Defined Benefit Floor-Offset Arrangements and Other Plan Designs

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INTERNAL REVENUE SERVICE

TAX EXEMPT AND GOVERNMENT ENTITIES

Overview

Introduction – A floor-offset arrangement is characterized by two separate, related retirement plans: a defined benefit (DB) "floor plan" and a defined contribution (DC) "base plan". The DB plan utilizes a standard formula to define a minimum benefit level or floor, taking into account age, service and/or compensation. The employee receives only the DC account balance if the annuity benefit that may be provided in the DC plan, the "DC Annuity Benefit," is equal to or exceeds the floor plan benefit otherwise provided. The "DC Annuity Benefit" is calculated by converting the DC account balance into an annuity benefit using the actuarial conversion factors specified in the DB plan. However, if the benefit in the floor plan exceeds the DC Annuity Benefit, the floor plan will pay the difference.

Objectives At the end of this chapter, you will be able to:

- Explain how floor-offset plans operate, including cash balance plans
- Determine if the floor-offset plan language is correct
- Determine if a floor-offset plan satisfies coverage and meaningful benefit requirements and
- Understand the top-heavy rules.

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Reference Materials

- Treas. Reg. § 1.401(a)(26)-5(a)(2)
- Treas. Reg. § 1.401(a)(4)-8(d)
- Rev. Rul. 1976-259
- IRC § 401(a)(26)
- IRC §1.410(b)
- Revenue Ruling 76-259
- Exhibit 1, June 6, 2002 Memorandum, Section 401(a)(26) – Cash Balance Plans
- Exhibit 2, June 6, 2006 Memorandum, Section 401(a)(26) – Offset Plans
- Exhibit 3, June 17, 2007 Memorandum, Section 401(a)(26)- Offset Plans
- Exhibit 4, October 22, 2004 Memorandum, Short Service Employees and Other Meaningful Benefit Schemes and Abuses
- Exhibit 5, February 4, 2005 letter follow up to October 22, 2004 memo
- Explanation 5A, Coverage and Nondiscrimination: Defined Benefit Plans
- Worksheet 5A, Form 9638, *Employee Benefit Plan Coverage & Nondiscrimination Requirements: Defined Benefit Plans*
- EP Examinations Phase V - Training 11305-002 (08-2010)
- FY 2013 CPE – 1st Quarter – Overview of Hybrid plans
http://tege.web.irs.gov/article.asp?category=career&title=ep-2013-cpe&path=/my-career/training
- Various Technical Advice Memos (TAMS) referred to in text

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Elements of Offset Plans

Overview

Under a floor-offset arrangement, an employee will never receive less than the floor benefit promised under the DB plan. Thus, if the DC Annuity Benefit is greater than the benefit under the DB plan, no benefits are due from the DB plan and all of the benefits will come from the DC plan. However, if the DC Annuity Benefit is less than the floor, the participant receives the difference from the DB plan.

The floor-offset arrangement is an effective plan design. For example, assume the employer's retirement plan objective is to provide a benefit equal to 50% of average compensation for an employee retiring at normal retirement age with 30 years of service. The "floor" is 50% of average compensation. Also assume the employer is contributing to a profit sharing plan.

If the profit sharing plan account balance provides an actuarial equivalent annuity benefit equal to 35% of average compensation, then the DB plan will make up the difference and provide 15% of average compensation. If the profit sharing account balance declines due to poor investment performance and only provides a monthly benefit equal to 30% of average compensation, the DB plan will make up the difference and provide 20% of average compensation.

Conversely, if the profit sharing account balances increases such that it provides an actuarially equivalent annuity value of 40% of average compensation, the DB plan will provide a monthly benefit equal to 10% of average compensation. Additionally, if the profit sharing account balance provides an actuarial equivalent annuity of 60% of average compensation, this amount will be provided by the DC plan and no benefit will be payable from the DB plan.

It is important to note that the DC account balance is the retiree's to annuitize, hold, or take a lump sum, as provided under the terms of the DC plan. Regardless of whether the retiree takes a lump sum or not, the same offset to benefits in the DB plan apply. Also, the floor benefit in the DB plan is fixed at termination of employment and is unaffected by future investment performance of the DC plan.

