the service provider has ceased providing services in both capacities. Notwithstanding the foregoing, if a service provider provides services both as an employee of a service recipient and a member of the board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as a director are not taken into account in determining whether the service provider has a separation from service as an employee for purposes of a nonqualified deferred compensation plan in which the service provider participates as an employee that is not aggregated with any plan in which the service provider participates as a director under paragraph (c)(2)(ii) of this section. In addition, if a service provider provides services both as an employee of a service recipient and a member of the

board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as an employee are not taken into account in determining whether the service provider has a separation from service as a director for purposes of a nonqualified deferred compensation plan in which the service provider participates as a director that is not aggregated with any plan in which the service provider participates as an employee under paragraph (c)(2)(ii) of this section.

(6) *Collectively bargained plans covering multiple employers.* Notwithstanding the foregoing provisions of this paragraph (h), to the extent a plan is established pursuant to a bona fide collective bargaining agreement covering services performed by employees for multiple employers, such plan may define a separation from service in a reasonable manner that treats the employee as not having separated from service during periods in which the employee is not providing services but is available to perform services covered by the collective bargaining agreement for one or more employers, provided that the definition also provides that the employee must be deemed to have separated from service at a specified date not later than the end of any period of at least 12 consecutive months during which the employee has not provided any services covered by the collective bargaining agreement to any participating employer. This paragraph (h)(6) applies only if the definition of separation from service provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and two or more employers, the agreement between employee representatives and such employers satisfies section 7701(a)(46), and the circumstances surrounding the agreement evidence good faith bargaining between adverse parties over such definition.

(i) *Specified employee*—(1) *In general.* The term *specified employee* means a service provider who, as of the date of the service provider's separation from service, is a key employee of a service recipient any stock of which is publicly traded on an established securities market or otherwise. For purposes of this paragraph (i)(1), a service provider is a key employee if the service provider meets the requirements of section 416(i)(1)(A)(i), (ii), or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)) at any time during the 12-month period ending on a specified employee identification date. If a service provider is a key employee as of a specified employee identification date, the service provider is treated as a key employee for purposes of this paragraph (i) for the entire 12-month period beginning on the specified employee effective date.

(2) *Definition of compensation.* For purposes of identifying a specified employee by applying the requirements of section 416(i)(1)(A)(i), (ii), and (iii), the definition of compensation under §1.415(c)–2(a) is used, applied as if the service recipient were not using any safe harbor provided in §1.415(c)–2(d), were not using any of the elective special timing rules provided in §1.415(c)–2(e), and were not using any of the elective special rules provided in §1.415(c)–2(g). Notwithstanding the foregoing, a service recipient may elect to use any available definition of compensation under section 415 and the regulations thereunder in accordance with the election requirements set forth in paragraph (i)(8) of this section, including any available safe harbor and any available election under the timing rules or special rules, provided that the definition is applied consistently to all employees of the service recipient for purposes of identifying specified employees. A service recipient may elect to use such an alternative definition regardless of whether another definition of compensation is being used for purposes of a qualified plan sponsored by the service recipient. However, once a list of specified employees has become effective, the service recipient cannot change the definition of compensation for purposes of identifying specified employees for the period with respect to which such list is effective.

(3) *Specified employee identification date.* Unless another date is designated in accordance with the requirements of this paragraph (i)(3) and paragraph (i)(8) of this section, the specified employee identification date is December

31. A service recipient may designate in accordance with the requirements of paragraph (i)(8) of this section any other date as the specified employee identification date, provided that a service recipient must use the same specified employee identification date with respect to all nonqualified deferred compensation plans, and any change to the specified employee identification date may not be effective for a period of at least 12 months. The service recipient may designate a specified employee identification date in each plan or in a separate document applicable to all plans, provided that the service recipient will not be treated as having designated a specified employee identification date before the designation is legally binding on the service recipient and all affected service providers. Any designation of a specified employee identification date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005, unless and until subsequently changed pursuant to this paragraph (i)(3).

(4) *Specified employee effective date.* Unless another date is designated in accordance with the requirements of this paragraph (i)(4) and paragraph (i)(8) of this section, the specified employee effective date is the first day of the fourth month following the specified employee identification date. A service recipient may designate in accordance with the requirements of paragraph (i)(8) of this section any date following the specified employee identification date as the specified employee effective date, provided that such date may not be later than the first day of the fourth month following the specified employee identification date, and provided further that a service recipient must use the same specified employee effective date with respect to all nonqualified deferred compensation plans, and any change to the specified employee effective date may not be effective for a period of at least 12 months. The service recipient may designate a specified employee effective date through inclusion in each plan document or through a separate document applicable to all plans, provided that the service recipient will not be treated as having designated a specified employee effective date on any date before the designation is legally binding on the service recipient and all affected service providers. Any designation of a specified employee effective date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005, unless and until subsequently changed pursuant to this paragraph (i)(4).

(5) *Alternative methods of satisfying the six-month delay rule.* A plan may provide, in accordance with the requirements of paragraph (i)(8) of this section, for an alternative method to identify service providers who will be subject to the six-month delay rule provided in section 409A(a)(2)(B)(i), provided that the alternative method is reasonably designed to include all specified employees (determined without respect to any available service recipient elections), the alternative method is an objectively determinable standard providing no direct or indirect election to any service provider regarding its application, and the alternative method results in either all service providers or no more than 200 service providers being identified in the class as of any date. Use of such an alternative method will not be treated as a change in the time and form of payment for purposes of § 1.409A–2(b) (the subsequent deferral rules), even if the service provider is not a specified employee when the payment is delayed.

(6) *Corporate transactions*—(i) *Mergers and acquisitions of public service recipients.* If as a result of a corporate transaction, two or more separate service recipients, more than one of which has stock outstanding that is publicly traded on an established securities market or otherwise immediately before the transaction, become one service recipient, any stock of which is publicly traded on an established securities market or otherwise immediately after the transaction (resulting public service recipient), the resulting public service recipient's next specified employee identification date and specified employee effective date following the corporate transaction are the specified employee identification date and specified employee effective date that

the acquiring service recipient would have been required to use absent such transaction. For this purpose, in the case of a corporate merger, the acquiring service recipient is the service recipient that included the surviving corporation in such merger, in the case of an acquisition by a corporation of the stock of another corporation, the acquiring service recipient is the service recipient that included the corporation that acquired such stock, and in all other cases, the surviving service recipient is determined on the basis of all of the facts and circumstances. For the period between the transaction and the next specified employee effective date, the list of specified employees of the resulting public service recipient is determined by combining the lists of specified employees of all service recipients participating in the transaction that were in effect at the date of the corporate transaction, ranking such specified employees in order of the amount of compensation used to determine each specified employee's status as a specified employee, and treating the top 50 of such specified employees, plus any employees described in section 416(i)(1)(ii) or section 416(i)(1)(iii) and the regulations thereunder (relating to 1-percent and 5-percent owners) who are not included in such top 50 specified employees, as specified employees for the period between the corporate transaction and the next specified employee effective date. Alternatively, the resulting service recipient may elect in accordance with the requirements of paragraph (i)(8) of this section to use any reasonable method to determine the specified employees of the resulting service recipient, including the use of an alternative method of compliance described in paragraph (i)(5) of this section, provided that such method is adopted no later than 90 days after the corporate transaction and applied prospectively from the date the method is adopted.

(ii) *Mergers and acquisitions of nonpublic service recipients.* If as part of a corporate transaction a service recipient that does not have outstanding stock that is publicly traded on an established securities market or otherwise immediately before the transaction (initial private service recipient), and a service recipient with stock outstanding that is publicly traded on an established securities market or otherwise immediately before the transaction (initial public service recipient), become a single service recipient having stock that is publicly traded on an established securities market or otherwise immediately after the transaction (resulting public service recipient), the resulting public service recipient's next specified employee identification date and specified employee effective date following the corporate transaction are the specified employee identification date and specified employee effective date that the initial public service recipient would have been required to use absent such transaction. For the period after the date of the corporate transaction and before the next specified employee effective date, the specified employees of the initial public service recipient immediately before the transaction continue to be the specified employees of the resulting public service recipient, and no service providers of the initial private service recipient are required to be treated as specified employees.

(iii) *Spinoffs.* If as part of a corporate transaction, a service recipient with stock outstanding that is publicly traded on an established securities market or otherwise immediately before the transaction (initial public service recipient), becomes two or more separate service recipients, each with stock outstanding that is publicly traded on an established securities market or otherwise immediately after the transaction (post-transaction public service recipients), the next specified employee identification date of each of the post-transaction public service recipients is the specified employee identification date that the initial public service recipient would have been required to use absent such transaction. For the period after the date of the corporate transaction and before the next specified employee effective date, the specified employees of the initial public service recipient immediately before the transaction continue to be the specified employees of the post-transaction public service recipients.

(iv) *Public offerings and other corporate transactions.* If as part of an initial public offering or corporate transaction not described in paragraph (i)(6)(ii) or (iii) of this section, a service recipient with no outstanding stock that is publicly traded on an established securities market or otherwise immediately before such offering or other transaction (initial private service recipient), becomes one or more service recipients with stock outstanding that is publicly traded on an established securities market or otherwise immediately after such offering or other transaction (post-transaction public service recipient), each post-transaction public service recipient has a specified employee identification date of December 31 and a specified employee effective date of April 1, effective retroactively to the December 31 and April 1 next preceding the offering or other transaction for purposes of identifying the specified employees between the corporation transaction and the next December 31. Alternatively, a post-transaction public service recipient may elect in accordance with the requirements of paragraph (i)(8) of this section, a specified employee identification date and specified employee effective date on or before the date of the offering or other transaction. If a public service recipient makes such an election, for the period after the offering or other transaction and before the next specified employee effective date, the specified employees of the post-transaction public service recipient consist of the service providers that at the time of the offering or other transaction would have been classified as specified employees of the initial private service recipient, had the initial private service recipient elected the same specified employee identification date and specified employee effective date as selected by the post-transaction public service recipient, and had such initial private service recipient had stock publicly traded on an established securities market or otherwise as of the specified employee identification date preceding the transaction.

(v) *Alternative methods of compliance.* For purposes of this paragraph (i)(6), references to specified employees as of a corporate transaction or offering include any specified employees identified through the use of an alternative method described in paragraph (i)(5) of this section, where the use of such alternative method was established and effective at the time of the corporate transaction or offering.

(7) *Nonresident alien employees.* For purposes of determining whether an employee meets the requirements of section 416(i)(1)(A)(i), (ii), or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)), and therefore is a key employee, the incorporation of the rules of §1.415(c)–2(g)(5) regarding the definition of compensation applies. Accordingly, the rule of §1.415(c)–2(g)(5)(i), generally requiring the treatment as compensation of certain compensation excludible from an employee's gross income due to the location of the services or the identity of the employer, applies. In addition, a service recipient may elect in accordance with paragraph (i)(8) of this section to apply the rule of §1.415(c)–2(g)(5)(ii) to not treat as compensation certain compensation excludible from an employee's gross income on account of the location of the services or the identity of the employer that is not effectively connected with the conduct of a trade or business within the United States. A service recipient may elect to apply the rule of §1.415–2(g)(5)(ii) regardless of whether the service recipient has elected to apply the rule to a qualified plan sponsored by the service recipient; however, once a list of specified employees has become effective, any election of the rule for that period may not be changed. Notwithstanding the foregoing, any election of the rule made before January 1, 2008, may be effective with respect to any specified employee identification date on or before December 31, 2007.

(8) *Elections affecting the identification of specified employees.* The elections described in paragraphs (i)(2) through (7) of this section are effective only as of the date that all necessary corporate action has been taken to make such elections binding for purposes of all affected nonqualified deferred compensation plans in which the service providers of the service recipient that would become a specified employee due

to the application of such election participate. Where a taxpayer attempts to make an election under paragraph (i)(2), (3), (4), (5), (6), or (7) of this section but such election is not binding on all the affected nonqualified deferred compensation plans and applied consistently to all such service providers, the election is not effective and the rule under paragraph (i)(2), (3), (4), (5), (6), or (7) of this section, as applicable, that would apply absent an election is applicable for identifying specified employees.

(j) *Nonresident alien.* (1) Except as provided in paragraph (j)(2) of this section, the term *nonresident alien* means an individual who is—

(i) A nonresident alien within the meaning of section 7701(b)(1)(B); or

(ii) A dual resident taxpayer within the meaning of §301.7701(b)–7(a)(1) of this chapter with respect to any taxable year in which such individual is treated as a nonresident alien for purposes of computing the individual's U.S. income tax liability.

(2) The term *nonresident alien* does not include—

(i) A nonresident alien with respect to whom an election is in effect for the taxable year under section 6013(g) to be treated as a resident of the United States;

(ii) A former citizen or long-term resident (within the meaning of section 877(e)(2)) who expatriated after June 3, 2004, and has not complied with the requirements of section 7701(n); or

(iii) An individual who is treated as a citizen or resident of the United States for the taxable year under section 877(g).

(k) *Established securities market.* The term *established securities market* means an established securities market within the meaning of §1.897–1(m).

(l) *Stock right.* The term *stock right* means a stock option (other than an incentive stock option described in section 422 or an option granted pursuant to an employee stock purchase plan described in section 423) or a stock appreciation right.

(m) *Separation pay plan.* The term *separation pay plan* means any plan that provides separation pay or, where a plan provides both amounts that are separation pay and that are not separation pay, that portion of the plan that provides separation pay. The term *separation pay* means any deferral of compensation (before the application of the exclusions from the definition of a deferral of compensation set forth in paragraph (b)(9) of this section) that will not be paid under any circumstances unless the service provider has had a separation from service, whether voluntary or involuntary, including payments in the form of reimbursements of expenses incurred, and the provision of in-kind benefits. A deferral of compensation that the service provider may receive without a separation from service does not become separation pay merely because the service provider elects to receive or receives the payment after or upon a separation from service. A deferral of compensation does not fail to be separation pay merely because the payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirements. Notwithstanding the foregoing, any amount, or entitlement to any amount, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a nonqualified deferred compensation plan constitutes a payment of compensation or deferral of compensation under such nonqualified deferred compensation plan.

(n) *Involuntary separation from service*—(1) *In general.* An involuntary separation from service means a separation from service due to the independent exercise of the unilateral authority of the service recipient to terminate the service provider's services, other than due to the service provider's implicit or explicit request, where the service provider was willing and able to continue performing services. An involuntary separation from service may include the service recipient's failure to renew a contract at the time such contract expires, provided that the service provider was willing and able to execute a new contract providing terms and conditions substantially similar to those in the expiring contract and to continue providing such services. The determination of whether a separation from service is involuntary is based on all the facts and circumstances. Any characterization of the separation from service as voluntary or involuntary by the service provider and the service recipient in the documentation of the separation from service is presumed to properly characterize the nature of the separation from service. However, the presumption may be rebutted where the facts and circumstances indicate otherwise. For example, if a separation from service is designated as a voluntary separation from service or resignation, but the facts and circumstances indicate that absent such voluntary separation from service the service recipient would have terminated the service provider's services, and that the service provider had knowledge that the service provider would be so terminated, the separation from service is involuntary.

(2) *Separations from service for good reason*—(i) *In general*. Notwithstanding paragraph (n)(1) of this section, a service provider's voluntary separation from service will be treated for purposes of this section and §§1.409A–2 through 1.409A–6 as an involuntary separation from service if the separation from service occurs under certain limited bona fide conditions, where the avoidance of the requirements of section 409A is not a purpose of the inclusion of these conditions in the plan or of the actions by the service recipient in connection with the satisfaction of these conditions, and a voluntary separation from service under such conditions effectively constitutes an involuntary separation from service. Generally such conditions will be prespecified under an agreement to provide compensation upon a separation from service for good reason. Such a good reason (or a similar condition) must be defined to require actions taken by the service recipient resulting in a material negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing such services. Other factors taken into account in determining whether a separation from service for good reason effectively constitutes an involuntary separation from service include the extent to which the payments upon a separation from service for good reason are in the same amount and are to be made at the same time and in the same form as payments available upon an actual involuntary separation from service, and whether the service provider is required to give the service recipient notice of the existence of the condition that would result in treatment as a separation from service for good reason and a reasonable opportunity to remedy the condition.

(ii) *Safe harbor*. For purposes of this section and §§1.409A–2 through 1.409A–6, if a plan provides that a voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain express conditions, a separation from service satisfying the conditions set forth in the plan will be treated as an involuntary separation from the service if the necessary conditions (or set of conditions) require the following:

(A) The separation from service must occur during a pre-determined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the service provider:

(*1*) A material diminution in the service provider's base compensation.

(*2*) A material diminution in the service provider's authority, duties, or responsibilities.

(*3*) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation).

(*4*) A material diminution in the budget over which the service provider retains authority.

(*5*) A material change in the geographic location at which the service provider must perform the services.

(*6*) Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.

(B) The amount, time, and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment payable due to an actual involuntary separation from service, to the extent such a right exists.

(C) The service provider must be required to provide notice to the service recipient of the existence of the condition described in paragraph (n)(2)(ii)(A) of this section within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the service recipient must be provided a period of at least 30 days during which it may remedy the condition and not be required to pay the amount.

(3) *Special rule for certain collectively bargained plans.* Notwithstanding the foregoing, for purposes of this paragraph (n), to the extent a plan is subject to a bona fide collective bargaining agreement covering services performed for multiple employers under which an employee must separate from service with all such employers in order to receive a payment, such plan may use any reasonable definition of involuntary separation from service, provided that such definition is consistent with any definition of a separation from service adopted under paragraph (h)(6) of this section, and provided further that the definition of an involuntary separation from service provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and two or more employers, the agreement between employee representatives and such employers satisfies section 7701(a)(46), and the circumstances surrounding the agreement evidence good faith bargaining between adverse parties over such definition.

(o) *Earnings.* Whether a deferred amount constitutes earnings on an amount deferred, or actual or notional income attributable to an amount deferred, is determined under the principles defining income attributable to the amount taken into account under §31.3121(v)(2)–1(d)(2) of this chapter. Accordingly, with respect to an account balance plan, earnings on an amount deferred generally include an amount credited on behalf of a service provider under the terms of the plan that reflects a rate of return that does not exceed either the rate of return on a predetermined actual investment or, if the income does not reflect the rate of return on a predetermined actual investment, a reasonable rate of interest. With respect to nonaccount balance plans, earnings on an amount deferred generally include an increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amount deferred (determined as of the date such amount was deferred), but only if the amount deferred was determined using reasonable actuarial assumptions and methods. A right to earnings on an amount deferred generally is treated as a right to a deferral of compensation for purposes of this section and §§1.409A–2 through 1.409A–6. However, for purposes of any provision of this section and §§1.409A–2 through 1.409A–6 referring to earnings on deferred compensation (or similar terms), the use of an unreasonable rate of return, or unreasonable actuarial assumptions and methods, generally will result in the treatment of some or all of such a right to deferred compensation as a right only to deferred compensation, and not a right to earnings on deferred compensation, so that the provision will not be applicable. With respect to plans that are neither account balance plans nor nonaccount balance plans, these rules apply by analogy.

(p) *In-kind benefits.* The term *in-kind benefits* refers to services provided to or on behalf of a service provider, such as financial planning services, or tangible personal or real property made available for use by or on behalf of the service provider, such as the use of an aircraft or vehicle, and does not refer to a transfer of property within the meaning of section 83 and the regulations thereunder, or a promise to transfer, or an option to purchase or receive, property in the future.

(q) *Application of definitions and rules.* The definitions and rules set forth in paragraphs (a) through (p) of this section apply for purposes of section 409A, this section, and §§1.409A–2 through 1.409A–6.

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§ 1.409A–2 Deferral elections.

(a) *Initial elections as to the time and form of payment*—(1) *In general.* A plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of section 409A(a)(4)(B) only if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made and becomes irrevocable not later than the latest date permitted in this paragraph (a). An election will not be considered to be revocable merely because the service provider or service recipient may make an election to change the time and form of payment pursuant to paragraph (b) of this section, or the service recipient may accelerate the time of payment pursuant to §1.409A–3(j)(4) (exceptions to prohibition on accelerated payments). Whether a plan provides a service provider an opportunity to elect the time or form of payment of compensation is determined based upon all the facts and circumstances surrounding the determination of the time and form of payment of the compensation. For purposes of this section, an election to defer includes an election as to the time of the payment, an election as to the form of the payment or an election as to both the time and the form of the payment, but does not include an election as to the medium of payment (for example, an election between a payment of cash or a payment of property). Except as otherwise expressly provided in this section, an election will not be considered made until such election becomes irrevocable under the terms of the applicable plan. Accordingly, a plan may provide that an election to defer may be changed at any time before the last permissible date for making such an election. Where a plan provides the service provider a right to make an initial deferral election, and further provides that the election remains in effect until terminated or modified by the service provider, the election will be treated as made as of the date such election becomes irrevocable as to compensation for services performed during the relevant service year. For example, where a plan provides that a service provider's election to defer a set percentage will remain in effect until changed or revoked, but that as of each December 31 the election becomes irrevocable with respect to salary payable in connection with services performed in the immediately following year, the initial deferral election with respect to salary payable with respect to services performed in the immediately following year will be deemed to have been made as of the December 31 upon which the election became irrevocable. For purposes of this paragraph (a), the reference to a service period or a performance period refers to the period of service for which the right to the compensation arises, and may include periods before the grant of a legally binding right to the compensation. For example, where a service recipient grants a bonus based upon services performed in the calendar year 2010, but retains the discretion to rescind the bonus until 2011 such that the promise of the bonus is not a legally binding right, the period of service or performance period to which the compensation relates is the calendar year 2010.

(2) *Service recipient elections.* A plan that provides for a deferral of compensation for services performed during a service provider's taxable year that does not provide the service provider with an opportunity to elect the time or form of payment of such compensation must designate the time and form of payment by no later than the later of the time the service provider first has a legally binding right to the compensation or, if later, the time the service provider would be required under this section to make such an election if the service provider were provided such an election. Such designation is treated as an initial deferral election for purposes of this section. Where a plan permits a service recipient to exercise discretion to disregard a service provider election as to the time or form of a payment, any service provider election that is subject to such discretion will be treated

as revocable so long as such discretion may be exercised.

(3) *General rule.* A plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of section 409A(a)(4)(B) if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of the service provider's taxable year next preceding the service year.

(4) *Initial deferral election with respect to short-term deferrals.* If a service provider has a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election, would be treated as a short-term deferral within the meaning of §1.409A–1(b)(4), an election to defer such compensation may be made in accordance with the requirements of paragraph (b) of this section, applied as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses. Notwithstanding the requirements of paragraph (b) of this section, such a deferral election may provide that the deferred amounts will be payable upon a change in control event (as defined in §1.409A–3(i)(5)) without regard to the five-year additional deferral requirement in paragraph (b) of this section.

(5) *Initial deferral election with respect to certain forfeitable rights.* If a service provider has a legally binding right to a payment in a subsequent year that is subject to a condition requiring the service provider to continue to provide services for a period of at least 12 months from the date the service provider obtains the legally binding right to avoid forfeiture of the payment, an election to defer such compensation may be made on or before the 30th day after the service provider obtains the legally binding right to the compensation, provided that the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse. For purposes of this paragraph (a)(5), a condition will not be treated as failing to require the service provider to continue to provide services for a period of at least 12 months from the date the service provider obtains the legally binding right merely because the condition immediately lapses upon the death or disability (as defined in §1.409A–3(i)(4)) of the service provider, or upon a change in control event (as defined in §1.409A–3(i)(5)), provided that if death, disability, or a change in control event occurs and the condition lapses before the end of such 12-month period, a deferral election may be given effect only if the deferral election is permitted under this section without regard to this paragraph (a)(5).

(6) *Initial deferral election with respect to fiscal year compensation.* In the case of a service recipient with a taxable year that is not the same as the taxable year of the service provider, a plan may provide that fiscal year compensation may be deferred at the service provider's election if the election to defer such compensation is made not later than the close of the service recipient's taxable year immediately preceding the first taxable year of the service recipient in which any services are performed for which such compensation is payable. For purposes of this paragraph (a)(6), the term *fiscal year compensation* means compensation relating to a period of service coextensive with one or more consecutive taxable years of the service recipient, of which no amount is paid or payable during the service recipient's taxable year or years constituting the period of service. For example, fiscal year compensation generally would include a bonus to an individual employee with a calendar year taxable year that is based on a service period consisting of the service recipient's two consecutive taxable years ending September 30, 2011, where the amount will be paid after the end of the second of such taxable years, but would not include either a bonus based on a service period consisting of one or more calendar years or salary that would otherwise be paid during such taxable years of the service recipient.

(7) *First year of eligibility*—(i) *In general.* In the case of the first year in which a service provider becomes eligible to participate in a plan, the service provider may make an initial deferral election within 30 days after the date

the service provider becomes eligible to participate in such plan, with respect to compensation paid for services to be performed after the election. In the case of a plan that does not provide for service provider elections with respect to the time or form of a payment, the time and form of the payment must be specified on or before the date that is 30 days after the date the service provider first becomes eligible to participate in such plan. For compensation that is earned based upon a specified performance period (for example, an annual bonus), where a deferral election is made in the first year of eligibility but after the beginning of the performance period, the election must apply only to the compensation paid for services performed after the election. For this purpose, an election will be deemed to apply to compensation paid for services performed after the election if the election applies to no more than an amount equal to the total amount of the compensation for the performance period multiplied by the ratio of the number of days remaining in the performance period after the election over the total number of days in the performance period.

(ii) *Eligibility to participate.* For purposes of this paragraph (a)(7), a service provider is eligible to participate in a plan at any time during which, under the plan's terms and without further amendment or action by the service recipient, the service provider is eligible to accrue an amount of deferred compensation under the plan other than earnings on amounts previously deferred, even if the service provider has elected not to accrue (or has not elected to accrue) an amount of deferred compensation. Where a service provider has been paid all amounts deferred under a plan, and on and before the date of the last payment was not eligible to continue (or to elect to continue) to participate in the plan for periods after the last payment (other than through an election of a different time and form of payment with respect to the amounts paid), the service provider may be treated as initially eligible to participate in a plan as of the first date following such payment that the service provider becomes eligible to accrue an additional amount of deferred compensation. Where a service provider has ceased being eligible to participate in a plan (other than the accrual of earnings), regardless of whether all amounts deferred under the plan have been paid, and subsequently becomes eligible to participate in the plan again, the service provider may be treated as being initially eligible to participate in the plan if the service provider had not been eligible to participate in the plan (other than the accrual of earnings) at any time during the 24-month period ending on the date the service provider again becomes eligible to participate in the plan.

(iii) *Application to excess benefit plans.* For purposes of this paragraph (a)(7), a service provider is treated as initially eligible to participate in an excess benefit plan as of the first day of the service provider's taxable year immediately following the first year the service provider accrues a benefit under the excess benefit plan; and any election made within 30 days following such date is treated as applying to benefits accrued under such plan for services performed before the election. For purposes of this paragraph (a)(7), the term *excess benefit plan* means all nonqualified deferred compensation plans in which a service provider participates, to the extent such plans do not provide for an election between current compensation (including a short-term deferral) and deferred compensation and solely provide deferred compensation equal to the excess of the benefits the service provider would have accrued under a qualified employer plan (as defined in §1.409A–1(a)(2)) in which the service provider also participates, in the absence of one or more of the limits incorporated into the plan to reflect one or more of the limits on contributions or benefits applicable to the qualified employer plan under the Internal Revenue Code, over the benefits the service provider actually accrues under the qualified employer plan. For purposes of this paragraph (a)(7), once a service provider has accrued a benefit or deferred compensation under a plan in any year, the service provider will not become eligible for an initial deferral election based upon an accrual or deferral under an excess benefit plan in a subsequent year, even if the benefit or deferred compensation accrued in a previous year is forfeited or eliminated.

(8) *Initial deferral election with respect to performance-based compensation.* In the case of any performance-based compensation (as defined in §1.409A–1(e)), an initial deferral election may be made with respect to such performance-based compensation on or before the date that is six months before the end of the performance period, provided that the service provider performs services continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date an election is made under this paragraph (a)(8), and provided further that in no event may an election to defer performance-based compensation be made after such compensation has become readily ascertainable. For purposes of this paragraph (a)(8), if the performance-based compensation is a specified or calculable amount, the compensation is readily ascertainable if and when the amount is first substantially certain to be paid. If the performance-based compensation is not a specified or calculable amount because, for example, the amount may vary based upon the level of performance, the compensation, or any portion of the compensation, is readily ascertainable when the amount is first both calculable and substantially certain to be paid. For this purpose, the performance-based compensation is bifurcated between the portion that is readily ascertainable and the amount that is not readily ascertainable. Accordingly, in general any minimum amount that is both calculable and substantially certain to be paid will be treated as readily ascertainable.

(9) *Nonqualified deferred compensation plans linked to qualified employer plans or certain other arrangements.* If a nonqualified deferred compensation plan provides that the amount deferred under the plan is determined under the formula for determining benefits under a qualified employer plan (as defined in §1.409A–1(a)(2)) or a broad-based foreign retirement plan (as defined in §1.409A–1(a)(3)(v)) maintained by the service recipient but applied without regard to one or more limitations applicable to the qualified employer plan under the Internal Revenue Code or to the broad-based foreign retirement plan under other applicable law, or that the amount deferred under the nonqualified deferred compensation plan is determined as an amount offset by some or all of the benefits provided under the qualified employer plan or the broad-based foreign retirement plan, an increase in amounts deferred under the nonqualified deferred compensation plan that results directly from the operation of the qualified employer plan or broad-based foreign retirement plan (other than service provider actions described in paragraphs (a)(9)(iii) and (iv) of this section) including changes in benefit limitations applicable to the qualified employer plan or the broad-based foreign retirement plan under the Internal Revenue Code or other applicable law does not constitute a deferral election under the nonqualified deferred compensation plan, provided that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan, and provided further that such change in the amounts deferred under the nonqualified deferred compensation plan does not exceed that change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable. In addition, with respect to such a nonqualified deferred compensation plan, the following actions or failures to act will not constitute a deferral election under the nonqualified deferred compensation plan even if in accordance with the terms of the nonqualified deferred compensation plan, the actions or inactions result in an increase in the amounts deferred under the plan, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan and provided further that with respect to actions or inactions described in paragraphs (a)(9)(i) or (ii), the change in the amount deferred under the nonqualified deferred compensation plan does not exceed the change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable:

(i) A service provider's action or inaction under the qualified employer plan or broad-based foreign retirement plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan or broad-based foreign retirement plan.

(ii) The amendment of a qualified employer plan or broad-based foreign retirement plan to add or remove a subsidized benefit or an ancillary benefit, or to freeze or limit future accruals of benefits under the qualified plan or freeze or limit future accruals of benefits or reduce existing benefits under the broad-based foreign retirement plan.

(iii) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), including an adjustment to a deferral election under such qualified employer plan, provided that for any given taxable year, the service provider's action or inaction does not result in an increase in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates (other than amounts described in paragraph (a)(9)(iv) of this section) in excess of the limit with respect to elective deferrals under section 402(g)(1)(A), (B), and (C) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), and after-tax contributions by the service provider to a qualified employer plan that provides for such contributions, that affects the amounts that are credited under one or more nonqualified deferred compensation plans as matching amounts or other similar amounts contingent on such elective deferrals, employee pre-tax contributions, or after-tax contributions, provided that the total of such matching or contingent amounts, as applicable, never exceeds 100 percent of the matching or contingent amounts that would be provided under the qualified employer plan absent any plan-based restrictions that reflect limits on qualified plan contributions under the Internal Revenue Code.

(10) *Changes in elections under a cafeteria plan*. A change in an election under a cafeteria plan does not constitute a deferral election with respect to an amount deferred under a nonqualified deferred compensation plan to the extent that the change in the amount deferred under the nonqualified deferred compensation plan results solely from the application of the change in amount eligible to be treated as compensation under the terms of the nonqualified deferred compensation plan resulting from the election change under the cafeteria plan, to a benefit formula under the nonqualified deferred compensation plan based upon the service provider's eligible compensation, and only to the extent that such change applies in the same manner as any other increase or decrease in compensation would apply to such benefit formula.

(11) *Initial deferral election with respect to certain separation pay*. In the case of separation pay (as defined in §1.409A–1(m)), where such separation pay is the subject of bona fide, arm's length negotiations at the time of the separation from service, an initial deferral election may be made at any time up to the time the service provider obtains a legally binding right to the payment. This paragraph (a)(11) does not apply to any separation pay to which the service provider obtained a legally binding right before the negotiations at the time of the separation from service, including a right to a payment subject to a condition such as that the service provider separate from service other than for cause. In the case of separation pay due to participation in a window program (as defined in §1.409A–1(b)(9)(vi)), an initial deferral election may be made at any time before the time the election to participate in the window program becomes irrevocable.

(12) *Initial deferral election with respect to certain commissions*—(i) *Sales commission compensation*. For purposes of this paragraph (a), a service provider earning sales commission compensation is treated as providing the services to

which such compensation relates only in the service provider's taxable year in which the customer remits payment to the service recipient or, if applied consistently to all similarly situated service providers, the service provider's taxable year in which the sale occurs. For purposes of this paragraph (a)(12), the term *sales commission compensation* means compensation or portions of compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient consist of the direct sale of a product or service to an unrelated customer, the compensation paid by the service recipient to the service provider consists of either a portion of the purchase price for the product or service or an amount substantially all of which is calculated by reference to the volume of sales, and payment of the compensation is either contingent upon the service recipient receiving payment from an unrelated customer for the product or services or, if applied consistently to all similarly situated service providers, is contingent upon the closing of the sales transaction and such other requirements as may be specified by the service recipient before the closing of the sales transaction. For this purpose, a customer is treated as an unrelated customer only if the customer is not related to either the service provider or the service recipient. A person is treated as related to another person if the person would be treated as related to the other person under §1.409A–1(f)(2)(ii) or the person would be treated as providing management services to the other person under §1.409A–1(f)(2)(iv).

(ii) *Investment commission compensation.* For purposes of this paragraph (a), a service provider earning investment commission compensation is treated as providing the services to which such compensation relates over the 12 months preceding the date as of which the overall value of the assets or asset accounts is determined for purposes of the calculation of the investment commission compensation. For purposes of this paragraph (a)(12), the term *investment commission compensation* means the compensation or the portion of compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient to which such compensation relates consists of sales of financial products or other direct customer services to an unrelated customer with respect to customer assets or customer asset accounts, the customer retains the right to terminate the customer relationship and may move or liquidate the assets or asset accounts without undue delay (which may be subject to a reasonable notice period), such compensation consists of a portion of the value of the overall assets or asset account balance, an amount substantially all of which is calculated by reference to the increase in the value of the overall assets or account balance during a specified period, or both, and the value of the overall assets or account balance and investment commission compensation is determined at least annually. For this purpose, a customer is treated as an unrelated customer only if the customer is not related to either the service provider or the service recipient. A person is treated as related to another person if the person would be treated as related to the other person under §1.409A–1(f)(2)(ii) or the person would be treated as providing management services to the other person under §1.409A–1(f)(2)(iv).

(iii) *Commission compensation and related persons.* The rules of paragraphs (a)(12)(i) and (ii) of this section apply to sales commission compensation and investment commission compensation involving a related customer, provided that substantial sales from which commission compensation arises are made, or substantial services from which commission compensation arises are provided, to unrelated customers by the service recipient, the sales and service arrangement and the commission arrangement with respect to the related customer are bona fide, arise from the service recipient's ordinary course of business, and are substantially the same, both in terms and in practice, as the terms and practices applicable to unrelated customers (as defined in such paragraphs) to which individually or in the aggregate substantial sales are made or substantial services provided by the service recipient.

(13) *Initial deferral election with respect to compensation paid for final payroll period*—(i) *In general.* Unless a plan provides otherwise, compensation payable after the last day of the service provider's taxable year solely for services performed during the final payroll period described in section 3401(b) containing the last day of the service provider's taxable year or, with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), where such amount is payable pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), is treated as compensation for services performed in the subsequent taxable year in which the payment is made. The preceding sentence does not apply to any compensation paid during such period for services performed during any period other than such final payroll period, such as a payment of an annual bonus. Any amendment of a plan after December 31, 2007, to add a provision providing for a differing treatment of such compensation may not be effective for 12 months from the date the amendment is executed and enacted.

(ii) *Transition rule.* For purposes of this paragraph (a)(13), a plan that was adopted and effective before December 31, 2007, whether written or unwritten, will be treated as designating such compensation for services performed in the taxable year in which the payroll period ends, unless otherwise set forth in writing before December 31, 2007.

(14) *Elections to annualize recurring part-year compensation.* In the case of a service provider receiving recurring part-year compensation, an election to defer all or a portion of the recurring part-year compensation to be earned during a particular service period is considered to meet the requirements of this paragraph (a) if the election is made before the services for which the recurring part-year compensation is paid begin, and the election does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first date of the service period. For purposes of this paragraph (a)(14), the term *recurring part-year compensation* means compensation paid for services rendered in a position that the service recipient and service provider reasonably anticipate will continue on similar terms and conditions in subsequent years, and will require services to be provided during successive service periods each of which comprises less than 12 months (for example, a teacher providing services during a school year comprised of 10 consecutive months), and each of which periods begins in one taxable year of the service provider and ends in the next such taxable year. The rules of this paragraph (a)(14) apply to a particular amount of compensation only once, so that an amount deferred under this rule may not again be treated as recurring part-year compensation for purposes of this paragraph and subject to a second deferral election under this paragraph (a)(14).

(15) *USERRA rights.* The requirements of this paragraph (a) are deemed satisfied to the extent an initial deferral election is provided to satisfy the requirements of the Uniformed Service Employment and Reemployment Rights Act of 1994, as amended, 38 U.S.C. 4301–4334.

(b) *Subsequent changes in time and form of payment*—(1) *In general.* A plan that permits under a subsequent election a delay in a payment or a change in the form of payment (a subsequent deferral election), including a subsequent deferral election made by a service provider or a service recipient, satisfies the requirements of section 409A(a)(4)(C) only if the conditions of this paragraph (b) are met. For purposes of this paragraph (b), except as otherwise expressly provided in this section, a subsequent deferral election is not considered made until such election becomes irrevocable under the terms of the plan. Accordingly, a plan may provide that a subsequent deferral election may be changed at any time before the last permissible date for making such a subsequent deferral election. Where a plan permits a subsequent deferral election, the requirements of this paragraph are satisfied only if the following conditions are met:

(i) The plan requires that such election not take effect until at least 12 months after the date on which the election is made.

(ii) In the case of an election related to a payment not described in §1.409A–3(a)(2) (payment on account of disability), §1.409A–3(a)(3) (payment on account of death), or §1.409A–3(a)(6) (payment on account of the occurrence of an unforeseeable emergency), the plan requires that the payment with respect to which such election is made be deferred for a period of not less than five years from the date such payment would otherwise have been paid (or in the case of a life annuity or installment payments treated as a single payment, five years from the date the first amount was scheduled to be paid).

(iii) The plan requires that any election related to a payment described in §1.409A–3(a)(4) (payment at a specified time or pursuant to a fixed schedule) be made not less than 12 months before the date the payment is scheduled to be paid (or in the case of a life annuity or installment payments treated as a single payment, 12 months before the date the first amount was scheduled to be paid).

(2) *Definition of payments for purposes of subsequent changes in the time or form of payment*—(i) *In general.* Except as provided in paragraphs (b)(2)(ii) and (iii) of this section, the term *payment* refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date, and includes amounts applied for the benefit of the service provider. An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula. For example, an amount identified as 10 percent of the account balance as of a specified payment date would be a separately identified amount. A payment includes the provision of any taxable benefit, including payment in cash or in kind. In addition, a payment includes, but is not limited to, the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, a fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income. For additional rules relating to the application of this paragraph (b) to amounts payable at a fixed time or pursuant to a fixed schedule, see §1.409A–3(i)(1).

(ii) *Life annuities*—(A) *In general.* The entitlement to a life annuity is treated as the entitlement to a single payment. Accordingly, an election to delay payment of a life annuity, or to change the form of payment of a life annuity, must be made at least 12 months before the scheduled commencement of the life annuity, and must defer the payment for a period of not less than five years from the originally scheduled commencement of the life annuity. For purposes of §1.409A–1, this section, and §§1.409A–3 through 1.409A–6, the term *life annuity* means a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider, or a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider, followed upon the death or end of the life expectancy of the service provider by a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider's designated beneficiary (if any). Notwithstanding the foregoing, a schedule of payments does not fail to be an annuity solely because such plan provides for an immediate payment of the actuarial present value of all remaining annuity payments if the actuarial present value of the remaining annuity payments falls below a predetermined amount, and the immediate payment of such amount does not constitute an accelerated payment for purposes of §1.409A–3(j), provided that such feature, including the predetermined amount, is established by no later than the time and form of payment is otherwise required to be established, and provided further that any change in such feature, including the predetermined amount, is a change in the time and form of payment. A change in designated beneficiary before any annuity payment has been made under the plan is not a change in the time or form of payment. A change in the form of a payment before any annuity payment has been made under the plan, from one type of life annuity to another type of life annuity with the same scheduled date for the first annuity payment, is not considered a change in the time and form of a payment, provided that the annuities are actuarially equivalent applying reasonable actuarial methods and assumptions. For purposes of this paragraph (b)(2)(ii), a requirement that a service provider obtain the consent of a spouse or other potential recipient of a survivor annuity to change a beneficiary or form of payment is disregarded, so that any annuity form that the service recipient could elect to receive with such consent is considered currently available.

(B) *Certain features disregarded.* Notwithstanding the foregoing provisions of this paragraph (b)(2)(ii), the following features are disregarded for purposes of determining whether a payment form is a life annuity within the meaning of this paragraph (b)(2)(ii), but are not disregarded for purposes of determining whether a life annuity is the actuarial equivalent of another life annuity except as otherwise provided in this paragraph (b)(2)(ii):

(*1*) Term certain features under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time.

(*2*) Pop-up features under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity.

(*3*) Cash refund features under which payment is provided upon the death of the last annuitant in an amount that is not greater than the excess of the present value of the annuity at the annuity starting date over the total of payments before the death of the last annuitant.

(*4*) Features under which an annuity form of payment provides higher periodic payments before the expected commencement of benefits under the Social Security Act (42 U.S.C. ch. 7) or the Railroad Retirement Act (45 U.S.C. 231 *et seq.*) and lower periodic payments after such expected commencement date, so that the combined periodic payments under the arrangement and the Social Security Act or the Railroad Retirement Act, as applicable, are approximately level before and after such expected commencement date (Social Security or Railroad Retirement leveling features).

(*5*) Features providing for an increase in the annuity payment in a manner described in § 1.401(a)(9)–6, Q&A–14(a)(1) or (2) (eligible cost-of-living adjustments).

(C) *Subsidized joint and survivor annuities.* For purposes of this paragraph (b)(2)(ii), a joint and survivor annuity will not fail to be treated as actuarially equivalent to a single life annuity due solely to the value of a subsidized survivor annuity benefit, provided that the annual lifetime annuity benefit available to the service provider under the joint and survivor annuity is not greater than the annual lifetime annuity benefit available to the service provider under the single life annuity alternative, and provided that the annual survivor annuity benefit is not greater than the annual lifetime annuity benefit available to the service provider under the joint and survivor annuity.

(D) *Actuarial assumptions and methods.* For purposes of this paragraph (b)(2)(ii), at any given time the same actuarial assumptions and methods must be used in valuing each annuity payment option, in determining whether the payments are actuarially equivalent and such assumptions must be reasonable. This requirement applies over the entire term of the service provider's participation in the plan, such that the annuity payment must be actuarially equivalent at all times for the annuity payment options to be treated as one time and form of payment. There is no requirement that the same actuarial methods and assumptions be used over the term of a service provider's participation in a plan. Accordingly, a plan may change the actuarial assumptions and methods used to determine the life annuity payments provided that all of the actuarial assumptions and methods are reasonable.

(iii) *Installment payments.* The entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the plan provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments. For purposes of §1.409A–1, this section, and §§1.409A–3 through 1.409A–6, a series of installment payments refers to an entitlement to the payment of a series of substantially equal periodic amounts to be paid over a predetermined period of years, except to the extent any increase (or decrease) in the amount reflects reasonable earnings (or losses) through the date the amount is paid. For this purpose, a series of installment payments over a predetermined period and a series of installment payments over a shorter or longer period, or a series of installment payments over the same predetermined period but with a different commencement date, are different times and forms of payment. Accordingly, a change in the predetermined period or the commencement date is a change in the time and form of payment. Notwithstanding the foregoing, a schedule of payments does not fail to be an installment payment solely because such plan provides for an immediate payment of all remaining installments if the present value of the deferred amount to be paid in the remaining installment payments falls below a predetermined amount, and the immediate payment of such amount does not constitute an accelerated payment for purposes of §1.409A–3(j), provided that such feature including the predetermined amount is established by no later than the time and form of payment is otherwise required to be established, and provided further that any change in such feature including the predetermined amount is a change in the time and form of payment.

(iv) *Transition rule.* For purposes of this section, a plan that was adopted and effective before December 31, 2007, whether written or unwritten, that fails to make a designation as to whether the entitlement to a series of payments is to be treated as an entitlement to a series of separate payments under paragraph (b)(2)(iii) of this section, may make such designation on or before December 31, 2007, provided such designation is set forth in writing on or before December 31, 2007.

(3) *Beneficiaries.* The rules of this paragraph (b) governing changes in the time and form of payment apply to elections by beneficiaries with respect to the time and form of payment, as well as elections by service providers or service recipients with respect to the time and form of payment to beneficiaries. An election to change the identity of a beneficiary does not constitute a change in the time and form of payment merely because the election changes the identity of the recipient of the payment, if the time and form of the payment is not otherwise changed. In addition, an election to change the identity of a beneficiary before the initial payment of a life annuity does not constitute a change in the time and form of payment if the change in the time of payments stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity.

(4) *Domestic relations orders.* The rules of this paragraph (b) governing changes in the time and form of payment do not apply to elections by individuals other than a service provider, with respect to payments to a person other than the service provider, to the extent such elections are reflected in, or made in accordance with, the terms of a domestic relations order (as defined in section 414(p)(1)(B)).

(5) *Coordination with prohibition against acceleration of payments.* For purposes of applying the prohibition against the acceleration of payments in §1.409A–3(j), the definition of payment is the same as the definition in paragraph (b)(2) of this section. Accordingly, a change in the form of a payment that results in a more rapid schedule for payments generally will not constitute an acceleration of a payment, if the change in the form of payment is made in compliance with the subsequent deferral rules. For example, a change in form from a 10-year installment payment treated as a single payment to a lump-sum payment would not constitute an acceleration if the change in the form of the payment is made in compliance with the requirements of paragraph (b)(1) of this section, generally meaning that the election to change to a lump-sum payment

must be made at least 12 months before the installment payments were scheduled to commence and the lump-sum payment could not be made until at least five years after the date the installment payments were scheduled to commence. See §1.409A–3(j)(4)(i) with respect to situations in which the failure to accelerate a payment or the modification of a plan term relating to certain accelerated payments will not be subject to the rules of this paragraph (b).

(6) *Application to multiple payment events.* In the case of a plan that permits a payment upon each of a number of potential permissible payment events, such as the earlier of a fixed date or separation from service, the requirements of paragraph (b)(1) of this section are applied separately to each payment (as defined in paragraph (b)(2) of this section) due upon each payment event. Notwithstanding the foregoing, the addition or deletion of a permissible payment event to a plan under which amounts were previously deferred is subject to the rules of this paragraph (b) where the addition or deletion of the permissible payment event may result in a change in the time or form of payment of the amount deferred. For application of the rules governing accelerations of payments to the addition of a permissible payment event to amounts deferred, see §1.409A–3(j).

(7) *Delay of payments under certain circumstances.* A payment may be delayed to a date after the designated payment date under any of the circumstances described in this paragraph (b)(7), and the provision will not fail to meet the requirements of establishing a permissible payment event and the delay in the payment will not constitute a subsequent deferral election, so long as the service recipient treats all payments to similarly situated service providers on a reasonably consistent basis.