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Example 1

Ripon, Inc. sponsors a floor-offset DB plan that provides a benefit of 1 percent of average compensation x years of service, offset by the DC Annuity Benefit provided by the DC plan.

Joe retires with 30 years of service, average compensation of $60,000, and a DC account balance of $120,000. Assume the annuity purchase rate (APR) used to convert the DC account balance to the DC Annuity Benefit is 120. [1]

The calculation of the floor and net benefits follows:

Calculation of Floor and Net Benefits (monthly)		
(1) Floor plan accrued benefit	$60,000 × 30 × .01 ÷ 12	= $1,500
(2) DC account balance	$120,000	
(3) DC Annuity Benefit	$120,000/120	= $1,000
(4) Net benefit payable from DB plan = (1) – (3)		= $500
(5) Total benefit payable = (3) + (4)		= $1,500

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[1] An Annuity Purchase Rate (APR) for a life annuity is the amount it would cost to provide $1.00 monthly benefit for life based on a given interest rate, mortality table, and age.

Example 2

Vanderbilt Company sponsors a floor-offset DB plan whereby an employee who retires at age 65 is entitled to a $2,000 monthly pension (floor benefit) from the DB plan, offset by the DC Annuity Benefit provided by the DC plan.

Mary's DC account balance is $108,000. Based on an APR of 120, this balance would provide a DC Annuity Benefit of $900 per month. The DB plan benefit would be offset by the $900 DC Annuity Benefit with a net benefit of $1,100 each month from the DB plan.

If, however, Mary's DC account balance was $324,000, the DC Annuity Benefit (based on an APR of 120) would be $2,700 monthly. This totally offsets the floor benefit otherwise provided in the DB plan and the employee receives no benefit from the DB plan.

The two calculations are summarized below;

Calculation of Floor and Net Benefits (monthly)		
(1) Floor Plan benefit level	$2,000	$2,000
(2) DC account balance	$108,000	$324,000
(3) DC Annuity Benefit ((2)/120)	$900	$2,700
(4) Net benefit payable from DB plan = (1) – (3)	$1,100	$0
(5) Total benefit = (3) + (4)	$2,000	$2,700

Definitely Determinable

Definitely Determinable Benefits

A DB plan must systematically provide for the payment of “definitely determinable benefits.” This means that given certain factors, like a participant’s age, service, and salary, the monthly benefit payable can be “definitely determined.” Any employer discretion in the amount of benefits provided is not allowed.

A floor-offset DB plan must define the DC plan that provides the benefits used as the offset, as well as the actuarial assumptions to convert the DC plan account balance to an accrued benefit. The DB plan will not fail definitely determinable if the profit sharing plan provides discretionary employer contributions. For example, it is common that the Board of Directors of a Company will determine the profit sharing plan contribution annually. But once the DC plan contribution is determined, the allocation of the contribution to each participant’s account must be determined by the plan document (such as allocated by pay, or a flat dollar amount per participant).

The accrued benefit used to offset benefits in the DB plan is determined using the actuarial equivalence of the current account balance in the DC plan where actuarial equivalence factors for converting this DC account balance must be defined in the DB plan document.

The law also provides that a DB plan shall not be treated as providing definitely determinable benefits unless, whenever the amount of any benefit is to be determined on the basis of actuarial assumptions, such assumptions are specified in the plan in a way that precludes employer discretion.[2]

In order to determine the amounts paid to the participant under the optional forms offered by the plan, the plan must specify the factors used to calculate actuarial equivalence. The factors form the basis for converting the benefit provided by the plan in its normal form (for example, life annuity) into other forms of benefit offered by the plan (such as a qualified joint and survivor annuity or a lump sum). However, these factors do not have to be the same as those used to convert the DC account balance to a DC Annuity Benefit used to offset a floor benefit in a DB plan.

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[2] IRC § 401(a)(25)

Benefits Defined as "415/401(a)(4) Maximum"

Some plans attempt to define benefits or contributions with reference to words like "the maximum allowed under IRC § 415" or "the amount needed to allow the plan to pass IRC § 401(a)(4) non-discrimination."