(i) *Payments subject to section 162(m).* A payment may be delayed to the extent that the service recipient reasonably anticipates that if the payment were made as scheduled, the service recipient's deduction with respect to such payment would not be permitted due to the application of section 162(m), provided that the payment is made either during the service provider's first taxable year in which the service recipient reasonably anticipates, or should reasonably anticipate, that if the payment is made during such year, the deduction of such payment will not be barred by application of section 162(m) or during the period beginning with the date of the service provider's separation from service and ending on the later of the last day of the taxable year of the service recipient in which the service provider separates from service or the 15th day of the third month following the service provider's separation from service, and provided further that where any scheduled payment to a specific service provider in a service recipient's taxable year is delayed in accordance with this paragraph, the delay in payment will be treated as a subsequent deferral election unless all scheduled payments to that service provider that could be delayed in accordance with this paragraph are also delayed. Where the payment is delayed to a date on or after the service provider's separation from service, the payment will be considered a payment upon a separation from service for purposes of the rules under §1.409A–3(i)(2) (payments to specified employees upon a separation from service) and, in the case of a specified employee, the date that is six months after a service provider's separation from service is substituted for any reference to a service provider's separation from service in the first sentence of this paragraph. No election may be provided to the service provider with respect to the timing of the payment under this paragraph (b)(7)(i).

(ii) *Payments that would violate Federal securities laws or other applicable law.* A payment may be delayed where the service recipient reasonably anticipates that the making of the payment will violate Federal securities laws or other applicable law; provided that the payment is made at the earliest date at which the service recipient reasonably anticipates that the making of the payment will not cause such violation. The making of a payment that would cause inclusion in gross income or the application of any penalty provision or other provision of the Internal Revenue

Code is not treated as a violation of applicable law.

(iii) *Other events and conditions.* A service recipient may delay a payment upon such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter). For additional rules applicable to certain delayed payments pursuant to a change in control event, see § 1.409A–3(i)(5)(iv). For additional rules applicable to amounts payable because of an unforeseeable emergency, see § 1.409A–3(i)(3).

(8) *USERRA rights.* The requirements of this paragraph (b) are deemed met to the extent an election to change the time or form of a payment of deferred compensation is provided to satisfy the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994, as amended, 38 U.S.C. 4301–4344.

(9) *Examples.* The following examples illustrate the application of the provisions of this section. For purposes of these examples, each employee is an individual with a calendar year taxable year, and is employed by the specified employer:

Example 1. Initial election to defer salary. Employer ZZ sponsors a plan under which Employee A may elect to defer a percentage of Employee A's salary. Employee A has participated in the plan in prior years. To satisfy the requirements of this section with respect to salary earned in calendar year 2008, if Employee A elects to defer any amount of such salary, the deferral election (including an election as to the time and form of payment) must be made no later than December 31, 2007.

Example 2. Designation of time and form of payment where an initial deferral election is not provided. Employer YY has a taxable year ending September 30. On July 1, 2008, Employer YY enters into a legally binding obligation to pay Employee B a $10,000 bonus. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A–1(e). Employer YY does not provide Employee B an election as to the time and form of payment. Unless the amount is to be paid in accordance with the short-term deferral rule of §1.409A–1(b)(4), Employer YY must specify the time and form of payment on or before July 1, 2008, to satisfy the requirements of this section.

Example 3. Initial election to defer bonus payable based on services during calendar year. Employer XX has a taxable year ending September 30. Employee C participates in a bonus plan under which Employee C is entitled to a bonus for services performed during the calendar year that, absent an election by Employee C, will be paid on March 15 of the following year. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A–1(e). If Employee C elects to defer the payment of the bonus with respect to services rendered during calendar year 2008, Employee C must elect the time and form of payment not later than December 31, 2007, to satisfy the requirements of this section.

Example 4. Initial election to defer bonus payable based on services during fiscal year other than calendar year. Employer WW has a taxable year ending September 30. Employee D participates in a bonus plan under which Employee D is entitled to a bonus for services performed during Employer WW's fiscal year that, absent an election by Employee D, will be paid on December 15 of the calendar year in which the fiscal year ends. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A–1(e). The amount qualifies as fiscal year compensation. If Employee D elects to defer the payment of the amount related to the fiscal year ending September 30, 2009, to satisfy the requirements of this section Employee D must elect the time and form of payment not later than September 30, 2008.

Example 5. Initial election to defer bonus payable only if service provider completes at least 12 months of services after the election. Employer VV has a calendar year taxable year. On March 1, 2008, Employer VV grants Employee E a $10,000 bonus, payable on March 1, 2010 (with reasonable interest), provided that Employee E continues performing services as an employee of Employer VV through March 1, 2010. The amount does not qualify as performance-based compensation as described in §1.409A–1(e), and Employee E already participates in another account balance nonqualified deferred compensation plan. Employee E may make an initial deferral election on or before March 31, 2008 (within 30 days after obtaining a legally binding right), because at least 12 months of additional services are required after the date of election for the risk of forfeiture to lapse.

Example 6. Initial election to defer bonus that would otherwise constitute a short-term deferral. The same facts as Example 5, except that Employee E does not make an initial deferral election on or before March 31, 2008. Because the right to the compensation would not be treated as a deferral of compensation pursuant to §1.409A–1(b)(4) absent a deferral election (because the arrangement would be treated as a short-term deferral), Employee

E may make an initial deferral election provided that the election may not become effective for 12 months and must defer the payment at least 5 years from March 1, 2010 (the first date the payment could become substantially vested). Accordingly, Employee E may make an election before March 1, 2009, provided that the election defers the payment to a date on or after March 1, 2015 (other than a payment due to death, disability, unforeseeable emergency, or a change in control event).

Example 7. Initial election to defer sales commissions. Employer UU has a calendar year taxable year. As part of Employee F's services for Employer UU, Employee F sells refrigerators to customers unrelated to Employee F or Employer UU. Under the employment arrangement, Employee F is entitled to 10% of the sales price of any refrigerator Employee F sells, payable only upon the receipt of payment from the customer who purchased the refrigerator. For purposes of the initial deferral rule, Employee F is treated as performing the services related to each refrigerator sale in the calendar year in which each customer pays for the refrigerator.

Example 8. Initial election to defer renewal sales commissions. The same facts as *Example 7*, except that Employee F also sells warranties related to the refrigerators sold. Under the warranty arrangement, refrigerator warranty customers are entitled in a future year to extend the warranty for an additional cost to be paid at the time of the extension. Under Employee F's arrangement with Employer UU, Employee F is entitled to 10% of the amount paid for an extension of any warranty, payable upon the receipt of payment from the customer extending the warranty. For purposes of the initial deferral election rule, Employee F is treated as performing the services related to the amount paid for the extension of the warranty in the taxable year in which the customer pays for the warranty extension.

Example 9. Initial election to defer investment commissions. Employer TT is in the trade or business of managing financial assets for customer accounts. Customers who deposit funds in an account with Employer TT are entitled to remove the account balance of such account upon 60 days notice to Employer TT. Employee G sells financial products and provides continuing customer service to certain unrelated customers involving the deposit and maintenance of funds in customer accounts managed by Employer TT. Under the employment arrangement, Employee G is entitled to a set percentage of the aggregate value of the assets held in the accounts of customers to whom Employee G sold financial products and provides customer service. Under the arrangement, the aggregate value of the assets held in the accounts is determined as of June 30 of each year, and unless Employee G elects to defer the payment, the amount is payable to Employee G in a lump sum on December 31 of the year in which the valuation is made. Employee G has no control over the valuation of the assets held in the accounts, or the calculation of the amount due Employee G. For purposes of the initial deferral rule, Employee G is treated as providing the services to which a payment relates during the July 1 through June 30 period ending on the June 30 date as of which the assets held in the account are valued.

Example 10. Initial election to defer part-year compensation. Employee H provides services as a teacher to Employer SS, a school system. The period of services routinely begins on the second Monday of August of one year and ends on the first Friday of June of the subsequent year. Employer SS provides an election to Employee H to receive the compensation for the period of services ratably over the period beginning on the second Monday of August of one year and ending on the last day of August of the subsequent year. Because the compensation constitutes recurring part-year compensation, as defined in paragraph (a)(14) of this section, and because the schedule will provide that all of the recurring part-year compensation is paid no later than September 30 of the subsequent year, Employee H will be deemed to have made a timely deferral election with respect to such recurring part-year compensation if Employee H elects before the first day of the service period to have the recurring part-year compensation paid under such schedule.

Example 11. Initial election to defer negotiated separation pay. Employer RR decides to terminate Employee J's employment involuntarily. As part of the process of terminating Employee J, Employer RR enters into bona fide, arm's length negotiations with respect to the terms of Employee J's termination of employment. As part of the process, Employer RR offers Employee J an amount that is in addition to any amounts to which Employee J is otherwise entitled, payable either as a lump sum payment at the end of 3 years or in 3 annual payments starting at the date of termination of employment. The election of the time and form of payment by Employee J may be made at any time before Employee J accepts the offer and obtains a legally binding right to the additional amount. The election may not apply to any amount to which Employee J already had a legally binding right.

Example 12. Election of time and form of payments under a window program. Employer QQ establishes a window program, as defined in §1.409A–1(b)(9)(vi). Individuals who elect to terminate employment under the window program are entitled to receive an amount equal to 2 weeks pay multiplied by every year of service with Employer QQ. The individuals participating in the window program may elect to receive the payment as either a lump sum payment payable on the first day of the month after making the election to participate in the window program, or as a payment of 3 equal annual installments on each January 1 of the first 3 years following the election to participate in the window program. Employee K is eligible to participate in the window program. Employee K will be treated as making a timely deferral election if the election as to the time and form of payment is made on or before the date Employee K's election to participate in the window program becomes irrevocable.

Example 13. Initial election to defer salary earned during final payroll period beginning in one calendar year and ending in the subsequent calendar year. Employer PP pays the salary of its employees, including Employee L, on a bi-weekly basis. One bi-weekly payroll period runs from December 24, 2008, through January 6, 2009, with a scheduled payment date of January 13, 2009. Employer PP sponsors, and Employee L participates in, a nonqualified deferred compensation plan under which Employee L may defer a specified percentage of his annual salary. The plan does not specify that any salary compensation paid for the payroll period in which falls January 1 is to be treated as compensation for services performed during the year preceding the year in which falls that January 1. For purposes of applying the initial deferral election rules, Employee L is deemed to have performed the services for the payroll period December 24, 2008, through January 6, 2009, during the calendar year 2009.

Example 14. Application of deferral election rules and anti-acceleration rules to a nonqualified deferred compensation plan linked to a qualified plan. Employee M participates in a qualified retirement plan that is a defined benefit plan that offers a subsidized early retirement benefit to employees who have attained age 55 and completed 30 years of service. Employee M, who has attained age 55 and completed 30 years of service, also participates in a nonqualified deferred compensation plan, under which the benefit payable is calculated under a formula, with that benefit then reduced by any benefit that Employee M has accrued under the qualified retirement plan. In 2008, Employee M fails to elect the subsidized early retirement benefit under the qualified retirement plan, with the effect that the amounts payable under the nonqualified deferred compensation plan are increased by an amount equal to the reduction in the benefit payable under the qualified plan. In 2009, Employer NN amends the qualified retirement plan to increase benefits under the plan, resulting in a decrease in the amounts payable under the nonqualified deferred compensation plan equal to the increase in the benefit payable under the qualified plan. Neither of these actions constitutes a deferral election or an acceleration of a payment under the nonqualified deferred compensation plan.

Example 15. Subsequent deferral election. Employee N participates in a nonqualified deferred compensation plan. Employee N elects to be paid in a lump sum payment at the earlier of age 65 or separation from service. Employee N anticipates that he will work after age 65, and wishes to defer payment to a later date. Provided that Employee N continues in employment and makes the election by his 64th birthday, Employee N may elect to receive a lump sum payment at the earlier of age 70 or separation from service.

Example 16. Subsequent deferral election rule—change in form of payment from lump sum payment to life annuity. Employee P participates in a nonqualified deferred compensation plan. Employee P elects to be paid in a lump sum payment at age 65. Employee P wishes to change the payment form to a life annuity. Provided that Employee P makes the election on or before his 64th birthday, Employee P may elect to receive a life annuity commencing at age 70.

Example 17. Subsequent deferral election rule—change in form of payment from life annuity to lump sum payment. Employee Q participates in a nonqualified deferred compensation plan. Employee Q elects to be paid in a life annuity at age 65. Employee Q wishes to change the payment form to a lump sum payment. Provided that Employee Q makes the election on or before his 64th birthday, Employee Q may elect to receive a lump sum payment at age 70.

Example 18. Subsequent deferral election rule—installment payments designated as separate payments. Employee R, whose taxable year is the calendar year, participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts, each designated as a separate payment. The first payment is scheduled to be made on January 1, 2010. Provided that Employee R makes the election on or before January 1, 2009, Employee R may elect for the first payment scheduled to be made on January 1, 2010, to be made on January 1, 2015. If Employee R makes that election, but does not elect to defer the remaining payments, the remaining payments continue to be due upon January 1 of the 4 consecutive calendar years commencing on January 1, 2011.

Example 19. Subsequent deferral election rule—change in form of payment from installment payments not designated as separate payments to lump sum payment. Employee S participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts that are not designated as a series of 5 separate payments. The first amount is scheduled to be paid on January 1, 2010. Employee S wishes to receive the entire amount equal to the sum of all 5 of the amounts to be paid as a lump sum payment. Provided that Employee S makes the election on or before January 1, 2009, Employee S may elect to receive a lump sum payment on or after January 1, 2015.

Example 20. Subsequent deferral election rule—change in form of payment from installment payments designated as separate payments to lump sum payment. Employee T participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts each of which is designated as a separate payment. The first amount is scheduled to be paid on January 1, 2010. Employee T wishes to receive the entire amount equal to the sum of all 5 of the amounts in a single lump sum payment. Provided that Employee T makes the election on or before January 1, 2009, Employee T may elect to receive a lump sum payment on or after January 1, 2019.

Example 21. Subsequent deferral election rule—change in form of payment from one life annuity form to another life annuity form. Employee U participates in a nonqualified deferred compensation plan that permits Employee U to elect before Employee U's separation from service whether to be paid in the form of a single life annuity beginning on the first day of the month following Employee U's separation from service, or an annuity beginning on the first day of the month following Employee U's separation from service under which annuity payments continue for Employee U's lifetime but not less than 10 years. The two types of annuities are actuarially equivalent at all times applying reasonable actuarial methods and assumptions. For purposes of this section, the two types of annuities are treated as a single form of payment. Accordingly, the election provided under the plan is not treated as providing a subsequent deferral election or accelerated payment, and an election by Employee U under the plan between the two annuity options made before the first scheduled payment date for an annuity payment is not treated as a subsequent deferral election or an acceleration of a payment.

Example 22. Subsequent deferral election rule—change in time of payment from payment at specified age to payment at later of specified age or separation from service. Employee V participates in a nonqualified deferred compensation plan that provides for a lump sum payment at age 65. Employee V wishes to modify the plan so that the deferred amount will be payable upon the later of Employee V's attainment of a specified age or separation from service. Provided that Employee V makes such election on or before his 64th birthday, Employee V may modify the plan so Employee V will receive a lump sum payment upon the later of age 70 or separation from service.

Example 23. Subsequent deferral election rule—change in time of payment from payment at separation from service to payment at later of separation from service or specified age. Employee W participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee W wishes to make the payment payable upon the later of separation from service or a predetermined age. Provided that Employee W makes such election on or before the date 1 year before a separation from service, Employee W may elect to receive a lump sum payment upon the later of the date 5 years following a separation from service or at a specified age.

Example 24. Subsequent deferral election rule—change in time of payment from payment at separation from service to payment at a change in control event. Employee X participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee X wishes to change the payment provision such that the payment is payable upon a change in control event. A change in the distribution provision to provide for a payment only upon a change in control event will violate the rules governing payment provisions, because the change could result in an acceleration if the change in control event occurs before Employee X separates from service, or a subsequent deferral if the change in control does not occur until after Employee X separates from service. However, provided that Employee X makes such election on or before the date 1 year before a separation from service, Employee X may elect to receive a payment upon the later of a change in control event or 5 years following a separation from service.

(c) *Special rules for certain resident aliens.* For the first taxable year of an individual in which such individual is a resident alien, a nonqualified deferred compensation plan is deemed to meet the requirements of paragraph (a) of this section if, with respect to compensation payable for services performed during that first taxable year or with respect to compensation the right to which is subject to a substantial risk of forfeiture as of the first day of that first taxable year, an initial deferral election is made by the end of such first taxable year, provided that the initial deferral election may not apply to amounts that have already been paid or made available to the service provider before the election is made. For any year after the first taxable year in which an individual is classified as a resident alien, this paragraph (c) does not apply, provided that a taxable year may again be treated as the first taxable year in which an individual is classified as a resident alien if such individual is classified as a resident alien in that taxable year and has not been classified as a resident alien for the three consecutive taxable years immediately preceding that taxable year.

[T.D. 9321, 72 FR 19276, Apr. 17, 2007; 72 FR 41621, July 31, 2007]

§ 1.409A–3 Permissible payments.

(a) *In general.* The requirements of section 409A(a)(2)(A) are met only if the plan provides that an amount of deferred compensation under the plan may be paid only upon an event or at a time set forth in this paragraph (a):

(1) The service provider's separation from service (as defined in §1.409A–1(h) and in accordance with paragraph (i)(2) of this section).

(2) The service provider becoming disabled (in accordance with paragraph (i)(4) of this section).

(3) The service provider's death.

(4) A time or a fixed schedule specified under the plan (in accordance with paragraph (i)(1) of this section).

(5) A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation (in accordance with paragraph (i)(5) of this section).

(6) The occurrence of an unforeseeable emergency (in accordance with paragraph (i)(3) of this section).

(b) *Designation of payment upon a permissible payment event.* Except as otherwise specified in this section, a plan provides for the payment upon an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the plan provides the date of the event is the payment date, or specifies another payment date that is objectively determinable and nondiscretionary at the time the event occurs. A plan may also provide that a payment upon an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section is to be made in accordance with a schedule that is objectively determinable and nondiscretionary based on the date the event occurs and that would qualify as a fixed schedule under paragraph (i)(1) of this section if the payment event were instead a fixed date, provided that the schedule must be fixed at the time the permissible payment event is designated. In addition, a plan may provide that a payment, including a payment that is part of a schedule, is to be made during a designated taxable year of the service provider that is objectively determinable and nondiscretionary at the time the payment event occurs such as, for example, a schedule of three substantially equal payments payable during the first three taxable years following the taxable year in which a separation from service occurs. A plan may also provide that a payment, including a payment that is part of a schedule, is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules of §1.409A–2(b)). Where a plan provides for a period of more than one day following a payment event during which a payment may be made, such as within 90 days following the date of the event, the payment date for purposes of the subsequent deferral rules under §1.409A–2(b) is treated as the first possible date upon which a payment could be made under the terms of the plan. A plan may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is described in paragraphs (a)(1) through (6) of this section. For examples illustrating the provisions of this paragraph, see paragraph (i)(1)(vi) of this section.

(c) *Designation of alternative specified dates or payment schedules based upon date of permissible event.* Except as otherwise provided in this paragraph (c), for an amount of deferred compensation under a plan, the plan may designate only one time and form of payment upon the occurrence of each event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. For example, a plan does not satisfy the requirements of this paragraph (c) if it provides for one payment date or schedule of payments if a specified event occurs on a Monday, but another payment date or schedule of payments if the event occurs on any other day of the week. However, a plan that provides for a payment upon an event described in paragraph (a)(2), (3), (5), or (6) of this section may allow for an alternative payment schedule if the event occurs on or before one (but not more than one) specified date, provided that the addition or deletion of such a different time and form of payment applicable to an existing deferral is subject to §1.409A–2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments). For example, a plan may provide that a service provider will receive a lump sum payment of the service provider's entire benefit under the plan on the first day of the month following a change in control event that occurs before the service provider attains age 55, but will receive 5 substantially equal annual payments commencing on the first day of the month following a change in control event that occurs on or after the service provider attains age 55. In the case of a plan that provides that a payment upon an event described in paragraph (a)(1) of this section (a payment upon a separation from service), a different time and form of payment may be designated with respect to a separation from service under each of the following conditions, provided that the addition or deletion of such a different time and form of payment applicable to an existing deferral is subject to §1.409A–2(b) and paragraph (j) of this section:

(1) A separation from service during a limited period of time not to exceed two years following a change in control event (as defined in paragraph (i)(5) of this section).

(2) A separation from service before or after a specified date (for example, the attainment of a specified age), or a separation from service before or after a combination of a specified date, such as attaining a specified age, and a specified period of service determined under a predetermined, nondiscretionary, objective formula or pursuant to the method for crediting service under a qualified plan sponsored by the service recipient.

(3) A separation from service not described in paragraphs (c)(1) or (c)(2) of this section.

(d) *When a payment is treated as made upon the designated payment date.* Except as otherwise specified in this section, a payment is treated as made upon the date specified under the plan (including a date specified under paragraph (a)(4) of this section) if the payment is made at such date or a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the date specified under the plan and the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment. In addition, a payment is treated as made upon the date specified under the plan (including a date specified under paragraph (a)(4) of this section) and is not treated as an accelerated payment if the payment is made no earlier than 30 days before the designated payment date and the service provider is not permitted, directly or indirectly to designate the taxable year of the payment. For purposes of this paragraph, if the date specified is only a designated taxable year of the service provider, or a period of time during such a taxable year, the date specified under the plan is treated as the first day of such taxable year or the first day of the period of time during such taxable year, as applicable. The payment with respect to a stock right generally occurs upon the exercise of the stock right, so that where a stock right designates a fixed exercise date, the stock right will be deemed to have been paid at such date if the exercise and payment occur on such date or a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the exercise date specified under the plan. If calculation of the amount of the payment is not administratively practicable due to events beyond the control of the service provider (or service provider's beneficiary), the payment will be treated as made upon the date specified under the plan if the payment is made during the first taxable year of the service provider in which the calculation of the amount of the payment is administratively practicable. For purposes of this paragraph, the inability of a service recipient to calculate the amount or timing of a payment due to a failure of a service provider (or service provider's beneficiary) to provide reasonably available information necessary to make such calculation does not constitute an event beyond the control of the service provider. Similarly, if the making of the payment at the date specified under the plan would jeopardize the ability of the service recipient to continue as a going concern, the payment will be treated as made upon the date specified under the plan if the payment is made during the first taxable year of the service provider in which the making of the payment would not have such effect.

(e) *Designation of time and form of payment with respect to earnings.* A nonqualified deferred compensation plan that provides for actual or notional earnings to be credited on amounts of deferred compensation may specify, in accordance with the requirements of §1.409A–2(a) (initial deferral elections), that such earnings are treated separately from the right to the other amounts deferred under the plan for purposes of designating the time and form of payments under such plan, provided that to satisfy the requirements of this paragraph (e), actual or notional earnings must be credited at least annually. For these purposes, a right to dividend equivalents may be treated analogously to a right to actual or notional earnings on an amount of deferred compensation. For purposes of this paragraph (e), the term *dividend equivalents* means the right to an amount equal to all or a specified portion of dividends declared and paid, if any, on a specified number of shares of stock.

(f) *Substitutions.* Except as otherwise provided under these regulations, the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. Whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances. However, where the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, or if the service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation. In addition, where a service provider's right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or the service provider's beneficiary, the deferred compensation is treated as having been paid. For the treatment of certain offsets, see paragraph (j)(4)(xiii) of this section. Even where there is no explicit reduction or offset, the payment of an amount or creation of a new right to a payment proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation. The presumption is rebuttable by a showing that the compensation paid would have been received regardless of the forfeiture or voluntary relinquishment of the right to deferred compensation. Factors indicating that a payment would have been received regardless of such forfeiture or voluntarily relinquishment include that the amount paid is materially less than the forfeited or relinquished amount, or consists of a type of payment customarily made in the ordinary course of business of the service recipient to service providers who do not forfeit or relinquish deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims). See §1.409A–1(b)(9)(i) with respect to certain separation pay plans.

(g) *Disputed payments and refusals to pay*. If a service recipient fails to make a payment in whole or in part as of the date specified under a plan, either intentionally or unintentionally, other than with the express or implied consent of the service provider, the payment will be treated as made upon the date specified under the plan if the service provider accepts the portion (if any) of the payment that the service recipient is willing to make (unless such acceptance will result in a relinquishment of the claim to all or part of the remaining amount), makes prompt and reasonable, good faith efforts to collect the remaining portion of the payment, and any further payment (including payment of a lesser amount that satisfies the obligation to make the payment) is made no later than the end of the first taxable year of the service provider in which the service recipient and the service provider enter into a legally binding settlement of such dispute, the service recipient concedes that the amount is payable, or the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision. For purposes of this paragraph (g), efforts to collect the payment will be presumed not to be prompt, reasonable, good faith efforts, unless the service provider provides notice to the service recipient within 90 days of the latest date upon which the payment could have been timely made in accordance with the terms of the plan and these regulations, and unless, if not paid, the service provider takes further enforcement measures within 180 days after such latest date. For purposes of this paragraph (g), a service recipient is not treated as having failed to make a payment where pursuant to the terms of the plan the service provider is required to request payment, or otherwise provide information or take any other action, and the service provider has failed to take such action. In addition, for purposes of this paragraph (g), the service provider is deemed to have requested that a payment not be made, rather than the service recipient having failed to make such payment, where the service recipient's decision to refuse to make the payment is made by the service provider or a member of the service provider's family (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or any person or group of persons over whom the service provider or service provider's family member has effective control, or any person any portion of whose compensation is controlled the service provider or service provider's family member.

(h) *Special rule for certain resident aliens*. An agreement, method, program, or other arrangement that is, or constitutes part of, a nonqualified deferred compensation plan is deemed to meet the requirements of this section with respect to any amount payable in the first taxable year of the service provider in which a service provider is a resident alien, and with respect to any amount payable in a subsequent taxable year if no later than the last day of the first taxable year of the service provider in which the service provider is a resident alien, the plan is amended as necessary so that the times and forms of payment of amounts payable in a subsequent year comply with the provisions of this section. For any year after the first taxable year of an individual in which the individual is a resident alien, this paragraph (h) does not apply, provided that a taxable year may again be treated as the first taxable year in which an individual is a resident alien if such individual has not been a resident alien for at least three consecutive taxable years immediately preceding the taxable year in which the service provider is again a resident alien.

(i) *Definitions and special rules*—(1) *Specified time or fixed schedule*—(i) *In general*. Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred. An amount is objectively determinable for this purpose if the amount is specifically identified or if the amount may be determined at the time payment is due pursuant to an objective, nondiscretionary formula specified at the time the amount is deferred (for example, 50 percent of a specified account balance). Except as otherwise provided in paragraph (i)(1) of this section, an amount is not objectively determinable if the amount of the payment is based all or in part upon the occurrence of an event, including the consummation of a transaction by, or a payment of an amount to, a service recipient. If an amount is payable in a service provider's taxable year (or pursuant to a fixed schedule of taxable years of the service provider) that is designated at the time the amount is deferred and that is objectively determinable, the amount is treated as payable at a specified time (or pursuant to a fixed schedule), provided that for purposes of the application of the subsequent deferral rules contained in §1.409A–2(b), the specified time or fixed schedule of payments is deemed to refer to the first day of the relevant taxable year or years. A specified time or fixed schedule also includes the designation at the time the amount is deferred of a defined period or periods within the service provider's taxable year or taxable years that are objectively determinable, provided that no such defined period may begin within one taxable year and end within another taxable year, and provided further that for purposes of the application of the subsequent deferral rules contained in §1.409A–2(b), the specified time or fixed schedule of payments is deemed to refer to the first day of the relevant period in which the payment will be made. A plan may provide that a payment upon the lapse of a substantial risk of forfeiture is to be made in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses (disregarding any discretionary acceleration of the lapse of the substantial risk of forfeiture), provided that the schedule must be fixed on the date the time and form of payment are designated, and any change in the fixed schedule will constitute a change in the time and form of payment. For example, a plan that provides for a bonus payment subject to the condition that the service provider complete three years of service, and subject to the further condition that such requirement of continued services will lapse upon the occurrence of an initial public offering, which condition if applied alone would constitute a substantial risk of forfeiture, may provide that a service provider is entitled to substantially equal payments on each of the first three anniversaries of the date the substantial risk of forfeiture lapses (the earlier of three years of service or the date of an initial public offering).

(ii) *Payment schedules with formula and fixed limitations*—(A) *Individual limitations.* A schedule of payments does not fail to be a fixed schedule of payments where the amount of a payment or payments that may be paid at a specified time or during a specified period is limited by an objective nondiscretionary formula or a specified amount that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, where such limitation is established on or before the date the time and form of payment is otherwise required to be set under these regulations, and the plan specifies the time and form of any payment that will be made or completed after its original payment date due to the application of the limitation. A change in the limitation or a change in the time and form of any payment that exceeds the limitation is subject to the requirements of §1.409A–2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments). For purposes of this paragraph, a plan provision that reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of Social Security payments received or receivable may be treated as a nondiscretionary, objective formula limitation, if such reduction does not otherwise affect the time of payment of the deferred compensation (other than a forfeiture due to the reduction), including changes based on the service provider's eligibility or elections related to Social Security benefits. Similarly, a plan provision that reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of bona fide disability pay (within the meaning of § 1.409A–1(a)(5)) received or receivable may be treated as a nondiscretionary, objective formula limitation, if the disability payments are made pursuant to a plan sponsored by the service recipient that covers a substantial number of service providers and was established before the service provider became disabled, and if such reduction does not otherwise affect the time of payment of the deferred compensation (other than a forfeiture due to the reduction). Whether an amendment to, or other change in the benefit payable under, such bona fide disability plan results in an acceleration of a payment for purposes of paragraph (j) of this section or a subsequent election to delay the time or change the form of payment for purposes of § 1.409A–2(b) is determined based on all of the relevant facts and circumstances.

(B) *Limitations on aggregate payments to all participants in substantially identical plans.* A schedule of payments does not fail to be a fixed schedule of payments where the amount of the aggregate payments that will be made during a specified period of time to all participants in substantially identical plans is limited by an objective nondiscretionary formula or specified amount that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, where the limit is established on or before the date the time and form of payment of the amount deferred is otherwise required to be set under these regulations, the method of allocating payments among the participants where there is an overall limitation on the aggregate amount that may be paid to a group of service providers during a specified period is an objective nondiscretionary allocation method that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, the method is established on or before the date the time and form of payment of the amount deferred is otherwise required to be set, and the plan specifies the time and form of any payment of any amount that will be paid after its original payment date due to the application of the limitation. A change in the limitation or a change in the time and form of payment of any payment that is not otherwise made at the scheduled payment date due to application of the formula limitation is subject to the requirements of § 1.409A–2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments).

(iii) *Payment schedules determined by timing of payments received by the service recipient.* A payment schedule determined by reference to the timing of payments received by the service recipient (not including payments from one entity to another entity where both entities are treated as part of a single service recipient), meets the requirements of a specified date or fixed schedule of payments if the following conditions are met:

(A) The payments due to the service recipient arise from bona fide and routine transactions in the ordinary course of business of the service recipient.

(B) The service provider does not have effective control of the service recipient, the person from whom such amounts are due, or the collection of any of the amounts due to the service recipient.

(C) The payment schedule provides an objective, nondiscretionary method of identification of the payments to the service recipient from which the amount of the payment from the service recipient to the service provider is determined.

(D) The payment schedule provides an objective, nondiscretionary schedule under which the payments will be made to the service provider.

(E) The payments to the service recipient from which the amount of the payments from service recipient to the service provider are determined result from sales of a type that the service recipient is in the trade or business of making and makes frequently, and either all such sales by the service recipient are taken into account for purposes of determining the payment to the service provider, or there is a legitimate, non-tax business reason for identifying the specific sales taken into account.

(iv) *Reimbursement or in-kind benefit plans*—(A) *General rule.* A plan that provides for reimbursements of expenses incurred by a service provider, or in-kind benefits, meets the requirements of a specified date or fixed schedule of payments with respect to such reimbursements or benefits if the following conditions are met:

(*1*) The plan provides an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or of the in-kind benefits to be provided.

(*2*) The plan provides for the reimbursement of expenses incurred or for the provision of the in-kind benefits during an objectively and specifically prescribed period (including the lifetime of the service provider).

(*3*) The plan provides that the amount of expenses eligible for reimbursement, or in-kind benefits provided, during a service provider's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year.

(*4*) The reimbursement of an eligible expense is made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.

(*5*) The right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.

(B) *Medical reimbursement arrangements.* Notwithstanding the foregoing, an arrangement providing for the reimbursement of expenses referred to in section 105(b) will not be deemed to fail to meet the requirements of paragraph (i)(1)(iv)(A)(*3*) of this section solely because the arrangement provides for a limit on the amount of expenses that may be reimbursed under such arrangement over some or all of the period in which the reimbursement arrangement remains in effect.

(v) *Tax gross-up payments.* A plan providing a right to a tax gross-up payment will be treated as providing for payment at a specified time or on a fixed schedule of payments if the plan provides that payment will be made, and the payment is made, by the end of the service provider's taxable year next following the service provider's taxable year in which the service provider remits the related taxes. For purposes of this paragraph (i)(1)(v), the term *tax gross-up payment* refers to a payment to reimburse the service provider in an amount equal to all or a designated portion of the Federal, state, local, or foreign taxes imposed upon the service provider as a result of compensation paid or made available to the service provider by the service recipient, including the amount of additional taxes imposed upon the service provider due to the service recipient's payment of the initial taxes on such compensation. In addition, a right to the reimbursement of expenses incurred due to a tax audit or litigation addressing the existence or amount of a tax liability, whether Federal, state, local, or foreign, satisfies the requirement of a fixed time and form of payment if the right to the reimbursement provides that payment will be made, and the payment is made, by the end of the service provider's taxable year following the service provider's taxable year in which the taxes that are the subject of the audit or litigation are remitted to the taxing authority, or where as a result of such audit or litigation no taxes are remitted, the end of the service provider's taxable year following the service provider's taxable year in which the audit is completed or there is a final and nonappealable settlement or other resolution of the litigation. Nothing in this paragraph (i)(1)(v) otherwise alters the application of section 409A to the underlying compensation arrangement or other arrangement that results in the taxes subject to the right to the tax gross-up payment.

(vi) *Examples.* The following examples (in which each employee is an individual whose taxable year is the calendar year) illustrate the principles of paragraphs (a), (b), (c), (d), and (i)(1) of this section:

Example 1. Employee A provides services as an employee of Employer Z, but is not a specified employee. Employee A participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before December 31 of the calendar year in which Employee A separates from service. The plan provides for a payment upon a separation from service in compliance with this section.

Example 2. Employee B provides services as an employee of Employer Y, but is not a specified employee. Employee B participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 90th day immediately following the date upon which Employee B separates from service. Employer Y retains the sole discretion to determine when during the 90-day period the payment will be made. Although the plan does not specify a period during one calendar year in which the payment will be made, the plan provides for a payment upon a separation from service in compliance with this section because the period over which the payment may be made is not longer than 90 days.

Example 3. Employee C provides services as an employee of Employer X, but is not a specified employee. Employee C participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 180th day following the date upon which Employee C separates from service. Employer X retains the sole discretion to determine when during the 180-day period the payment will be made. Because the plan does not specify a period during one calendar year in which the payment will be made, and because the period over which the payment may be made is longer than 90 days, the plan does not provide for a payment upon a separation from service that complies with this section.

Example 4. Employee D provides services as an employee of Employer W, but is not a specified employee. Employee D participates in a nonqualified deferred compensation plan providing for 10 installment payments payable on the first 10 anniversaries of the date Employee D separates from service, provided that no installment payment in any year may be more than 1% of Employer W's net income for the previous calendar year, and provided further that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payment otherwise due Employee D, does not exceed 1% of Employer W's net income for the previous calendar year. Provided that Employee D does not retain effective control of the calculation of Employer W's net income or the amount that Employee D will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 5. Employee E and Employee F provide services as employees of Employer V, but neither is a specified employee. Employee E and Employee F both participate in substantially identical nonqualified deferred compensation plans providing for 10 installment payments payable on the first 10 anniversaries of the date the respective employee separates from service, provided that the total amount of installment payments in any year may not be more than 1% of Employer V's net income for the previous year, that where any payments are not made due to application of the limit the determination of the amount not paid to a particular employee will be made by applying the overall limit proportionately based upon the installment payment due the employee that year, and that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payments otherwise due the participants, does not exceed 1% of Employer V's net income for the previous calendar year. Provided that neither Employee E nor Employee F retains effective control of the calculation of Employer V's net income or the amount that the respective employee will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 6. Employee G provides services as an employee of Employer U, but is not a specified employee. As a bona fide part of this employment relationship, Employee G provides professional services to clients of Employer U as part of the bona fide, ordinary course of Employer U's trade or business. Under an arrangement between Employee G and Employer U, Employer U agrees to pay Employee G upon Employee G's separation from service an amount equal to 5% of any amount collected from Company T, a client of Employer U for which Employee G performed services during his employment with Employer U, during the 36 months following Employee G's separation from service. Under the arrangement, the amounts due to Employee G based upon payments received by Employer U during any calendar year are payable to Employee G on April 1 of the subsequent calendar year. Provided that Employee G does not have effective control of Employer U, Company T, or the collection of any amounts due Employer Y from Company T, the arrangement provides for a schedule of payments upon a separation from service that complies with this section.

Example 7. Employee H provides services as an employee of Employer S, but is not a specified employee. Under a plan sponsored by Employer S, Employee H has a legally binding right upon a separation from service to the reimbursement of country club dues paid in the calendar year of the separation from service and each of the next 3 calendar years following the separation from service in an amount not to exceed $30,000 in any calendar year, provided that the amount of dues paid in any calendar year that are eligible for reimbursement equals only the amount actually expended during such calendar year, and the maximum amount available for reimbursement in any calendar year will not be increased or decreased to reflect the amount expended or reimbursed in a prior or subsequent calendar year. The plan further provides that any reimbursement must be paid to Employee H by December 31 of the calendar year following the year in which Employee H pays the country club dues. The reimbursement plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 8. Employee J provides services as an employee of Employer Q, but is not a specified employee. Under a plan sponsored by Employer Q, Employee J has a legally binding right upon a separation from service to the reimbursement of country club dues paid during the calendar year in which the separation from service occurs and the next 3 calendar years in a total amount not to exceed $90,000. The plan further provides that any reimbursement must be paid to Employee J by December 31 of the calendar year following the year in which Employee J pays the country club dues. Because the reimbursement of a payment of country club dues in one calendar year may affect the amount of country club dues available for reimbursement in another calendar year, the plan does not provide for a schedule of payments upon a separation from service that complies with this section.

(2) *Separation from service—required delay in payment to a specified employee pursuant to a separation from service*—(i) *In general*. In the case of any service provider who is a specified employee (as defined in §1.409A–1(i)) as of the date of a separation from service, the requirements of paragraph (a)(1) of this section permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service (or, if earlier than the end of the six-month period, the date of death of the specified employee). For this purpose, a service provider who is not a specified employee as of the date of a separation from service will not be treated as subject to this requirement even if the service provider would have become a specified employee if the service provider had continued to provide services through the next specified employee effective date. Similarly, a service provider who is treated as a specified employee as of the date of a separation from service will be subject to this requirement even if the service provider would not have been treated as a specified employee after the next specified employee effective date had the specified employee continued providing services through the next specified employee effective date. Notwithstanding the foregoing, this paragraph (i)(2)(i) does not apply to a payment made under the circumstances described in paragraph (j)(4)(ii) (domestic relations order), (j)(4)(iii) (conflicts of interest), or (j)(4)(vi) (payment of employment taxes) of this section.

(ii) *Application of payment rules to delayed payments*. The required delay in payment is met if payments to which a specified employee would otherwise be entitled during the first six months following the date of separation from service are accumulated and paid on the first day of the seventh month following the date of separation from service, or if each payment to which a specified employee is otherwise entitled upon a separation from service is delayed by six months. A service recipient may retain discretion to choose which method will be implemented, provided that no direct or indirect election as to the method may be provided to the service provider. For an affected specified employee, a date upon which the plan or the service recipient designates that the payment will be made after the six-month delay is treated as a fixed payment date for purposes of paragraph (d) of this section once the separation from service has occurred.

(3) *Unforeseeable emergency*—(i) *Definition*. For purposes of §§1.409A–1 and 1.409A–2, this section, and §§1.409A–4 through 1.409A–6, an *unforeseeable emergency* is a severe financial hardship to the service provider resulting from an illness or accident of the service provider, the service provider's spouse, the service provider's beneficiary, or the service provider's dependent (as defined in section 152, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)); loss of the service provider's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by insurance, for example, not as a result of a

natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider. For example, the imminent foreclosure of or eviction from the service provider's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the costs of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse, a beneficiary, or a dependent (as defined in section 152, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)) may also constitute an unforeseeable emergency. Except as otherwise provided in this paragraph (i)(3)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies. Whether a service provider is faced with an unforeseeable emergency permitting a distribution under this paragraph (i)(3)(i) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets, to the extent the liquidation of such assets would not cause severe financial hardship, or by cessation of deferrals under the plan. A plan may provide for a payment upon a specific type or types of unforeseeable emergency, without providing for payment upon all unforeseeable emergencies, provided that any event upon which a payment may be made qualifies as an unforeseeable emergency.

(ii) *Amount of payment permitted upon an unforeseeable emergency*. Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include amounts necessary to pay any Federal, state, local, or foreign income taxes or penalties reasonably anticipated to result from the distribution). Determinations of amounts reasonably necessary to satisfy the emergency need must take into account any additional compensation that is available if the plan provides for cancellation of a deferral election upon a payment due to an unforeseeable emergency. See paragraph (j)(4)(viii) of this section. However, the determination of amounts reasonably necessary to satisfy the emergency need is not required to take into account any additional compensation that is available from a qualified employer plan as defined in § 1.409A–1(a)(2) (including any amount available by obtaining a loan under the plan), or that due to the unforeseeable emergency is available under another nonqualified deferred compensation plan (including a plan that would provide for deferred compensation except due to the application of the effective date provisions under § 1.409A–6). The payment may be made from any plan in which the service provider participates that provides for payment upon an unforeseeable emergency, provided that the plan under which the payment was made must be designated at the time of payment.

(iii) *Payments due to an unforeseeable emergency*. A service provider may retain discretion with respect to whether to apply for a payment upon an unforeseeable emergency, and a service recipient may retain discretion with respect to whether to make a payment available under the plan due to an unforeseeable emergency. A service provider who has experienced an unforeseeable emergency will not be treated as making a subsequent deferral election under § 1.409A–2(b) (subsequent deferral election rules) if the service provider does not apply for or elect to receive a payment available under the plan. A service recipient will not be treated as making a subsequent deferral election under § 1.409A–2(b) (subsequent deferral election rules) if the service recipient exercises its discretion not to make a payment otherwise available due to an unforeseeable emergency.

(4) *Disability*—(i) *In general*. For purposes of §§ 1.409A–1 and 1.409A–2, this section, and §§ 1.409A–4 through 1.409A–6, except as otherwise specifically provided, a service provider is considered disabled if the service provider meets one of the following requirements:

(A) The service provider is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months.

(B) The service provider is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the service provider's employer.

(ii) *Limited plan definition of disability.* A plan may provide for a payment upon any disability, and need not provide for a payment upon all disabilities, provided that any disability upon which a payment may be made under the plan complies with the provisions of this paragraph (i)(4).

(iii) *Determination of disability.* A plan may provide that a service provider will be deemed disabled if determined to be totally disabled by the Social Security Administration or Railroad Retirement Board. A plan may also provide that a service provider will be deemed disabled if determined to be disabled in accordance with a disability insurance program, provided that the definition of disability applied under such disability insurance program complies with the requirements of this paragraph (i)(4).

(5) *Change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation*—(i) *In general.* Pursuant to section 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in paragraph (i)(5)(v) of this section), a change in effective control of the corporation (as defined in paragraph (i)(5)(vi) of this section), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in paragraph (i)(5)(vii) of this section) (collectively referred to as a change in control event). To qualify as a change in control event, the occurrence of the event must be objectively determinable and any requirement that any other person or group, such as a plan administrator or compensation committee, certify the occurrence of a change in control event must be strictly ministerial and not involve any discretionary authority. The plan may provide for a payment on a particular type or types of change in control events, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a change in control event. For rules regarding the ability of the service recipient to terminate the plan and pay amounts of deferred compensation upon a change in control event, see paragraph (j)(4)(ix)(B) of this section.

(ii) *Identification of relevant corporation*—(A) *In general.* To constitute a change in control event with respect to the service provider, the change in control event must relate to—

(*1*) The corporation for whom the service provider is performing services at the time of the change in control event;

(*2*) The corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable) but only if either the deferred compensation is attributable to the performance of service by the service provider for such corporation (or corporations) or there is a bona fide business purpose for such corporation or corporations to be liable for such payment and, in either case, no significant purpose of making such corporation or corporations liable for such payment is the avoidance of Federal income tax; or

(*3*) A corporation that is a majority shareholder of a corporation identified in paragraph (i)(5)(ii)(A)(*1*) or (*2*) of this section, or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in paragraph (i)(5)(ii)(A)(*1*) or (*2*) of this section.

(B) *Majority shareholder.* For purposes of this paragraph (i)(5)(ii), a majority shareholder is a shareholder owning more than 50 percent of the total fair market value and total voting power of such corporation.

(C) *Example*. The following example illustrates the rules of this paragraph (i)(5)(ii):

Example. Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B constitutes a change in control event to service providers performing services for Corporation B or Corporation C, and to service providers for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but is not a change in control event as to Corporation A or any other corporation of which Corporation A is a majority shareholder unless the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see paragraph (i)(5)(vii) of this section).

(iii) *Attribution of stock ownership*. For purposes of paragraph (i)(5) of this section, section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option.

(iv) *Special rules for certain delayed payments pursuant to a change in control event*—(A) *Certain transaction-based compensation*. Payments of compensation related to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets), that occur because a service recipient purchases its stock held by the service provider or because the service recipient or a third party purchases a stock right held by a service provider, or that are calculated by reference to the value of stock of the service recipient (collectively, transaction-based compensation), may be treated as paid at a designated date or pursuant to a payment schedule that complies with the requirements of section 409A if the transaction-based compensation is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or as apply to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets), and to the extent that the transaction-based compensation is paid not later than five years after the change in control event, the payment of such compensation will not violate the initial or subsequent deferral election rules set out in §1.409A–2(a) and (b) solely as a result of such transaction-based compensation being paid pursuant to such schedule and terms and conditions. If before and in connection with a change in control event described in paragraph (i)(5)(v) or (i)(5)(vii) of this section, transaction-based compensation that would otherwise be payable as a result of such event is made subject to a condition on payment that constitutes a substantial risk of forfeiture (as defined in §1.409A–1(d), without regard to the provisions of that section under which additions or extensions of forfeiture conditions are disregarded) and the transaction-based compensation is payable under the same terms and conditions as apply to payments made to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section or to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section, for purposes of determining whether such transaction-based compensation is a short-term deferral the requirements of §1.409A–1(b)(4) are applied as if the legally binding right to such transaction-based compensation arose on the date that it became subject to such substantial risk of forfeiture.

(B) *Certain nonvested compensation*. Notwithstanding the provisions of §1.409A–1(d) (definition of a substantial risk of forfeiture) that disregard the extension or modification of a condition for purposes of determining whether a condition on payment constitutes a substantial risk of forfeiture, a condition that is a substantial risk of forfeiture that otherwise would lapse as a result of a change in control event described in paragraph (i)(5)(v) or (i)(5)(vii) of this section may be extended or modified before and in connection with such event to provide for a condition on payment that will not lapse as a result of such change in control event, and such extended or modified condition will be treated as continuing to subject the amount to a substantial risk of forfeiture, provided that the transaction constituting the change in control event is a bona fide arm's length transaction between the service recipient or its shareholders and one or more parties who are unrelated to the service recipient and service provider (applying the rules of §1.409A–1(f)(2)(ii)) and the modified or extended condition to which the payment is subject would otherwise be treated as a substantial risk of forfeiture under §1.409A–1(d) (without regard to the provisions disregarding additions or extensions of forfeiture conditions). In such a case, the continued application of a fixed schedule of payments based upon the lapse of the substantial risk of forfeiture, so that payments commence upon the lapse of the modified or extended condition on payment, will not be treated as a change in the fixed schedule of payments for purposes of §1.409A–2(b) (subsequent deferral elections) or paragraph (j) of this section (prohibition on the acceleration of payments).

(v) *Change in the ownership of a corporation*—(A) *In general.* Except as provided in paragraph (i)(5)(vi)(C) of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (i)(5)(v)(B) of this section), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. A nonqualified deferred compensation plan may provide that amounts payable upon a change in the ownership of a corporation will be paid only if the conditions in the preceding sentence are satisfied but substituting a percentage specified in the plan that is higher than 50 percent for the words ''50 percent'' in the preceding sentence, but only if the provision is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A–2. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation (or such higher percentage specified in accordance with the preceding sentence), the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of paragraph (i)(5)(vi) of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This section applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see paragraph (i)(5)(vii) of this section for rules regarding the transfer of assets of a corporation). See §1.280G–1, Q&A–27(d), *Example 1*, *Example 2*, *Example 5*, and *Example 6*.

(B) *Persons acting as a group.* For purposes of paragraph (i)(5)(v)(A) of this section, persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders only with respect to the ownership in that corporation before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G–1, Q&A–27(d), *Example 3* and *Example 4*.

(vi) *Change in the effective control of a corporation*—(A) *In general.* Notwithstanding that a corporation has not undergone a change in ownership under paragraph (i)(5)(v) of this section, a change in the effective control of the corporation occurs only on either of the following dates:

(*1*) The date any one person, or more than one person acting as a group (as determined under paragraph (i)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 30 percent or more of the total voting power of the stock of such corporation. A nonqualified deferred compensation plan may provide that amounts payable upon an effective change in control of a corporation will be paid only if the conditions in the preceding sentence are satisfied but substituting a percentage specified in the plan that is higher than 30 percent for the word ''30 percent'' in the preceding sentence, but only if the percentage is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A–2).

(*2*) The date a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors before the date of the appointment or election, provided that for purposes of this paragraph (i)(5)(vi)(A) the term *corporation* refers solely to the relevant corporation identified in paragraph (i)(5)(ii) of this section for which no other corporation is a majority shareholder for purposes of that paragraph. For example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term *corporation* for purposes of this paragraph (i)(5)(vi)(A)(*2*) would refer solely to Corporation A. A nonqualified deferred compensation plan may provide that amounts payable upon a change in the effective control of a corporation will be paid only if the conditions in the first sentence of this paragraph are satisfied substituting a portion of the members of the corporation's board of directors that is higher than the words ''a majority of the members of the corporation's board of directors'' in the first sentence of this paragraph, but only if the higher portion is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A–2(a)).

(B) *Multiple change in control events.* A change in effective control may occur in a transaction in which one of the two corporations involved in the transaction has a change in control event under paragraph (i)(5)(v) or (i)(5)(vii) of this section. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under paragraph (i)(5)(vii) of this section and O has a change in effective control under this paragraph (i)(5)(vi).

(C) *Acquisition of additional control.* If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this paragraph (i)(5)(vi)), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of paragraph (i)(5)(v) of this section).

(D) *Persons acting as a group.* Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G–1, Q&A–27(d), *Example 4*.

(vii) *Change in the ownership of a substantial portion of a corporation's assets*—(A) *In general*. A change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (i)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately before such acquisition or acquisitions (or such higher amount specified by the plan no later than the date by which the time and form of payment must be established under §1.409A–2). For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(B) *Transfers to a related person*—(*1*) There is no change in control event under this paragraph (i)(5)(vii) when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (i)(5)(vii)(B). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(*i*) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(*ii*) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(*iii*) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(*iv*) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (i)(5)(vii)(B)(*1*)(*iii*) of this section.

(*2*) For purposes of this paragraph (i)(5)(vii)(B) and except as otherwise provided in this paragraph (i), a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but that is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(C) *Persons acting as a group*. Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of assets, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G–1, Q&A–27(d), *Example 4*.

(6) *Certain back-to-back arrangements*—(i) *In general*. This paragraph (i)(6) applies where a service provider is

providing services to a service recipient (the intermediate service recipient), who in turn is providing services to another service recipient (the ultimate service recipient), the services provided by the service provider to the intermediate service recipient are closely related to the services provided by the intermediate service recipient to the ultimate service recipient, there is a nonqualified deferred compensation plan providing for payments by the ultimate service recipient to the intermediate service recipient (the ultimate service recipient plan), there is a nonqualified deferred compensation plan or other agreement, method, program, or other arrangement providing for payments of compensation by the intermediate service recipient to the service provider (the intermediate service recipient plan), and the intermediate service recipient plan provides for a payment upon the occurrence of an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. In such a case, notwithstanding the generally applicable limits on payments in paragraph (a) of this section, the ultimate service recipient plan may provide for a payment to the intermediate service recipient upon the occurrence of a payment event under the intermediate service recipient plan described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the time and form of payment is defined as the same time and form of payment provided under the intermediate service recipient plan, the amount of the payment under the ultimate service recipient plan does not exceed the amount of the payment under the intermediate service recipient plan, and the ultimate service recipient plan and the intermediate service recipient plan otherwise satisfy the requirements of section 409A (regardless of whether such plan is subject to section 409A).

(ii) *Example.* The provisions of paragraph (i)(6)(i) of this section are illustrated by the following example:

Example. Company B (intermediate service recipient) provides services to Company C (ultimate service recipient). Employee A (service provider) provides services to Company B that are closely related to the services Company B provides to Company C. Pursuant to a nonqualified deferred compensation plan meeting the requirements of section 409A, Employee A is entitled to a payment of deferred compensation upon a separation from service with Company B (the intermediate service recipient plan). Under an arrangement between Company B and Company C (the ultimate service recipient plan), Company C agrees to pay an amount of deferred compensation to Company B upon Employee A's separation from service with Company B, in accordance with the time, form and amount of payment provided in the intermediate service recipient plan. Provided that the intermediate service recipient plan and the ultimate service recipient plan otherwise comply with the requirements of section 409A (regardless of whether such arrangements are subject to section 409A), Company C's payment to Company B of the amount due under the ultimate service recipient plan upon the separation from service of Employee A from Company B may constitute a permissible payment event for purposes of paragraph (a) of this section.

(j) *Prohibition on acceleration of payments*—(1) *In general.* Except as provided in paragraph (j)(4) of this section, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the terms of the plan, and no such accelerated payment may be made whether or not provided for under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (substituted payments) apply. For purposes of this paragraph (j), an impermissible acceleration does not occur if payment is made in accordance with plan provisions or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules applicable to subsequent deferral elections under §1.409A–2(b)) pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening event that is an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. For example, a plan may provide that a participant will receive six installment payments commencing at separation from service, and also provide that if the participant dies after such payments commence but before all payments have been made, all remaining amounts will be paid in a lump sum payment. Additionally, it is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of section 409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of section 409A if the service recipient reduces the vesting requirement to five years of service, even if a service provider becomes vested as a result and receives a payment in connection with a separation from service before the service provider would have completed 10 years of service. However, if the plan in this example had provided for a payment at a fixed date, rather than at separation from service, the date of payment could not be accelerated due to the accelerated vesting. For the definition of a payment for purposes of this paragraph (j), see §1.409A–2(b)(5) (coordination of the subsequent deferral election rules with the prohibition on acceleration of payments). For other permissible payments, see §1.409A–2(b)(2)(iii) (certain immediate payments of remaining installments) and paragraph (d) of this section (certain payments made no more than 30 days before the designated payment date).

(2) *Application to multiple payment events.* Generally, the addition of a permissible payment event, the deletion of a permissible payment event, or the substitution of one permissible payment event for another permissible payment event, results in an acceleration of a payment if the addition, deletion, or substitution could result in the payment being made at an earlier date than such payment would have been made absent such addition, deletion, or substitution. Notwithstanding the previous sentence, the addition of death, disability (as defined in paragraph (i)(4) of this section), or an unforeseeable emergency (as defined in paragraph (i)(3) of this section), as a potentially earlier alternative payment event to an amount previously deferred will not be treated as resulting in an acceleration of a payment, even if such addition results in the payment being paid at an earlier time than such payment would have been made absent the addition of the payment event. However, the addition of such a payment event as a potentially later alternative payment event generally is subject to the rules governing changes in the time and form of payment (see §1.409A–2(b)).

(3) *Beneficiaries.* The rules of this paragraph (j) apply to elections by beneficiaries with respect to the time and form of payment, as well as elections by service providers or service recipients with respect to the time and form of payment to beneficiaries. An election to change the identity of a beneficiary does not constitute an acceleration of a payment merely because the election changes the identity of the recipient of the payment, if the time and form of the payment is not otherwise changed. In addition, an election before the commencement of a life annuity to change the identity of a beneficiary does not constitute an acceleration of a payment if the change in the time of payments stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity, and does not change the commencement date of the life annuity.

(4) *Exceptions*—(i) *In general.* Except as otherwise expressly provided, a plan may provide for the acceleration of a payment in accordance with paragraphs (j)(4)(ii) through (xiv) of this section, or may provide a service recipient discretion to accelerate payments in accordance with the provisions of paragraphs (j)(4)(ii) through (xiv) of this section. A plan may not provide a service provider discretion with respect to whether a payment will be accelerated, and a service recipient may not provide a service provider a direct or indirect election as to whether the service recipient's discretion to accelerate a payment will be exercised, even if such acceleration would be permitted under paragraphs (j)(4)(ii)

through (xiv) of this section. Whether a service recipient has provided a service provider an election as to whether the service recipient's discretion to accelerate a payment will be exercised is determined based on all the facts and circumstances, including whether similarly situated service providers have been treated differently. Except as otherwise provided in paragraphs (j)(4)(ii) through (xiv) of this section, the plan need not set forth the exception in writing, and provided all other requirements of this section are met, the making of such a payment or the addition of a plan term permitting the making of such a payment will not constitute the acceleration of a payment, and the failure to make such a payment or the deletion or modification of a plan term permitting the making of such a payment will not be subject to the rules regarding a change in the time and form of payment under § 1.409A–2(b).

(ii) *Domestic relations order*. A plan may provide for acceleration of the time or schedule of a payment under the plan to an individual other than the service provider, or a payment under such plan may be made to an individual other than the service provider, to the extent necessary to fulfill a domestic relations order (as defined in section 414(p)(1)(B)).

(iii) *Conflicts of interest*—(A) *Compliance with ethics agreements with the Federal government*. A plan may provide for acceleration of the time or schedule of a payment under the plan, or a payment may be made under a plan, to the extent necessary for any Federal officer or employee in the executive branch to comply with an ethics agreement with the Federal government.

(B) *Compliance with ethics laws or conflicts of interest laws*. A plan may provide for acceleration of the time or schedule of a payment under the plan, or a payment may be made under a plan, to the extent reasonably necessary to avoid the violation of an applicable Federal, state, local, or foreign ethics law or conflicts of interest law (including where such payment is reasonably necessary to permit the service provider to participate in activities in the normal course of his or her position in which the service provider would otherwise not be able to participate under an applicable rule). A payment is reasonably necessary to avoid the violation of a Federal, state, local, or foreign ethics law or conflicts of interest law if the payment is a necessary part of a course of action that results in compliance with a Federal, state, local, or foreign ethics law or conflicts of interest law that would be violated absent such course of action, regardless of whether other actions would also result in compliance with the Federal, state, local, or foreign ethics law or conflicts of interest law. For this purpose, a provision of foreign law is considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(iv) *Section 457 plans*. A plan subject to section 457(f) may provide for an acceleration of the time or schedule of a payment to a service provider, or a payment may be made under such a plan, to pay Federal, state, local, and foreign income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the Federal, state, local, and foreign income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the service provider under section 457(f) at the time of the vesting.

(v) *Limited cashouts*. A plan may require or provide a service recipient discretion to require (or be amended to require or to provide a service recipient discretion to require), a mandatory lump sum payment of amounts deferred under the plan that do not exceed a specified amount, provided that such plan term or amendment is executed and effective, and any required exercise of service recipient discretion is evidenced in writing, no later than the date of such payment, and provided that—

(A) The payment results in the termination and liquidation of the entirety of the service provider's interest under the plan, including all agreements, methods, programs, or other arrangements with respect to which deferrals of compensation are treated as having been deferred under a single nonqualified deferred compensation plan under §1.409A–1(c)(2); and

(B) The payment is not greater than the applicable dollar amount under section 402(g)(1)(B).

(vi) *Payment of employment taxes.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under the plan, to pay the Federal Insurance Contributions Act (FICA) tax imposed under section 3101, section 3121(a), and section 3121(v)(2), or the Railroad Retirement Act tax imposed under section 3201, section 3211, section 3231(e)(1), and section 3231(e)(8), where applicable, on compensation deferred under the plan (the FICA or RRTA amount). Additionally, a plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under the plan, to pay the income tax at source on wages imposed under section 3401 or the corresponding withholding provisions of applicable state, local, or foreign tax laws as a result of the payment of the FICA or RRTA amount, and to pay the additional income tax at source on wages attributable to the pyramiding section 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA or RRTA amount, and the income tax withholding related to such FICA or RRTA amount.

(vii) *Payment upon income inclusion under section 409A.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment under such plan may be made, at any time the plan fails to meet the requirements of section 409A and these regulations. Such payment may not exceed the amount required to be included in income as a result of the failure to comply with the requirements of section 409A and these regulations.

(viii) *Cancellation of deferrals following an unforeseeable emergency or hardship distribution.* A plan may provide for a cancellation of a service provider's deferral election, or such a cancellation may be made, due to an unforeseeable emergency or a hardship distribution pursuant to §1.401(k)–1(d)(3). The deferral election must be cancelled, not merely postponed or otherwise delayed. Accordingly, any later deferral election will be subject to the provisions governing initial deferral elections. See §1.409A–2(a).

(ix) *Plan terminations and liquidations.* A plan may provide for the acceleration of the time and form of a payment, or a payment under such plan may be made, where the acceleration of the payment is made pursuant to a termination and liquidation of the plan in accordance with one of the following:

(A) The service recipient's termination and liquidation of the plan within 12 months of a corporate dissolution taxed under section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. §503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received).

(*1*) The calendar year in which the plan termination and liquidation occurs.

(*2*) The first calendar year in which the amount is no longer subject to a substantial risk of forfeiture.

(*3*) The first calendar year in which the payment is administratively practicable.

(B) The service recipient's termination and liquidation of the plan pursuant to irrevocable action taken by the service recipient within the 30 days preceding or the 12 months following a change in control event (as defined in paragraph (i)(5) of this section), provided that this paragraph will only apply to a payment under a plan if all agreements, methods, programs, and other arrangements sponsored by the service recipient immediately after the time of the change in control event with respect to which deferrals of compensation are treated as having been deferred under a single plan under §1.409A–1(c)(2) are terminated and liquidated with respect to each participant that experienced the change in control event, so that under the terms of the termination and liquidation all such participants are required to receive all amounts of compensation deferred under the terminated agreements, methods, programs, and other arrangements within 12 months of the date the service recipient irrevocably takes all necessary action to terminate and liquidate the agreements, methods, programs, and other arrangements. Solely for purposes of this paragraph (j)(4)(ix)(B), the applicable service recipient with the discretion to liquidate and terminate the agreements, methods, programs, and other arrangements is the service recipient that is primarily liable immediately after the transaction for the payment of the deferred compensation.

(C) The service recipient's termination and liquidation of the plan, provided that—

(*1*) The termination and liquidation does not occur proximate to a downturn in the financial health of the service recipient;

(*2*) The service recipient terminates and liquidates all agreements, methods, programs, and other arrangements sponsored by the service recipient that would be aggregated with any terminated and liquidated agreements, methods, programs, and other arrangements under §1.409A–1(c) if the same service provider had deferrals of compensation under all of the agreements, methods, programs, and other arrangements that are terminated and liquidated;

(*3*) No payments in liquidation of the plan are made within 12 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan other than payments that would be payable under the terms of the plan if the action to terminate and liquidate the plan had not occurred;

(*4*) All payments are made within 24 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan; and

(*5*) The service recipient does not adopt a new plan that would be aggregated with any terminated and liquidated plan under §1.409A–1(c) if the same service provider participated in both plans, at any time within three years following the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan.

(D) Such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(x) *Certain distributions to avoid a nonallocation year under section 409(p).* A plan may provide for an acceleration of the time and form of a payment, or a payment may be made under such plan, to prevent the occurrence of a nonallocation year (within the meaning of section 409(p)(3)) in the plan year of an employee stock ownership plan next following the plan year in which such payment is made, provided that the amount distributed may not exceed 125 percent of the minimum amount of distribution necessary to avoid the occurrence of a nonallocation year. Solely for purposes of determining permissible distributions under this paragraph (j)(4)(x), synthetic equity (within the meaning of section 409(p)(6)(C) and §1.409(p)–1(f)) granted during the plan year of the employee stock ownership plan in which such payment is made is disregarded for purposes of determining whether the subsequent plan year would result in a nonallocation year.

(xi) *Payment of state, local, or foreign taxes.* A plan may provide for an acceleration of the time and form of a payment, or a payment may be made under such plan, to reflect payment of state, local, or foreign tax obligations arising from participation in the plan that apply to an amount deferred under the plan before the amount is paid or made available to the participant (the state, local, or foreign tax amount). Such payment may not exceed the amount of such taxes due as a result of participation in the plan. Such payment may be made by distributions to the participant in the form of withholding pursuant to provisions of applicable state, local, or foreign law or by distribution directly to the participant. Additionally, an arrangement may provide for the acceleration of the time or schedule of payment, or a payment may be made under such arrangement, to pay the income tax at source on wages imposed under section 3401 as a result of such payment and to pay the additional income tax at source on wages imposed under section 3401 attributable to such additional section 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the state, local, and foreign tax amount, and the income tax withholding related to such state, local, and foreign tax amount.

(xii) *Cancellation of deferral elections due to disability*. A plan may provide for a cancellation of a service provider's deferral election, or a cancellation of such election may be made, where such cancellation occurs by the later of the end of the taxable year of the service provider or the 15th day of the third month following the date the service provider incurs a disability. For purposes of this paragraph, a disability refers to any medically determinable physical or mental impairment resulting in the service provider's inability to perform the duties of his or her position or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months.

(xiii) *Certain offsets*. A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under such plan, as satisfaction of a debt of the service provider to the service recipient, where such debt is incurred in the ordinary course of the service relationship between the service recipient and the service provider, the entire amount of reduction in any of the service recipient's taxable years does not exceed $5,000, and the reduction is made at the same time and in the same amount as the debt otherwise would have been due and collected from the service provider.

(xiv) *Bona fide disputes as to a right to a payment*. A plan may provide for the acceleration of the time or schedule of one or more payments, or a payment may be made under such plan, where such payments occur as part of a settlement between the service provider and the service recipient of an arm's length, bona fide dispute as to the service provider's right to the deferred amount. Discretion to accelerate payments, other than due to an arm's length settlement of a bona fide dispute as to the service provider's right to the deferred amount, is not permitted under this paragraph (j)(4)(xiv). Whether a payment qualifies for the exception under this paragraph is based on all relevant facts and circumstances. A payment will be presumed not to meet this exception unless the payment is subject to a substantial reduction in the value of the payment made in relation to the amount that would have been payable had there been no dispute as to the service provider's right to the payment. For this purpose, a reduction that is less than 25 percent of the present value of the deferred amount in dispute generally is not a substantial reduction. In addition, a payment will be presumed not to meet this exception if the payment is made proximate to a downturn in the financial health of the service recipient.

(5) *Nonqualified deferred compensation plans linked to qualified employer plans or certain other arrangements*. If a nonqualified deferred compensation plan provides that the amount deferred under the plan is the amount determined under the formula determining benefits under a qualified employer plan (as defined in §1.409A–1(a)(2)), or a broad-based foreign retirement plan (as defined in §1.409A–1(a)(3)(v)) maintained by the service recipient but applied without regard to one or more limitations applicable to the qualified employer plan under the Internal Revenue Code or to the broad-based foreign retirement plan under other applicable law, or that the amount deferred under the nonqualified deferred compensation plan is determined as an amount offset by some or all of the benefits provided under the qualified employer plan or broad-based foreign retirement plan, a decrease in amounts deferred under the nonqualified deferred compensation plan that results directly from the operation of the qualified employer plan or broad-based foreign retirement plan (other than service provider actions described in paragraphs (j)(5)(iii) and (iv) of this section) including changes in benefit limitations applicable to the qualified employer plan or the broad-based foreign retirement plan under

the Internal Revenue Code or other applicable law does not constitute an acceleration of a payment under the nonqualified deferred compensation plan, provided that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan, and provided further that the change in the amounts deferred under the nonqualified deferred compensation plan does not exceed such change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable. In addition, with respect to such a nonqualified deferred compensation plan, the following actions or failures to act will not constitute an acceleration of a payment under the nonqualified deferred compensation plan even if in accordance with the terms of the nonqualified deferred compensation plan, the actions or inactions result in a decrease in the amounts deferred under the plan, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan, and provided further that with respect to actions or inactions described in paragraphs (j)(5)(i) and (ii) of this section, the change in the amount deferred under the nonqualified deferred compensation plan does not exceed the change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable:

(i) A service provider's action or inaction under the qualified employer plan or broad-based foreign retirement plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan or broad-based foreign retirement plan.

(ii) The amendment of a qualified employer plan or broad-based foreign retirement plan to increase benefits provided under such plan, or to add or remove a subsidized benefit or an ancillary benefit.

(iii) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), including an adjustment to a deferral election under such qualified employer plan, provided that for any given taxable year, the service provider's action or inaction does not result in a decrease in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates (other than amounts described in paragraph (j)(5)(iv) of this section) in excess of the limit with respect to elective deferrals under section 402(g)(1)(A), (B), and (C) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contributions restrictions under section 401(a)(30) or section 402(g), and after-tax contributions by the service provider to a qualified employer plan that provides for such contributions, that affects the amounts that are credited under one or more nonqualified deferred compensation plans as matching amounts or other similar amounts contingent on such elective deferrals, pre-tax contributions, or after-tax contributions, provided that the total of such matching or contingent amounts, as applicable, never exceeds 100 percent of the matching or contingent amounts that would be provided under the qualified employer plan absent any plan-based restrictions that reflect limits on qualified plan contributions under the Internal Revenue Code.

(6) *Changes in elections under a cafeteria plan.* A change in an election under a cafeteria plan (as defined in section 125(d)) does not result in an accelerated payment of an amount deferred under a nonqualified deferred compensation plan to the extent that the change in the amount deferred under the nonqualified deferred compensation plan results solely from the application of the change in amount eligible to be treated as compensation under the terms of the nonqualified deferred compensation plan resulting from the election change under the cafeteria plan, to a benefit formula under the nonqualified deferred compensation plan based upon the service provider's eligible compensation, and only to the

extent that such change applies in the same manner as any other increase or decrease in compensation would apply to such benefit formula.

[T.D. 9321, 72 FR 19276, Apr. 17, 2007; 72 FR 41622, July 31, 2007]

§ 1.409A–4 Calculation of income inclusion. [Reserved]

§ 1.409A–5 Funding. [Reserved]

§ 1.409A–6 Application of section 409A and effective dates.

(a) *Statutory application and effective dates*—(1) *Application to amounts deferred*—(i) *In general.* Except as otherwise provided in this section, section 409A applies with respect to amounts deferred in taxable years beginning after December 31, 2004, and with respect to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. For amounts deferred in taxable years beginning before January 1, 2005, under a plan that is materially modified after October 3, 2004, whether the plan complies with the requirements of section 409A and these regulations is determined by reference to the terms of the plan in effect as of, and any actions taken under the plan on or after, the date of the material modification. Section 409A is applicable with respect to earnings on amounts deferred only to the extent that section 409A is applicable with respect to the amounts deferred. Accordingly, section 409A does not apply with respect to earnings on amounts deferred before January 1, 2005, unless section 409A applies with respect to the amounts deferred. For this purpose, a right to earnings that is subject to a substantial risk of forfeiture (as defined in §1.83–3(c)) or a requirement to perform further services, on an amount deferred that is not subject to a substantial risk of forfeiture (as defined in §1.83–3(c)) or a requirement to perform further services, is not treated as earnings on the amount deferred, but a separate right to compensation. Except as otherwise provided in applicable guidance (see §601.601(d)(2) of this chapter), the provisions of §§1.409A–1 through 1.409A–5 and this section provide the exclusive means of identifying agreements, methods, programs, or other arrangements subject to section 409A, and the exclusive means of satisfying the requirements of section 409A with respect to such agreements, methods, programs, or other arrangements.

(ii) *Collectively bargained plans.* Section 409A does not apply with respect to amounts deferred under a plan maintained pursuant to one or more bona fide collective bargaining agreements in effect on October 3, 2004, for the period ending on the earlier of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after October 3, 2004) or December 31, 2009.

(2) *Identification of date of deferral for statutory effective date purposes.* For purposes of determining whether section 409A is applicable with respect to an amount, the amount is considered deferred before January 1, 2005, if before January 1, 2005, the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested. For purposes of this paragraph (a)(2), a right to an amount was earned and vested only if the amount was not subject to a substantial risk of forfeiture (as defined in §1.83–3(c)) or a requirement to perform further services. Amounts to which the service provider did not have a legally binding right before January 1, 2005 (for example, because the service recipient retained discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider had a legally binding right before January 1, 2005, but the right to which was subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004, are not considered deferred before January 1, 2005, for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider had a legally binding right before January 1, 2005, but for which the service provider was required to continue performing services to retain the right only through the completion of the payroll period (as defined in §1.409A–1(b)(3)) that includes December 31, 2004,

is not treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date. For purposes of this paragraph (a)(2), a stock option, stock appreciation right, or similar compensation that on or before December 31, 2004, was immediately exercisable for cash or substantially vested property (as defined in §1.83–3(b)) is treated as earned and vested, regardless of whether the right would terminate if the service provider ceased providing services for the service recipient.

(3) *Calculation of amount of compensation deferred for statutory effective date purposes*—(i) *Nonaccount balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in §1.409A–1(c)(2)(i)(C)), equals the present value of the amount to which the service provider would have been entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services, and received the benefits in the form with the maximum value.

Notwithstanding the foregoing, for any subsequent taxable year of the service provider, the grandfathered amount may increase to equal the present value of the benefit the service provider actually becomes entitled to, in the form and at the time actually paid, determined under the terms of the plan (including applicable limits under the Internal Revenue Code), as in effect on October 3, 2004, without regard to any further services rendered by the service provider after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than a participant election with respect to the time or form of an available benefit). For purposes of calculating the present value of a benefit under this paragraph (a)(3)(i), reasonable actuarial assumptions and methods must be used. Whether assumptions and methods are reasonable for this purpose is determined as of each date the benefit is valued for purposes of determining the grandfathered benefit, provided that any reasonable actuarial assumptions and methods that were used by the service recipient with respect to such benefit as of December 31, 2004, will continue to be treated as reasonable assumptions and methods for purposes of calculating the grandfathered benefit.

Actuarial assumptions and methods will be presumed reasonable if they are the same as those used to value benefits under a qualified plan sponsored by the service recipient the benefits under which are part of the benefit formula under, or otherwise impact the amount of benefits under, the nonaccount balance nonqualified deferred compensation plan.

(ii) *Account balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqualified deferred compensation plan that is an account balance plan (as defined in §1.409A–1(c)(2)(i)(A)), equals the portion of the service provider's account balance as of December 31, 2004, the right to which was earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004, plus any future contributions to the account, the right to which was earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004, to the extent such contributions are actually made.

(iii) *Equity-based compensation plans.* For purposes of determining the amounts deferred before January 1, 2005, under an equity-based compensation plan, the rules of paragraph (a)(3)(ii) of this section governing account balance plans are applied except that the account balance is deemed to be the amount of the payment available to the service provider on December 31, 2004 (or that would be available to the service provider if the right were immediately exercisable) the right to which is earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004. For this purpose, the payment available to the service provider excludes any exercise price or other amount that must be paid by the service provider.

(iv) *Earnings.* Earnings on amounts deferred under a plan before January 1, 2005, include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004, or to such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004, generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available pursuant to a stock option, stock appreciation right, or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, or accrual of other earnings such as dividends, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004, to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(v) *Definition of plan*. For purposes of paragraphs (a)(1), (2), and (3) of this section, the term ''plan'' has the meaning provided in §1.409A–1(c), except that the plan aggregation rules do not apply for purposes of the actuarial assumptions and methods used in paragraph (a)(3)(i) of this section. Accordingly, different reasonable actuarial assumptions and methods may be used to calculate the amounts deferred by a service provider in two different agreements, methods, programs, or other arrangements each of which constitutes a nonaccount balance plan.

(4) *Material modifications*—(i) *In general*. Except as otherwise provided, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or to the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments of deferred amounts earned and vested before January 1, 2005, may be allowed upon request if service providers are required to forfeit 20 percent of the amount of the payment (a haircut) would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. It is not a material modification for a service provider to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of section 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that materially enhances an existing benefit or right or adds a new material benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under section 409A. For example, the addition of a right to a payment upon an unforeseeable emergency of an amount earned and vested before January 1, 2005, would be considered a material modification. The reduction of an existing benefit is not a material

modification. For example, the removal of a haircut provision generally would not constitute a material modification. The following modifications also are not material modifications for purposes of this paragraph (a)(4)(i):

(A) The establishment of or contributions to a trust or other arrangement from which benefits under the plan are to be paid is not a material modification of the plan, provided that the contribution to the trust or other arrangement would not otherwise cause an amount to be includible in the service provider's gross income.

(B) The modification of a provision requiring the immediate cancellation of a current deferral election, to require the cancellation of deferrals for the same length of time beginning with the first date at which the application of such cancellation would not violate section 409A (for example, the first date of the service provider's first taxable year following the cancellation).

(C) Compliance with a domestic relations order (as defined in §1.409A–3(j)(4)(ii)) with respect to payments to an individual other than the service provider, or an amendment to a plan to require compliance with a domestic relations order with respect to payments to an individual other than the service provider.

(D) The modification of a plan providing a life annuity form of payment to permit an election between the existing life annuity form of payment and other forms of annuity payments that would be treated as a single form of payment with the existing life annuity form of payment under §1.409A–2(b)(2)(ii).

(E) The modification of a grandfathered plan to add a limited cashout feature consistent with §1.409A–3(j)(4)(v) (exception to prohibition on accelerated payments).

(ii) *Adoptions of new plans.* It is presumed that the adoption of a new plan or the grant of an additional benefit under an existing plan after October 3, 2004, and before January 1, 2005, constitutes a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the plan or grant of the additional benefit was consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a discounted stock option on November 1, 2004, is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar discounted stock options (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a)(4)(i) of this section and this paragraph (a)(4)(ii), the grant of an additional benefit under an existing plan that consists of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to section 409A. Accordingly, amendments to conform a plan to the requirements of section 409A with respect to deferrals under a plan occurring after December 31, 2004, will not constitute a material modification of the plan with respect to amounts deferred that are earned and vested on or before December 31, 2004, provided that there is no concurrent material modification with respect to the amount of, or rights to, amounts deferred that were earned and vested on or before December 31, 2004. Similarly, a grant of an additional benefit under a new plan adopted after October 3, 2004, and before January 1, 2005, will not be treated as a material modification of an existing plan to the extent that the new plan explicitly identifies additional deferrals of compensation and provides that the additional deferrals of compensation are subject to section 409A.

(iii) *Suspension or termination of a plan.* A cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification. Amending a plan to provide participants an election whether to terminate participation in a plan generally constitutes a material modification of the plan.

(iv) *Changes to investment measures—account balance plans.* With respect to an account balance plan (as defined in

§1.409A–1(c)(2)(i)(A)), it is not a material modification to change a notional investment measure to, or to add to an existing investment measure, an investment measure that qualifies as a predetermined actual investment within the meaning of §31.3121(v)(2)–1(d)(2) of this chapter or, for any given taxable year, reflects a reasonable rate of interest (determined in accordance with §31.3121(v)(2)–1(d)(2)(i)(C) of this chapter).

(v) *Stock rights.* The modification, extension, or renewal of a stock right will not constitute a material modification of the stock right, if the modification, extension, or renewal would not be treated as the grant of a new stock right under §1.409A–1(b)(5)(v)(A), and would not result in the stock right being treated as having had a deferral feature from the date of grant pursuant to §1.409A–1(b)(5)(v)(C).

(vi) *Rescission of modifications.* Any modification to the terms of a plan that would inadvertently result in treatment as a material modification under this section is not considered a material modification of the plan to the extent the modification in the terms of the plan is rescinded by the earlier of a date before the right is exercised (if the change grants a discretionary right) or the last day of the taxable year of the service provider during which such change occurred. Thus, for example, if a service recipient modifies the terms of a plan on March 1 to allow an individual employee to elect a new change in the time or form of payment without realizing that such a change constituted a material modification that would subject the plan to the requirements of section 409A, and the modification is rescinded on November 1, then if no change in the time or form of payment has been made pursuant to the modification before November 1, the plan is not considered materially modified under this section.

(vii) *Definition of plan.* For purposes of this paragraph (a)(4), the term ''plan'' has the same meaning provided in §1.409A–1(c), except that the plan aggregation rules of §1.409A–1(c)(2) do not apply.

(b) *Regulatory applicability date.* §1.409A–1, §1.409A–2, §1.409A–3 and this section are applicable for taxable years beginning on or after January 1, 2008.

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§1.409(p)–1 Prohibited allocation of securities in an S corporation.

(a) *Organization of this section and definition*—(1) *Organization of this section.* Section 409(p) applies if a nonallocation year occurs in an ESOP that holds shares of stock of an S corporation that are employer securities. Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting any accrual or allocation to a disqualified person in a nonallocation year. Paragraph (c) of this section sets forth rules under section 409(p)(3), (5), and (7) for determining whether a year is a nonallocation year, generally based on whether disqualified persons own at least 50 percent of the shares of the S corporation, either taking into account only the outstanding shares of the S corporation (including shares held by the ESOP) or taking into account both the outstanding shares and synthetic equity of the S corporation. Paragraphs (d), (e), and (f) of this section contain definitions of disqualified person under section 409(p)(4) and (5), deemed-owned ESOP shares under section 409(p)(4)(C), and synthetic equity under section 409(p)(6)(C). Paragraph (g) of this section contains a standard for determining when the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p).

(2) *Definitions.* The following definitions apply for purposes of section 409(p) and this section, as well as for purposes of section 4979A, which imposes an excise tax on certain events.

(i) *Deemed-owned ESOP shares* has the meaning set forth in paragraph (e) of this section.

(ii) *Disqualified person* has the meaning set forth in paragraph (d) of this section.

(iii) *Employer* has the meaning set forth in §1.410(b)–9.

(iv) *Employer securities* means employer securities within the meaning of section 409(l).

(v) *ESOP* means an employee stock ownership plan within the meaning of section 4975(e)(7).

(vi) *Prohibited allocation* has the meaning set forth in paragraph (b)(2) of this section.

(vii) *S corporation* means S corporation within the meaning of section 1361.

(viii) *Synthetic equity* has the meaning set forth in paragraph (f) of this section.

(b) *Prohibited allocation in a nonallocation year*—(1) *General rule*. Section 409(p)(1) provides that an ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person.

(2) *Additional rules*—(i) *Prohibited allocation definition*. For purposes of section 409(p) and this section, a *prohibited allocation* means an impermissible accrual or an impermissible allocation. Whether there is impermissible accrual is determined under paragraph (b)(2)(ii) of this section and whether there is an impermissible allocation is determined under paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the amount of the impermissible accrual plus the amount of the impermissible allocation.

(ii) *Impermissible accrual*. There is an impermissible accrual to the extent that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. For this purpose, assets attributable to stock in an S corporation owned by an ESOP include any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon). Thus, in the event of a nonallocation year, all S corporation shares and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings on either distributions or proceeds, held for the account of such disqualified person in the ESOP during that year are an impermissible accrual for the benefit of that person, whether attributable to contributions in the current year or in prior years.

(iii) *Impermissible allocation*. An impermissible allocation occurs during a nonallocation year to the extent that a contribution or other annual addition (within the meaning of section 415(c)(2)) is made with respect to the account of a disqualified person, or the disqualified person otherwise accrues additional benefits, directly or indirectly under the ESOP or any other plan of the employer qualified under section 401(a) (including a release and allocation of assets from a suspense account, as described at §54.4975–11(c) and (d) of this chapter) that, for the nonallocation year, would have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP that precludes such addition to the account of the disqualified person, and investment in employer securities during a nonallocation year.

(iv) *Effects of prohibited allocation*—(A) *Deemed distribution*. If a plan year is a nonallocation year, the amount of any prohibited allocation in the account of a disqualified person as of the first day of the plan year, as determined under this paragraph (b)(2), is treated as distributed from the ESOP (or other plan of the employer) to the disqualified person on the first day of the plan year. In the case of an impermissible accrual or impermissible allocation that is not in the account of the disqualified person as of the first day of the plan year, the amount of the prohibited allocation, as determined under this paragraph (b)(2), is treated as distributed on the date of the prohibited allocation. Thus, the fair market value of assets in the disqualified person's account that constitutes an impermissible accrual or allocation is included in gross income (to the extent in excess of any investment in the contract allocable to such amount) and is subject to any additional income tax that applies under section 72(t). A deemed distribution under this paragraph (b)(2)(iv)(A) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution under section 402(c). However, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount that the disqualified person previously took into account as income as a result of the deemed distribution is treated as investment in the contract.

(B) *Other effects.* If there is a prohibited allocation, then the plan fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. In such a case, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan). As a result of these failures, the plan would lose the prohibited transaction exemption for loans to an ESOP under section 4975(d)(3) of the Code and section 408(b)(3) of title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Finally, a plan that does not operate in accordance with its terms to reflect section 409(p) fails to satisfy the qualification requirements of section 401(a), which would cause the corporation's S election to terminate under section 1362. See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(C) *Example.* The rules of this paragraph (b)(2)(iv) are illustrated by the following example:

Example. (i) *Facts.* Corporation M, an S corporation under section 1361, establishes Plan P as an ESOP in 2006, with a calendar plan year. Plan P is a qualified plan that includes terms providing that a prohibited allocation will not occur during a nonallocation year in accordance with section 409(p). On December 31, 2006, all of the 1,000 outstanding shares of stock of Corporation M, with a fair market value of $30 per share, are contributed to Plan P and allocated among accounts established within Plan P for the benefit of Corporation M's three employees, individuals A, B, and C, based on their compensation for 2006. As a result, on December 31, 2006, participant A's account includes 800 of the shares ($24,000); participant B's account includes 140 of the shares ($4,200); and participant C's account includes the remaining 60 shares ($1,800). The plan year 2006 is a nonallocation year, participants A and B are disqualified persons on December 31, 2006, and a prohibited allocation occurs for A and B on December 31, 2006.

(ii) *Conclusion.* On December 31, 2006, participants A and B each have a deemed distribution as a result of the prohibited allocation, resulting in income of $24,000 for participant A and $4,200 for participant B. Corporation M owes an excise tax under section 4979A, based on an amount involved of $28,200. Plan P ceases to be an ESOP on the date of the prohibited allocation (December 31, 2006) and also fails to satisfy the qualification requirements of section 401(a) on that date due to the failure to comply with the provisions requiring compliance with section 409(p). As a result of having an ineligible shareholder under section 1361(b)(1)(B), Corporation M ceases to be an S corporation under section 1361 on December 31, 2006.

(v) *Prevention of prohibited allocation*—(A) *Transfer of account to non-ESOP.* An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by providing for assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person absent a transfer described in this paragraph (b)(2)(v)(A)) to be transferred into a separate portion of the plan that is not an ESOP, as described in §54.4975–11(a)(5) of this chapter, or to another plan of the employer that satisfies the requirements of section 401(a) and that is not an ESOP. Any such transfer must be effectuated by an affirmative action taken no later than the date of the transfer, and all subsequent actions (including benefit statements) generally must be consistent with the transfer having occurred on that date. In the event of such a transfer involving S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under section 512.

(B) *Relief from nondiscrimination requirement.* Pursuant to this paragraph (b)(2)(v)(B), if a transfer described in paragraph (b)(2)(v)(A) of this section is made from an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP, then both the ESOP and the plan or portion of a plan that is not an ESOP do not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the transfer. Further, subsequent to the transfer, that plan will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the benefits, rights, and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of §1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at §1.410(b)–7(c)(2) did not apply.

(c) *Nonallocation year.* A year is a nonallocation year if it is described in the general definition in paragraph (c)(1) of this section or if the special rule of paragraph (c)(3) of this section applies.

(1) *General definition.* For purposes of section 409(p) and this section, a *nonallocation year* means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either—

(i) Disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); or

(ii) Disqualified persons own at least 50 percent of the sum of:

(A) The outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); and

(B) The shares of synthetic equity in the S corporation owned by disqualified persons.

(2) *Attribution rules.* For purposes of this paragraph (c), the rules of section 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, for this purpose, section 318(a)(4) (relating to options to acquire stock) is disregarded and, in applying section 318(a)(1), the members of an individual's family include members of the individual's family under paragraph (d)(2) of this section. In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in section 318(a)(2)(B)(i). If the attribution rules in paragraph (f)(1) of this section apply, then the rules of paragraph (f)(1) of this section are applied before (and in addition to) the rules of this paragraph (c)(2).

(3) *Special rule for avoidance or evasion.* (i) Any ownership structure described in paragraph (g)(3) of this section results in a nonallocation year. In addition, each individual referred to in paragraph (g)(3) of this section is treated as a disqualified person and the individual's interest in the separate entity described in paragraph (g)(3) of this section is treated as synthetic equity.

(ii) Pursuant to section 409(p)(7)(B), 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), may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). For any year that is a nonallocation year under this paragraph (c)(3), the Commissioner may treat any person as a disqualified person. See paragraph (g) of this section for guidance regarding when the principal purpose of an ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p).

(4) *Special rule for certain stock rights.* (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock if the person has an exercisable right to acquire the stock, the stock is both issued and outstanding, and the stock is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(3) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) of this section results in a nonallocation year. This paragraph (c)(4) does not apply to a right to acquire stock of an S corporation held by a shareholder that is subject to Federal income tax that, under §1.1361–1(l)(2)(iii)(A) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock, provided that a principal purpose of the right is not the avoidance or evasion of section 409(p). Under the last sentence of paragraph (f)(2)(i) of this section, this paragraph (c)(4)(ii) does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity.

(5) *Application with respect to shares treated as owned by more than one person.* For purposes of applying paragraph (c)(1) of this section, if, by application of the rules of paragraph (c)(2), (c)(4), or (f)(1) of this section, any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.

(6) *Effect of nonallocation year.* See paragraph (b) of this section for a prohibition applicable during a nonallocation year. See also section 4979A for an excise tax applicable in certain cases, including section 4979A(a)(3) and (4) which applies during a nonallocation year (whether or not there is a prohibited allocation during the year).

(d) *Disqualified persons.* A person is a disqualified person if the person is described in paragraph (d)(1), (d)(2), or (d)(3) of this section.

(1) *General definition.* For purposes of section 409(p) and this section, a *disqualified person* means any person for whom—

(i) The number of such person's deemed-owned ESOP shares of the S corporation is at least 10 percent of the number of the deemed-owned ESOP shares of the S corporation;

(ii) The aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares of the S corporation is at least 10 percent of the sum of—

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The person's synthetic equity shares of the S corporation;

(iii) The aggregate number of the S corporation's deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or

(iv) The aggregate number of the S corporation's deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the sum of—

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The synthetic equity shares of the S corporation owned by such person and the members of such person's family.

(2) *Treatment of family members; definition*—(i) *Rule.* Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section and who owns any deemed-owned ESOP shares or synthetic equity shares is a disqualified person.

(ii) *General definition.* For purposes of section 409(p) and this section, *member of the family* means, with respect to an individual—

(A) The spouse of the individual;

(B) An ancestor or lineal descendant of the individual or the individual's spouse;

(C) A brother or sister of the individual or of the individual's spouse and any lineal descendant of the brother or sister; and

(D) The spouse of any individual described in paragraph (d)(2)(ii)(B) or (C) of this section.

(iii) *Spouse.* A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance is not treated as such individual's spouse under paragraph (d)(2)(ii) of this section.

(3) *Special rule for certain nonallocation years.* See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for special rules under which certain persons are treated as disqualified persons.

(4) *Example.* The rules of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts.* An S corporation has 800 outstanding shares, of which 100 are owned by individual O and 700 are held in an employee stock ownership plan (ESOP) during 2006, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, 65 shares held in the ESOP account of participant Q who is P's spouse, and 14 shares held in the ESOP account of R, who is the daughter of P and Q. There are no unallocated suspense account shares in the ESOP. The S corporation has no synthetic equity.

(ii) *Conclusion.* Under paragraph (d)(1)(i) of this section, O is a disqualified person during 2006 because O's account in the ESOP holds at least 10% of the shares owned by the ESOP (200 is 28.6% of 700). During 2006, neither P, Q, nor R is a disqualified person under paragraph (d)(1)(i) of this section, because each of their accounts holds less than 10% of the shares owned by the ESOP. However, each of P, Q, and R is a disqualified person under paragraph (d)(1)(iii) of this section because P and members of P's family own at least 20% of the deemed-owned ESOP shares (144 (the sum of 65, 65 and 14) is 20.6% of 700). As a result, disqualified persons own at least 50% of the outstanding shares of the S corporation during 2006 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, Q's 65 deemed-owned shares, and R's 14 deemed-owned shares are 55.5% of 800).

Example 2. (i) *Facts.* An S corporation has shares that are owned by an ESOP and various individuals. Individuals S and T are married and have a son, U. Individuals V and W are married and have a daughter, X. Individuals U and X are married. Individual V has a brother Y. Their percentages of the deemed-owned ESOP shares of the S corporation are as follows: T has 6%; U has 7%; and V has 8%. Neither S, W, X, nor Y has any deemed-owned ESOP shares and the S corporation has no synthetic equity. However, individual S and individual Y each own directly a number of shares of the outstanding shares of the S corporation.

(ii) *Conclusion.* In this example, individual U is a disqualified person under paragraph (d)(1) of this section (because U's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares) and individual X is also a disqualified person under paragraph (d)(1) of this section (because T's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares). Further, individuals T and V are each a disqualified person under paragraph (d)(2) of this section because each is a member of a family that includes one or more disqualified persons and each has deemed-owned ESOP shares. However, individuals S, W, and Y are not disqualified persons under this paragraph (d). For example, S does not own more than 10% of the deemed-owned ESOP shares, and S's family, which consists of S, T, U, and X, owns, in the aggregate, only 13% of the deemed-owned ESOP shares (X's parents are not members of S's family because the family members of a person do not include the parents-in-law of the person's descendants). Further, note that, for purposes of determining whether the ESOP has a nonallocation year under paragraph (c) of this section, the shares directly owned by S and Y would be taken into account as shares owned by disqualified persons under the attribution rules in paragraph (c)(2) of this section.

(e) *Deemed-owned ESOP shares.* For purposes of section 409(p) and this section, a person is treated as owning his or her deemed-owned ESOP shares. Deemed-owned ESOP shares owned by a person mean, with respect to any person—

(1) Any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and

(2) Such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the shares released and allocated from a suspense account, as described at §54.4975–11(c) and (d) of the Excise Tax Regulations, under the ESOP for the most recently ended plan year for which there were shares released and allocated from a suspense account, or if there has been no such prior release and allocation from a suspense account, then determined in proportion to a reasonable estimate of the shares that would be released and allocated in the first year of a loan repayment).

(f) *Synthetic equity and rights to acquire stock of the S corporation*—(1) *Ownership of synthetic equity.* For purposes of section 409(p) and this section, synthetic equity means the rights described in paragraph (f)(2) of this section. Synthetic equity is treated as owned by the person that has any of the rights specified in paragraph (f)(2) of the section. In addition, the attribution rules as set forth in paragraph (c)(2) of this section apply for purposes of attributing ownership of synthetic equity.

(2) *Synthetic equity*—(i) *Rights to acquire stock of the S corporation*—(A) *General rule.* Synthetic equity includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Rights to acquire stock in an S

corporation with respect to stock that is, at all times during the period when such rights are effective, both issued and outstanding, and held by a person other than the ESOP, the S corporation, or a related entity are not synthetic equity but only if that person is subject to federal income taxes. (See also paragraph (c)(4) of this section.)

(B) *Exception for certain rights of first refusal.* A right of first refusal to acquire stock held by an ESOP is not treated as a right to acquire stock of an S corporation under this paragraph if the right to acquire stock would not be taken into account under §1.1361–1(l)(2)(iii)(A) in determining if an S corporation has a second class of stock and the price at which the stock is acquired under the right of first refusal is not less than the price determined under section 409(h). See §54.4975–11(d)(5) of the Excise Tax Regulations. The right of first refusal must also comply with the requirements of §54.4975–7(b)(9) of the Excise Tax Regulations. This paragraph (f)(2)(i)(B) does not apply if, based on the facts and circumstances, the Commissioner finds that the right to acquire stock held by the ESOP constitutes an avoidance or an evasion of section 409(p). See also section 408(d) of ERISA, under which the exemption provided by section 408(e) of ERISA (and the related exemption at section 4975(d)(13) of the Code) does not apply to an owner-employee, including an employee or officer of an S corporation who is a 5 percent owner.

(ii) *Special rule for certain stock rights.* Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation, such as appreciation in such value. Thus, for example, synthetic equity includes a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

(iii) *Rights to acquire interests in or assets of an S corporation or a related entity.* Synthetic equity includes a right to acquire stock or other similar interests in a related entity to the extent of the S corporation's ownership. Synthetic equity also includes a right to acquire assets of an S corporation or a related entity other than either rights to acquire goods, services, or property at fair market value in the ordinary course of business or fringe benefits excluded from gross income under section 132.

(iv) *Special rule for nonqualified deferred compensation.* (A) Synthetic equity also includes any of the following with respect to an S corporation or a related entity: any remuneration to which section 404(a)(5) applies; remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained; any right to receive property, as defined in §1.83–3(e) of the Income Tax Regulations (including a payment to a trust described in section 402(b) or to an annuity described in section 403(c)) in a future year for the performance of services; any transfer of property in connection with the performance of services to which section 83 applies to the extent that the property is not substantially vested within the meaning of §1.83–3(i) by the end of the plan year in which transferred; and a split-dollar life insurance arrangement under §1.61–22(b) entered into in connection with the performance of services (other than one under which, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in §1.61–22(d)(3)). Synthetic equity also includes any other remuneration for services under a plan, method, or arrangement deferring the receipt of compensation to a date that is after the 15th day of the 3rd calendar month after the end of the entity's taxable year in which the related services are rendered. However, synthetic equity does not include benefits under a plan that is an eligible retirement plan within the meaning of section 402(c)(8)(B).

(B) For purposes of applying paragraph (f)(2)(iv)(A) of this section with respect to an ESOP, synthetic equity does not include any interest described in such paragraph (f)(2)(iv)(A) of this section to the extent that—

(*1*) The interest is nonqualified deferred compensation (within the meaning of section 3121(v)(2)) that was outstanding on December 17, 2004;

(*2*) The interest is an amount that was taken into account (within the meaning of §31.3121(v)(2)–1(d) of this chapter) prior to January 1, 2005, for purposes of taxation under chapter 21 of the Internal Revenue Code (or income attributable thereto); and

(*3*) The interest was held before the first date on which the ESOP acquires any employer securities.

(v) *No overlap among shares of deemed-owned ESOP shares or synthetic equity*. Synthetic equity under this paragraph (f)(2) does not include shares that are deemed-owned ESOP shares (or any rights with respect to deemed-owned ESOP shares to the extent such rights are specifically provided under section 409(h)). In addition, synthetic equity under a specific subparagraph of this paragraph (f)(2) does not include anything that is synthetic equity under a preceding provision of paragraph (f)(2)(i), (ii), (iii), or (iv) of this section.

(3) *Related entity*. For purposes of this paragraph (f), *related entity* means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under §301.7701–3 of this chapter, or a qualified subchapter S subsidiary under section 1361(b)(3).

(4) *Number of synthetic shares*—(i) *Synthetic equity determined by reference to S corporation shares*. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, the person who is entitled to the synthetic equity is treated as owning the number of shares of stock deliverable pursuant to such synthetic equity. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, but for which payment is made in cash or other property (besides stock of the S corporation), the number of shares of synthetic equity treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property (disregarding lapse restrictions as described in §1.83–3(i)). Where such synthetic equity is a right to purchase or receive S corporation shares, the corresponding number of shares of synthetic equity is determined without regard to lapse restrictions as described in §1.83–3(i) or to any amount required to be paid in exchange for the shares. Thus, for example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, exercisable in the future only after the satisfaction of certain performance conditions, the employee is the deemed owner of 100 synthetic equity shares of the corporation as of the date the option is granted. If the same employee were granted 100 shares of restricted S corporation stock (or restricted stock units), subject to forfeiture until the satisfaction of performance or service conditions, the employee would likewise be the deemed owner of 100 synthetic equity shares from the grant date. However, if the same employee were granted a stock appreciation right with regard to 100 shares of S corporation stock (whether payable in stock or in cash), the number of synthetic equity shares the employee is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

(ii) *Synthetic equity determined by reference to shares in a related entity*. In the case of synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)).

(iii) *Other synthetic equity*—(A) *General rule*. In the case of any synthetic equity to which neither paragraph (f)(4)(i) of this section nor paragraph (f)(4)(ii) of this section apply, the person who is entitled to the synthetic equity is treated as owning on any date a number of shares of stock in the S corporation equal to the present value (on that date) of the synthetic equity (with such value determined without regard to any lapse restriction as defined at

§ 1.83–3(i)) divided by the fair market value of a share of the S corporation's stock as of that date.

(B) *Use of annual or more frequent determination dates.* A year is a nonallocation year if the thresholds in paragraph (c) of this section are met at any time during that year. However, for purposes of this paragraph (f)(4)(iii), an ESOP may provide that the number of shares of S corporation stock treated as owned by a person who is entitled to synthetic equity to which this paragraph (f)(4)(iii) applies is determined annually (or more frequently), as of the first day of the ESOP's plan year or as of any other reasonable determination date or dates during a plan year. If the ESOP so provides, the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies that are treated as owned by that person for any period from a given determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the given determination date.

(C) *Use of triennial recalculations.* (*1*) Although an ESOP must have a determination date that is no less frequent than annually, if the terms of the ESOP so provide, then the number of shares of synthetic equity with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies may be fixed for a specified period from a determination date identified under the ESOP through the day before a determination date that is not later than the third anniversary of the identified determination date. Thus, the ESOP must provide for the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies to be re-determined not less frequently than every three years, based on the S corporation share value on a determination date that is not later than the third anniversary of the identified determination date and the aggregate present value of the synthetic equity to which this paragraph (f)(4)(iii) applies (including all grants made during the three-year period) on that determination date.

(*2*) However, additional accruals, allocations, or grants (to which this paragraph (f)(4)(iii) applies) that are made during such three-year period are taken into account on each determination date during that period, based on the number of synthetic equity shares resulting from the additional accrual, allocation, or grant (determined as of the determination date on or next following the date of the accrual, allocation, or grant). See *Example 3* of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(C).

(*3*) If, as permitted under this paragraph (f)(4)(iii)(C), an ESOP provides for the number of shares of synthetic equity to be fixed for a specified period from a determination date to a subsequent determination date, then that subsequent determination date can be changed to a new determination date, subject to the following conditions:

(*i*) The change in the subsequent determination date must be effectuated through a plan amendment adopted before the new determination date;

(*ii*) The new determination date must be earlier than the prior determination date (that is, the new determination date must be earlier than the determination date applicable in the absence of the plan amendment);

(*iii*) The conditions in paragraph (f)(4)(iii)(C)(*2*) of this section must be satisfied measured from the new determination date; and

(*iv*) Except to the extent permitted 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 change must be adopted in connection with either a change in the plan year of the ESOP or a merger, consolidation, or transfer of plan assets of the ESOP under section 414(l) (and the new determination date must consistent with that plan year change or section 414(l) event).

(4) *Conditions for application of rules.* This paragraph (f)(4)(iii)(C) only applies with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(C) of this section applies only if the fair market value of a share of the S corporation securities on any determination date is not unrepresentative of the value of the S corporation securities throughout the rest of the plan year and only if the terms of

the ESOP include provisions conforming to paragraph (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(C)(*1*) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons.

(iv) *Adjustment of number of synthetic equity shares where ESOP owns less than 100 percent of S corporation.* The number of synthetic shares otherwise determined under this paragraph (f)(4) is decreased ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP and who is subject to Federal income taxes. For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated under this paragraph (f)(4) as owning 100 synthetic equity shares of the S corporation but for this paragraph (f)(4)(iv), then, under the rule of this paragraph (f)(4)(iv), the number of synthetic shares treated as owned by B under this paragraph (f)(4) is decreased from 100 to 75 (because the ESOP only owns 75 percent of the outstanding stock of the S corporation, rather than 100 percent).

(v) *Special rule for shares with greater voting power than ESOP shares.* Notwithstanding any other provision of this paragraph (f)(4), if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is not less than the number of shares that would have the same voting rights if the shares had the same per-share voting rights as shares held by the ESOP with the least voting rights. For example, if shares of S corporation stock held by the ESOP have one voting right per share, then an individual who holds an option to purchase one share with 100 voting rights is treated as owning 100 shares of synthetic equity.

(g) *Avoidance or evasion of section 409(p) involving synthetic equity*—(1) *General rule.* Paragraph (g)(2) of this section sets forth a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p). Paragraph (g)(3) of this section identifies certain specific ownership structures that constitute an avoidance or evasion of section 409(p). See also paragraph (c)(3) of this section for a rule under which the ownership structures in paragraph (g)(3) of this section result in a nonallocation year for purposes of section 409(p).

(2) *Standard for determining when there is an avoidance or evasion of section 409(p) involving synthetic equity.* For purposes of section 409(p) and this section, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances, including all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the cash distributions made to shareholders, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives those economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity. For example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

(3) *Specific transactions that constitute an avoidance or evasion of section 409(p) involving segregated profits.* Taking into account the standard in paragraph (g)(2) of this section, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p) in any case in which—

(i) The profits of the S corporation generated by the business activities of a specific individual or individuals are not provided to the ESOP, but are instead substantially accumulated and held for the benefit of the individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation described in paragraph (f)(2)(iv) of this section);

(ii) The individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary); and

(iii) A nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP).

(h) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. Relating to determination of disqualified persons and nonallocation year if there is no synthetic equity. (i) *Facts.* Corporation X is a calendar year S corporation that maintains an ESOP. X has a single class of common stock, of which there are a total of 1,200 shares outstanding. X has no synthetic equity. In 2006, individual A, who is not an employee of X (and is not related to any employee of X), owns 100 shares directly, B, who is an employee of *X*, owns 100 shares directly, and the remaining 1,000 shares are owned by an ESOP maintained by X for its employees. The ESOP's 1,000 shares are allocated to the accounts of individuals who are employees of X (none of whom are related), as set forth in columns 1 and 2 in the following table:

1 Shareholders	2 Deemed-owned ESOP shares (total of 1,000)	3 Percentage deemed-owned ESOP shares	4 Disqualified person
B	330	33	Yes.
C	145	14.5	Yes.
D	75	7.5	No.
E	30	3	No.
F	20	2	No.
Other participants	[1] 400	([2])	No.

[1] None exceed 10 shares.
[2] 1% or less.

(ii) *Conclusion with respect to disqualified persons.* As shown in column 4 in the table contained in paragraph (i) of *Example 1*, individuals B and C are disqualified persons for 2006 under paragraph (d)(1) of this section because each owns at least 10% of X's deemed-owned ESOP shares. However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares.

(iii) *Conclusion with respect to nonallocation year.* 2006 is not a nonallocation year under section 409(p) because disqualified persons do not own at least 50% of X's outstanding shares (the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, plus C's 145 deemed-owned ESOP shares equal only 47.9% of the 1,200 outstanding shares of X).

Example 2. Relating to determination of disqualified persons and nonallocation year if there is synthetic equity. (i) *Facts.* The facts are the same as in *Example 1*, except that, as shown in column 4 of the table in this *Example 2*, individuals E and F have options to acquire 110 and 130 shares, respectively, of the common stock of X from X:

1 Shareholder	2 Deemed-owned ESOP shares (total of 1,000)	3 Percentage deemed-owned ESOP shares	4 Options (240)	5 Shareholder percentage of deemed-owned ESOP plus synthetic equity shares	6 Disqualified person
B	330	33			Yes (col. 3).
C	145	14.5			Yes (col. 3).
D	75	7.5			No.
E	30	3	110	11.1% ([30+ 91.7] divided by 1,091.7).	Yes (col. 5).
F	20	2	130	11.6% ([20 +108.3] divided by 1,108.3).	Yes (col. 5).
Other participants	[1] 400	([2])			No.

[1] None exceeds 10 shares.
[2] 1% or less.

(ii) *Conclusion with respect to disqualified persons.* Individual E's synthetic equity shares are counted in determining whether E is a disqualified person for 2006, and individual F's synthetic equity shares are counted in determining whether F is a disqualified person for 2006. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts under paragraph (f)(4)(iv) of this section, into 91.7 shares of synthetic equity (110 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Similarly, F's option to acquire 130 shares of the S corporation converts into 108.3 shares of synthetic equity (130 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, as shown in column 6 in the table contained in paragraph (i) of *Example 2*, individuals B, C, E, and F are disqualified persons for 2006.

(iii) *Conclusion with respect to nonallocation year.* The 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, E's 91.7 synthetic equity shares, F's 20 deemed-owned ESOP shares, plus F's 108.3 synthetic equity shares total 825, which equals 58.9% of 1,400, which is the sum of the 1,200 outstanding shares of X and the 200 shares of synthetic equity shares of X held by disqualified persons. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of the total shares of outstanding stock of X and the total synthetic equity shares of X held by disqualified persons. In addition, independent of the preceding conclusion, 2006 would be a nonallocation year because disqualified persons own at least 50% of X's outstanding shares because the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, plus F's 20 deemed-owned ESOP shares equal 52.1% of the 1,200 outstanding shares of X.

Example 3. Relating to determination of number of shares of synthetic equity. (i) *Facts.* Corporation Y is a calendar year S corporation that maintains an ESOP. Y has a single class of common stock, of which there are a total of 1,000 shares outstanding, all of which are owned by the ESOP. Y has no synthetic equity, except for four grants of nonqualified deferred compensation that are made to an individual during the period from 2005 through 2011, as set forth in column 2 in the following table. The ESOP provides for the special rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual with a determination date of January 1 and the triennial rule redetermining value, as shown in columns 4 and 5:

1 Determination date	2 Present value of nonqualified deferred compensation on determination date	3 Share value on determination date	4 New shares of synthetic equity on determination date	5 Aggregate number of synthetic equity shares on determination date
January 1, 2005	A grant is made on January 1, 2005, with a present value of $1,000. An additional grant of nonqualified deferred compensation with a present value of $775 is made on March 1, 2005.	$10 per share	100	100

1	2	3	4	5
Determination date	Present value of nonqualified deferred compensation on determination date	Share value on determination date	New shares of synthetic equity on determination date	Aggregate number of synthetic equity shares on determination date
January 1, 2006 ...	An additional grant is made on December 31, 2005, which has a present value of $800 on January 1, 2006. The March 1, 2005, grant has a present value on January 1, 2006, of $800.	$8 per share	200	300
January 1, 2007 ...	No new grants made	$12 per share	....	300
January 1, 2008 ...	An additional grant is made on December 31, 2007, which has a present value of $3,000 on January 1, 2008. The grants made during 2005 through 2007 have an aggregate present value on January 1, 2008, of $3,750.	$15 per share	200	450
January 1, 2009 ...	No new grants are made	$11 per share	....	450
January 1, 2010 ...	No new grants are made	$22 per share	....	450
January 1, 2011 ...	No new grants are made. The grants made during 2005 through 2008 have an aggregate present value on January 1, 2011, of $7,600.	$20 per share	....	380

(ii) *Conclusion.* The grant made on January 1, 2005, is treated as 100 shares until the determination date in 2008. The grant made on March 1, 2005, is not taken into account until the 2006 determination date and its present value on that date, along with the then present value of the grant made on December 31, 2005, is treated as a number of shares that are based on the $8 per share value on the 2006 determination date, with the resulting number of shares continuing to apply until the determination date in 2008. On the January 1, 2008, determination date, the grant made on the preceding day is taken into account at its present value of $3,000 on January 1, 2008 and the $15 per share value on that date with the resulting number of shares (200) continuing to apply until the next determination date. In addition, on the January 1, 2008, determination date, the number of shares determined under other grants made between January 1, 2005 and December 31, 2007, must be revalued. Accordingly, the aggregate value of all nonqualified deferred compensation granted during that period is determined to be $3750 on January 1, 2008, and the corresponding number of shares of synthetic equity based on the $15 per share value is determined to be 250 shares on the 2008 determination date, with the resulting aggregate number of shares (450) continuing to apply until the determination date in 2011. On the January 1, 2011, determination date, the aggregate value of all nonqualified deferred compensation is determined to be $7,600 and the corresponding number of shares of synthetic equity based on the $20 per share value on the 2011 determination date is determined to be 380 shares (with the resulting number of shares continuing to apply until the day before the determination date in 2014, assuming no further grants are made).

(i) *Effective dates*—(1) *Statutory effective date.* (i) Except as otherwise provided in paragraph (i)(1)(ii) of this section, section 409(p) applies for plan years ending after March 14, 2001.

(ii) If an ESOP holding stock in an S corporation was established on or before March 14, 2001, and the election under section 1362(a) with respect to that S corporation was in effect on March 14, 2001, section 409(p) applies for plan years beginning on or after January 1, 2005.

(2) *Regulatory effective date.* This section applies for plan years beginning on or after January 1, 2006. For plan years beginning before January 1, 2006, §1.409(p)–1T (as it appeared in the April 1, 2005, edition of 26 CFR part 1) applies.

[T.D. 9302, 71 FR 76137, Dec. 20, 2006]

§ 1.409(p)–1T Prohibited allocations of securities in an S corporation (temporary).

(a) *Organization of this section.* Section 409(p) applies if a nonallocation year occurs in an employee stock ownership plan (ESOP), as defined in section 4975(e)(7), that holds shares of stock of an S corporation, as defined in section 1361, that are employer securities as defined in section 409(l). Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting any accrual or allocation to a disqualified person in a nonallocation year. Paragraph (c) of this section sets forth rules under section 409(p)(3), (5), and (7) for determining whether a year is a nonallocation year, generally based on whether disqualified persons own at least 50 percent of the shares of the S corporation, either taking into account only the outstanding shares of the S corporation (including shares held by the ESOP) or taking into account both the outstanding shares and synthetic equity of the S corporation. Paragraphs (d), (e), and (f) of this section contain definitions of disqualified person under section 409(p)(4) and (5), deemed-owned ESOP shares under section 409(p)(4)(C), and synthetic equity under section 409(p)(6)(C). Paragraph (g) of this section contains a standard for determining when the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). The definitions used in section 409(p) and this section are also applicable for purposes of section 4979A, which imposes an excise tax on certain events, including a nonallocation year under section 409(p).

(b) *Prohibited allocation in a nonallocation year*—(1) *General rule*. An ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person (a prohibited allocation).

(2) *Additional rules*—(i) *Prohibited allocation definition*. For purposes of section 409(p)(2)(A) and paragraph (b)(1) of this section, there is a prohibited allocation (*i.e.*, assets accrue or are allocated as prohibited under paragraph (b)(1) of this section) if there is either an impermissible accrual as defined in paragraph (b)(2)(ii) of this section or an impermissible allocation as defined in paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the impermissible accrual plus the amount of the impermissible allocation (if any).

(ii) *Impermissible accrual*. There is an impermissible accrual to the extent (and only to the extent) that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. For this purpose, assets attributable to S corporation securities include any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon). Thus, for example, in the event of a nonallocation year, all S corporation shares and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings on either the distribution or proceeds, held for the account of such disqualified person in the ESOP during that year are an impermissible accrual for the benefit of that person, whether attributable to contributions in the current year or in prior years.

(iii) *Impermissible allocation*. An impermissible allocation means any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under section 401(a) that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits, under the ESOP or any other plan of the employer qualified under section 401(a) (including a release and allocation of assets from a suspense account, as described at § 54.4975–11(c) and (d) of this chapter) that, for the nonallocation year, would otherwise have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP to comply with section 409(p).

(iv) *Effects of prohibited allocation*—(A) *Deemed distribution*. If there is a prohibited allocation, the amount of the prohibited allocation, as determined under this paragraph (b)(2), is treated as distributed from the ESOP (or other plan of the employer) to the disqualified person on the first day of the plan year on which there is an impermissible accrual or on the date of the allocation in the case of an additional impermissible accrual or impermissible allocation during the plan year but after the first day of the plan year. Thus, the fair market value of assets in the disqualified person's account that constitutes an impermissible accrual or allocation is included in gross income (to the extent in excess of any investment in the contract allocable to such amount) and is subject to any additional income tax that applies under section 72(t). A deemed distribution under this paragraph (b)(2)(iv)(A) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution under section 402(c). However, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount that the disqualified person previously took into account as income as a result of the deemed distribution is treated as an investment in the contract.

(B) *Other effects.* If there is a prohibited allocation, then the plan fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. In such a case, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan) and, further, the exception in section 512(e)(3) would not apply to the plan (with the result that the plan may owe income tax as a result of unrelated business taxable income under section 512 with respect to S corporation stock held by the plan). See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(v) *Prevention of prohibited allocation*—(A) *Transfer of account to non-ESOP.* An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by permitting assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person absent a transfer described in this paragraph (b)(2)(v)(A)) to be transferred into a separate portion of the plan that is not an ESOP, as described in §54.4975–11(a)(5) of this chapter, or to another plan of the employer that satisfies the requirements of section 401(a) (and that is not an ESOP). In the event of such a transfer involving S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under section 512.

(B) *Relief from nondiscrimination requirement.* Pursuant to this paragraph (b)(2)(v)(B), if a transfer described in paragraph (b)(2)(v)(A) of this section is made from an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP, then both the ESOP and the plan or portion of a plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the transfer. Further, subsequent to the transfer, that plan will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the benefits, rights, or features with respect to the transferred benefits if those benefits, rights, or features would satisfy the requirements of §1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at §1.410(b)–7(c)(2) did not apply.

(c) *Nonallocation year*—(1) *Definition generally.* For purposes of section 409(p) and this section, a *nonallocation year* means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either—

(i) Disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); or

(ii) Disqualified persons own at least 50 percent of the sum of:

(A) The outstanding shares of stock in the S corporation (including deemed-owned ESOP shares), plus

(B) The shares of synthetic equity in the S corporation owned by disqualified persons.

(2) *Attribution rules.* For purposes of this paragraph (c), the rules of section 318(a) apply to determine ownership of

shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, for this purpose, section 318(a)(4) (relating to options to acquire stock) is disregarded and, in applying section 318(a)(1), the members of an individual's family include members of the individual's family under paragraph (d)(2) of this section. In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in section 318(a)(2)(B)(i). If the attribution rules in paragraph (f)(1) of this section apply, then the rules of paragraph (f)(1) of this section are applied before the rules of this paragraph (c)(2).

(3) *Special rule for avoidance or evasion.* (i) The ownership structures described in paragraph (g)(3) of this section result in a nonallocation year. In addition, under the ownership structures described in paragraph (g)(3) of this section, the individual referred to in paragraph (g)(3) of this section is treated as a disqualified person and that person's interest in the separate entity is treated as synthetic equity.

(ii) Under section 409(p)(7)(B), 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), may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). For any year that is a nonallocation year under this paragraph (c)(3), the Commissioner may treat any person as a disqualified person. See paragraph (g) of this section for guidance regarding when the principal purpose of an ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p).

(4) *Special rule for certain stock rights.* (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock that the person has a right to acquire if, at all times during the period when such right is effective, the stock that the person has the right to acquire is both issued and outstanding and is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(3) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) of this section results in a nonallocation year. This paragraph (c)(4) does not apply to a right to acquire stock of an S corporation held by a shareholder subject to Federal income tax that, under §1.1361–1(l)(2)(iii) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock provided that a principal purpose of the right is not the avoidance or evasion of section 409(p). Under the last sentence of paragraph (f)(2)(i) of this section, this paragraph (c)(4)(ii) does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity.

(5) *Application with respect to shares treated as owned by more than one person.* For purposes of applying paragraph (c)(1) of this section, if, by application of the rules of paragraph (c)(2), (c)(4), or (f)(1) of this section, any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.

(6) *Effect of nonallocation year.* See paragraph (b) of this section for a prohibition applicable during a nonallocation year. See also section 4979A for an excise tax applicable in certain cases, including section 4979A(a)(3) and (4) which applies during a nonallocation year (whether or not there is a prohibited allocation during the year).

(d) *Disqualified persons*—(1) *General definition.* For purposes of section 409(p) and this section, a *disqualified person* means any person for whom—

(i) The number of such person's deemed-owned ESOP shares of the S corporation is at least 10 percent of the number of the deemed-owned ESOP shares of the S corporation;

(ii) The aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares of the S corporation is at least 10 percent of the sum of:

(A) The total number of deemed-owned ESOP shares; and

(B) The person's synthetic equity shares of the S corporation;

(iii) The aggregate number of the S corporation's deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or

(iv) The aggregate number of the S corporation's deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the sum of:

(A) The total number of deemed-owned ESOP shares, and

(B) The synthetic equity shares of the S corporation owned by such person and the members of such person's family.

(2) *Treatment of family members; definition*—(i) *Rule.* Each member of the family of any person who is a disqualified person under paragraph (d)(1) (iii) or (iv) of this section is a disqualified person.

(ii) *General definition.* For purposes of section 409(p) and this section, *member of the family* means, with respect to an individual—

(A) The spouse of the individual;

(B) An ancestor or lineal descendant of the individual or the individual's spouse;

(C) A brother or sister of the individual or of the individual's spouse and any lineal descendant of the brother or sister; and

(D) The spouse of any individual described in paragraph (d)(2)(ii) (B) or (C) of this section.

(iii) *Spouse.* A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance is not treated as such individual's spouse under paragraph (d)(2)(ii)(A) of this section.

(3) *Special rule for certain nonallocation years.* See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for special rules permitting certain persons to be treated as disqualified persons in certain nonallocation years.

(4) *Example.* The rules of this paragraph (d) are illustrated by the following example:

Example. (i) *Facts.* An S corporation has 800 outstanding shares of which 100 are owned by individual O and 700 are held in an employee stock ownership plan (ESOP) during 2005, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, and 40 shares held in the ESOP account of participant Q who is P's spouse. The S corporation has no synthetic equity.

(ii) *Conclusion.* O is a disqualified person during 2005 because O's account in the ESOP holds at least 10 percent of the shares owned by the ESOP (200 is 28.6 percent of 700). In addition, P is a disqualified person during 2005 because, under paragraph (d)(2) of this section, P is treated as owning the shares held by Q and P's total deemed-owned shares are thus at least 10 percent of the shares owned by the plan (65 plus 40 is more than 10 percent of 700). In addition, Q is a disqualified person as a result of the rules in paragraph (d)(2) of this section. As a result, disqualified persons own at least 50 percent of the outstanding shares of the S corporation during 2005 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, plus Q's 40 deemed owned shares are 50.6 percent of 800).

(e) *Deemed-owned ESOP shares.* For purposes of section 409(p) and this section, a person is treated as owning his or her deemed-owned ESOP shares.

Deemed-owned ESOP shares mean, with respect to any person—

(1) Any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and

(2) Such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the shares released and allocated from a suspense account, as described at §54.4975–11(c) and (d) of this chapter, under the ESOP for the most recently ended plan year for which there were shares released and allocated from a suspense account, or if there has been no such prior release and allocation from a suspense account, then determined in proportion to a reasonable estimate of the shares that would be released and allocated in the first year of loan repayment).

(f) *Synthetic equity*—(1) *Ownership of synthetic equity.* For purposes of section 409(p) and this section, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of section 318(a)(2) and (3). *Synthetic equity* means the rights described in paragraph (f)(2) of this section.

(2) *Synthetic equity*—(i) *Rights to acquire stock of the S corporation.* Synthetic equity includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Rights to acquire stock in an S corporation with respect to stock that is, at all times during the period when such rights are effective, both issued and outstanding and held by persons (who are subject to federal income taxes) other than the ESOP, the S corporation, or a related entity are not synthetic equity (but see paragraph (c)(4) of this section).

(ii) *Special rule for certain stock rights. Synthetic equity* also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation, such as appreciation in such value. Thus, synthetic equity includes a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

(iii) *Rights to acquire interests in or assets of an S corporation or a related entity*. Synthetic equity includes a right to acquire stock or other similar interests in a related entity to the extent of the S corporation's ownership. Synthetic equity also includes a right to acquire assets of an S corporation or a related entity other than either rights to acquire goods, services, or property at fair market value in the ordinary course of business or fringe benefits excluded from gross income under section 132.

(iv) *Special rule for nonqualified deferred compensation.* (A) Synthetic equity also includes any of the following with respect to an S corporation or a related entity: any remuneration to which section 404(a)(5) applies; remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained; any right to receive property to which section 83 applies (including a payment to a trust described in section 402(b) or to an annuity described in section 403(c)) in a future year for the performance of services; any transfer of property (to which section 83 applies) in connection with the performance of services to the extent that the property is not substantially vested within the meaning of §1.83–3(i) by the end of the plan year in which transferred; and a split-dollar life insurance arrangement under §1.61–22(b) entered into in connection with the performance of services (other than one under which, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in §1.61–22(d)(3)). Synthetic equity also includes any other remuneration for services under a plan, or method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3rd calendar month after the end of the entity's taxable year in which the related services are rendered. However, synthetic equity does not include benefits under a plan that is an eligible retirement plan within the meaning of section 402(c)(8)(B).

(B) For purposes of applying paragraph (f)(2)(iv)(A) of this section with respect to an ESOP, synthetic equity does not include any interest described in such paragraph (f)(2)(iv)(A) of this section to the extent that—

(*1*) The interest is nonqualified deferred compensation (within the meaning of section 3121(v)(2)) that was outstanding on December 17, 2004;

(*2*) The interest is an amount that was taken into account (within the meaning of §31.3121(v)(2)–1(d) of this chapter) prior to January 1, 2005, for purposes of taxation under chapter 21 of the Internal Revenue Code (or income attributable thereto); and

(*3*) The interest was held before the first date on which the ESOP acquires any employer securities.

(v) *No overlap among shares of deemed-owned ESOP shares or synthetic equity.* Synthetic equity under this paragraph (f)(2) does not include shares that are deemed-owned ESOP shares (or any rights with respect to deemed-owned ESOP shares to the extent such rights are specifically permitted under section 409(h)). In addition, synthetic equity under a specific subparagraph of this paragraph (f)(2) does not include anything that is synthetic equity under paragraph (f)(2)(i), (ii), (iii) or (iv) of this section.

(3) *Related entity*. For purposes of this paragraph (f), *related entity* means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under §301.7701–3 of this chapter, or a Qualified Subchapter S Subsidiary under section 1361(b)(3).

(4) *Number of synthetic shares*—(i) *Synthetic equity determined by reference to S corporation shares*. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, the person who is entitled to the synthetic equity is treated as owning the number of shares of stock deliverable pursuant to such synthetic equity. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, but for which payment is made in cash or other property (besides stock of the S corporation), the number of shares of synthetic equity treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property (disregarding lapse restrictions as described in §1.83–3(i)). Where such synthetic equity is a right to purchase or receive S corporation shares, the corresponding number of shares of synthetic equity is determined without regard to lapse restrictions as described in §1.83–3(i) or to any amount required to be paid in exchange for the shares. Thus, for example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, exercisable in the future only after the satisfaction of certain performance conditions, the employee is the deemed owner of 100 synthetic equity shares of the corporation as of the date the option is granted. If the same employee were granted 100 shares of restricted S corporation stock (or restricted stock units), subject to forfeiture until the satisfaction of performance or service conditions, the employee would likewise be the deemed owner of 100 synthetic equity shares from the grant date. However, if the same employee were granted a stock appreciation right with regard to 100 shares of S corporation stock (whether payable in stock or in cash), the number of synthetic equity shares the employee is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

(ii) *Synthetic equity determined by reference to shares in a related entity*. In the case of synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)).

(iii) *Other synthetic equity*—(A) *General rule*. In the case of any synthetic equity to which neither paragraph (f)(4)(i) nor paragraph (f)(4)(ii) of this section apply, the person who is entitled to the synthetic equity is treated as owning on any date a number of shares of stock in the S corporation equal to the present value (on that date) of the synthetic equity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)) divided by the fair market value of a share of the S corporation's stock as of that date.

(B) *Special rules*—(*1*) *Use of annual or more frequent determination dates*. For purposes of this paragraph (f)(4)(iii), while the determination of whether there is a nonallocation year depends on day-by-day determinations under paragraph (c) of this section, the number of shares of S corporation stock treated as owned by a person who is entitled to synthetic equity to which this paragraph (f)(4)(iii) applies is permitted to be determined only annually (or more frequently), as of the first day of the ESOP's plan year or as of any other reasonable determination date or dates during a plan year. If the ESOP so provides, the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies that are treated as owned by that person for any period from a given determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the given determination date.

(*2*) *Use of triannual recalculations.* In addition, if the terms of the ESOP so provide, then the number of shares of synthetic equity with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies may be fixed for a specified period from a determination date identified under the ESOP through a date that is not later than the day before the determination date that is on or immediately preceding the third anniversary of the identified determination date. Additional accruals, allocations, or grants (to which this paragraph (f)(4)(iii) applies) that are made during such three-year period are taken into account on each determination date during that period, based on the number of synthetic equity shares resulting from the additional accrual, allocation, or grant (determined as of the determination date on or next following the date of the accrual, allocation, or grant). However, the ESOP must provide for the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies to be re-determined not less frequently than every three years, based on the S corporation share value on a determination date that is not later than the third anniversary of the identified determination date and the aggregate present value of the synthetic equity to which this paragraph (f)(4)(iii) applies (including all grants made during the three-year period) on that determination date. See *Example 3* of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(B)(*2*).

(*3*) *Conditions for application of rules.* Paragraph (f)(4)(iii)(B) of this section only applies with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(B)(*1*) of this section applies only if the fair market value of a share of the S corporation securities on any determination date is not unrepresentative of the value of the S corporation securities throughout the rest of the plan year and only if the terms of the ESOP include provisions conforming to paragraph (f)(4)(iii)(B)(*1*) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(B)(*2*) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(B)(*1*) and (*2*) of this section which are consistently used by the ESOP for all persons.

(iv) *Adjustment of number of synthetic equity shares where ESOP owns less than 100% of S corporation.* Under this paragraph (f)(4)(iv), the number of synthetic shares otherwise determined under this paragraph (f)(4) is decreased ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP (and who is subject to Federal income taxes). For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated under this paragraph (f)(4) as owning 200 synthetic equity shares of the S corporation but for this paragraph (f)(4)(iv), then, under the rule of this paragraph (f)(4)(iv), the number of synthetic shares treated as owned by B under this paragraph (f)(4) is decreased from 200 to 150 (because the ESOP only owns 75% of the outstanding stock of the S corporation, rather than 100%).

(v) *Special rule for shares with greater voting power than ESOP shares.* Notwithstanding any other provision of this paragraph (f)(4), if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is not less than the number of shares that would have the same voting rights if the shares had the same per-share voting rights as shares held by the ESOP with the least voting rights. For example, if shares of S corporation stock held by the ESOP have one voting right per share, then an individual who holds an option to purchase one share with 100 voting rights is treated as owning 100 shares of synthetic equity.

(g) *Avoidance or evasion of section 409(p) involving synthetic equity*—(1) *General rule.* Paragraph (g)(2) of this section sets forth a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p). Paragraph (g)(3) of this section identifies certain specific ownership structures that constitute an avoidance or evasion of section 409(p). See also paragraph (c)(3) of this section for a rule under which the ownership structures in paragraph (g)(3) result in a nonallocation year for purposes of section 409(p).

(2) *Standard for determining when there is an avoidance or evasion of section 409(p) involving synthetic equity*—For purposes of section 409(p) and this section, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances, including all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the cash distributions made to shareholders, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives these economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity, for example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

(3) *Specific transactions that constitute an avoidance or evasion of section 409(p) involving segregated profits.* Taking into account the standard in paragraph (g)(2) of this section, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p) in any case in which—

(i) The profits of the S corporation generated by the business activities of a specific individual or individuals are not provided to the ESOP, but are instead substantially accumulated and held for the benefit of that individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation described in paragraph (f)(2)(iv) of this section);

(ii) The individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary); and

(iii) A nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP).

(h) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. Relating to determination of disqualified persons and nonallocation year if there is no synthetic equity. (i) *Facts.* Corporation X is a calendar year S corporation that maintains an ESOP. X has a single class of common stock, of which there are a total of 1,200 shares outstanding. X has no synthetic equity. In 2006, individual A, who is not an employee of X (and is not related to any employee of X), owns 100 shares directly, individual B owns 100 shares directly, and the remaining 1,000 shares are owned by an ESOP maintained by X for its employees. The ESOP's 1,000 shares are allocated to the accounts of individuals who are employees of X (none of whom are related), as set forth in columns 1 and 2 in the following table:

1 Shareholders	2 Deemed-owned ESOP shares (total of 1,000)	3 Percentage deemed-owned ESOP shares	4 Disqualified person
B	330	33	Yes.
C	145	14.5	Yes.
D	75	7.5	No.
E	30	3	No.
F	20	2	No.
Other participants	400 (none exceed 10 shares)	1 or less	No.

(ii) *Conclusion with respect to disqualified persons*. As shown in column 4 in the table above, individuals B and C are disqualified persons for 2006 under paragraph (d)(1) of this section because each owns at least 10% of X's deemed-owned ESOP shares.

(iii) *Conclusion with respect to nonallocation year*. However, 2006 is not a nonallocation year under section 409(p) because disqualified persons do not own at least 50% of X's outstanding shares (the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, plus C's 145 deemed-owned ESOP shares equal only 47.9% of the 1,200 outstanding shares of X).

Example 2. Relating to determination of disqualified persons and nonallocation year if there is synthetic equity. (i) *Facts*. The facts are the same as in *Example 1*, except that, as shown in column 4 of the table in this *example 2*, individuals E and F have options to acquire 110 and 130 shares, respectively, of the common stock of X from X:

1 Shareholders	2 Deemed-owned ESOP shares (total of 1,000)	3 Percentage deemed-owned ESOP shares	4 Options (240)	5 Shareholder percentage of deemed-owned ESOP plus synthetic equity shares	6 Disqualified person
B	330	33			Yes (col. 3).
C	145	14.5			Yes (col. 3).
D	75	7.5			No.
E	30	3	110	11.1% ([30 + 91.7] divided by 1,091.7).	Yes (col. 5).
F	20	2	130	11.6% ([20 + 108.3] divided by 1,108.3).	Yes (col. 5).
Other participants	400 (none exceeds 10 shares).	1 or less			No.

(ii) *Conclusion with respect to disqualified persons*. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts into 91.7 shares of synthetic equity (110 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Similarly, F's option to acquire 130 shares of the S corporation converts into 108.3 shares of synthetic equity (130 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Accordingly, as shown in column 6 in the table above, individual E's synthetic equity shares are counted in determining whether E is a disqualified person for 2006, and individual F's synthetic equity shares are counted in determining whether F is a disqualified person for 2006, but the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, individuals B, C, E, and F are disqualified persons for 2006.

(iii) *Conclusion with respect to nonallocation year*. The 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, E's 91.7 synthetic equity shares, F's 20 deemed-owned ESOP shares, plus F's 108.3 synthetic equity shares total 825, which equals 58.9% of 1,400, which is the sum of the 1,200 outstanding shares of X and the 200 shares of synthetic equity shares of X held by disqualified persons. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of the total shares of outstanding stock of X and the total synthetic equity shares of X held by disqualified persons. In addition, independent of the preceding conclusion, 2006 would be a nonallocation year because disqualified persons own at least 50% of X's outstanding shares because the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, plus F's 20 deemed-owned ESOP shares equal 52.1% of the 1,200 outstanding shares of X.

Example 3. Relating to determination of number of shares of synthetic equity. (i) *Facts.* Corporation Y is a calendar year S corporation that maintains an ESOP. Y has a single class of common stock, of which there are a total of 1,000 shares outstanding, all of which are owned by the ESOP. Y has no synthetic equity, except for four grants of nonqualified deferred compensation that are made to an individual during the period from 2005 through 2011, as set forth in column 2 in the following table, and the ESOP uses the special rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual, as shown in columns 4 and 5:

1 Determination date	2 Present value of nonqualified deferred compenstion on determination date	3 Share value on determination date	4 New shares of synthetic equity on determination date	5 Aggregate number of synthetic equity shares on determination date
January 1, 2005	A grant is made on January 1, 2005 with a present value of $1,000. An additional grant of nonqualified deferred compensation with a present value of $775 is made on March 1, 2005.	$10 per share	100	100
January 1, 2006	An additional grant is made on December 31, 2005 which has a present value of $800 on January 1, 2006. The March 1, 2005 grant has a present value on January 1, 2006 of $800.	$8 per share	200	300
January 1, 2007	No new grants made	$12 per share		300
January 1, 2008	An additional grant is made on December 31, 2007 which has a present value of $3,000 on January 1, 2008. The grants made during 2005 through 2007 have an aggregate present value on January 1, 2008 of $3,750.	$15 per share	200	450
January 1, 2009	No new grants are made	$11 per share		450
January 1, 2010	No new grants are made	$22 per share		450
January 1, 2011	No new grants are made. The grants made during 2005 through 2008 have an aggregate present value on January 1, 2011 of $7,600.	$20 per share		380

(ii) *Conclusion.* The grant made on January 1, 2005, is treated as 100 shares until the determination date in 2008. The grant made on March 1, 2005, is not taken into account until the 2006 determination date and its present value on that date, along with the then present value of the grant made on the preceding day, is treated as a number of shares that are based on the $8 per share value on the 2006 determination date, with the resulting number of shares continuing to apply until the determination date in 2008. On the January 1, 2008, determination date, the grant made on the preceding day is taken into account at its present value of $3,000 on January 1, 2008 and the $15 per share value on that date with the resulting number of shares (200) continuing to apply until the next determination date. In addition, on the January 1, 2008, determination date, the number of shares determined under other grants made between January 1, 2005 and December 31, 2007, must be revalued. Accordingly, the aggregate value of all nonqualified deferred compensation granted during that period is determined to be $3750 on January 1, 2008, and the corresponding number of shares of synthetic equity based on the $15 per share value is determined to be 250 shares on the 2008 determination date, with the resulting aggregate number of shares (450) continuing to apply until the determination date in 2011. On the January 1, 2011, determination date, the aggregate value of all nonqualified deferred compensation is determined to be $7,600 and the corresponding number of shares of synthetic equity based on the $20 per share value on the 2011 determination date is determined to be 380 shares (with the resulting number of shares continuing to apply until the determination date in 2014, assuming no further grants are made).

(i) *Effective dates*—(1) *Statutory effective date.* (i) Except as otherwise provided in paragraph (i)(1)(ii) of this section, section 409(p) applies for plan years ending after March 14, 2001.

(ii) If an ESOP holding stock in an S corporation was established on or before March 14, 2001, and the election under section 1362(a) with respect to that S corporation was in effect on March 14, 2001, section 409(p) applies for plan years beginning on or after January 1, 2005.

(2) *Regulation effective date*—(i) *General effective date.* Except as otherwise provided in paragraph (i)(2)(ii) of this section, this section applies for plan years beginning on or after January 1, 2005.

(ii) *Rules for plan years beginning before January 1, 2005.* (A) Except as provided in this paragraph (i)(2)(ii), §1.409(p)–1T as in effect prior to December 17, 2004 (*see* §1.409(p)–1T in 26 CFR part 1 revised as of April 1, 2004) applies for plan years ending after October 20, 2003, and beginning before January 1, 2005.

(B) Paragraphs (c)(3) and (g) of this section apply for plan years ending on or after December 31, 2004, but do not apply with respect to an interest held in a qualified subchapter S subsidiary (QSUB) of an S corporation or another entity to which paragraph (g)(3) of this section applies before March 15, 2004 if:

(*1*) All interests in the entity held by individuals who would be disqualified persons under paragraph (g)(3) of this section or under guidance issued by the Commissioner before March 15, 2004 are distributed to those individuals as compensation on or before March 15, 2004; and

(*2*) No such individual has been a participant in the ESOP of the S corporation at any time after October 20, 2003 and before March 15, 2004.

(C) Paragraph (f)(2)(iv)(B) of this section (providing that synthetic equity does not include certain preexisting nonqualified deferred compensation) applies for plan years ending before January 1, 2005.

(D) Paragraph (f)(4)(iv) of this section (permitting an adjustment of the number of synthetic equity shares where an ESOP owns less than 100% of an S corporation) applies for plan years ending before January 1, 2005.

(E) In no event does this paragraph (i)(2)(ii) apply for any plan year ending before January 1, 2005, for an ESOP holding stock in an S corporation that was established on or before March 14, 2001, if the election under section 1362(a) with respect to that S Corporation was in effect on March 14, 2001.

(iii) *Transition rules.* (A) Assets held in the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, will not be treated as an impermissible accrual with respect to that disqualified person under paragraph (b)(2)(ii) of this section for the first plan year beginning on or after January 1, 2005, to the extent those assets are not held in that person's account on or after July 1, 2005. Thus, for example, to the extent the assets allocated to the account of a disqualified person as of the last day of the first plan year beginning before January 1, 2005, are transferred to a non-ESOP portion of the plan as described in paragraph (b)(2)(v)(A) of this section before July 1, 2005, those assets will not be treated as an impermissible accrual under paragraph (b)(2)(ii) of this section for the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005. However, see section 4979A(a)(3), (a)(4), and (e)(2)(C) for excise tax provisions that apply to all deemed-owned shares during the first nonallocation year for the ESOP.

(B) An individual is not treated as a disqualified person during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005 if that person would not be a disqualified person during that period under the modified rules of this paragraph (i)(2)(iii)(B) as of any date during that same period. Further, solely for the purpose of determining whether the first plan year beginning on or after January 1, 2005 is a nonallocation year under section 409(p) and this section, if that plan year would not have been a nonallocation year under the modified rules of this paragraph (i)(2)(iii)(B), then synthetic equity that is not owned by a person on July 1, 2005 is disregarded during the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005. For purposes of this paragraph (i)(2)(iii)(B), the *modified rules of this paragraph (i)(2)(iii)(B)* are the rules in § 1.409(p)–1T as in effect prior to December 17, 2004 (see § 1.409(p)–1T in 26 CFR Part 1 revised as of April 1, 2004), modified to exclude from the definition of synthetic equity any stock option, stock appreciation right (payable in cash or stock), or similar rights with respect to shares of the S corporation or a related entity where the facts and circumstances indicate that there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value). For this purpose, there is no reasonable likelihood that the holder of the right will receive the shares (or equivalent value) in any case in which the option is based on an exercise price that is more than 200% of the fair market value of the shares on the date of grant or the right (in the case of a stock appreciation right or similar right to acquire shares of the S corporation or a related entity) is payable only if the appreciation exceeds 100% of the fair market value of the shares on the date of grant.

(C) For the period from the first day of the first plan year beginning on or after January 1, 2005 through June 30, 2005, there is no nonallocation year under this section if there would be no nonallocation year under this section during that period if this section were applied without regard to paragraph (f)(4)(v) of this section (relating to voting rights).

(D) This paragraph (iii) does not apply to an ESOP for which the first plan year beginning on or after January 1, 2005 begins after June 30, 2005.

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