The regulations define a pension plan, which includes a DB plan, within the meaning of IRC § 401(a) as a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits.[3] In general, plan documents worded like this would not meet the definitely determinable requirements.

Definitely Determinable Benefits – Guidance

Several Technical Advice Memorandums (TAMs) have addressed the issue of definitely determinable benefits.

The first relates to the proposed principal credits under a cash balance plan.[4] The principal credits are defined in the plan as the lesser of:

a. Ten (10) times the Partici pant's Special Bonus, or

b. The maximum benefit permitted under section 415.

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[3] Treas. Reg. §1.401-1(b)(1)(i)
[4] TAM dated 1.03.2007.

Definitely Determinable Benefits – Guidance, (continued)

The Special Bonus is equal to a percentage of compensation and does not require an amendment to the plan. The determination is made individually for each Participant at the discretion of the Board of Directors. Because the Board of Directors determines the Special Bonus, it is clearly within the discretion of the employer. Given that benefits are subject to employer discretion, they are not definitely determinable.

The second TAM also relates to a cash balance plan.[5] The proposed principal credit equals the maximum permitted under section 415 of the Code, not to exceed the lesser of (1) the maximum permitted amount which enables the plan to comply with section 401(a)(4) of the Code, or (2) for highly compensated employees, 100 times such participant's March monthly cash salary.

Because of the large number of approaches and the wide range of assumptions permitted for nondiscrimination testing under IRC § 401(a)(4) of the Code and the associated regulations, a plan that bases benefits for any member on the results of nondiscrimination testing is not definitely determinable unless it specifies each assumption and each part of the procedure for performing that testing.

In addition, the amount of compensation paid to an individual participant during the month of March can easily be manipulated by the employer by accelerating or delaying payment of all or a portion of the employee's compensation for a few weeks, without significant adverse effect on the employee or the employer. Therefore, a benefit based on the compensation paid during the month of March each year is subject to employer discretion and is therefore not definitely determinable.

[5] TAM dated 7.31.2007

Accrual of Benefits

Accrual of Benefits

How does a DB plan meet the definitely determinable requirements if one element is a DC plan account balance that varies daily? Rev. Rul. 76-259 provides important guidance.

Rev. Rul. 76-259 provides that a floor-offset DB plan will meet the accrued benefit rules of IRC § 411 if:

- The accrued benefit under the DB plan determined without regard to the offset (gross benefit) derived from the profit sharing plan satisfies the requirements of IRC § 411(b)(1), and
- The offset to the benefit otherwise payable is equal to the amount deemed provided on the determination date by the vested portion of the account balance in the profit sharing plan.

Thus, if any portion of the benefit being offset is nonforfeitable (i.e. vested), that portion may only be offset by the DC account (or portion of a DC account) that is nonforfeitable.

Type of DC Plans

The DC plan being used as a floor-offset arrangement may not be either an IRC § 401(k) plan or an IRC § 401(m) plan.[6]

Generally, a defined benefit plan cannot invest more than 10% of its assets in qualifying employer securities. ERISA also provides that the defined contribution offset plan is treated as part of the defined benefit plan for this purpose. However, for floor-offset arrangements that were established on or before ***December 17, 1987***, the defined contribution offset plan can be disregarded in determining whether the defined benefit plan complies with the 10% limit on investment in employer securities. From a practical standpoint, ESOPs would generally not be used on a floor-offset arrangement.

This avoids the possibility that the DB plan benefits are offset by contributions made by the employee; only company contributions may be used as an offset.

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[6] Treas. Reg. § 1.401(a)(4)-8(d)(1)(vii).

Project Prorate -Example 3

Albright Company has two employees, Eli and Hanna. The company maintains a DB floor-offset arrangement. Eli is projected to have a NRA benefit in the DB plan of $2,000 per month at age 65, while Hanna has a projected NRA benefit of $400 per month at age 65. Eli has accrued 15 years of service and has 10 years until his normal retirement date. Hanna has accrued 3 years of service, and has 30 years until her normal retirement date.

Assume that the DB plan determines the accrued benefit under the "project-prorate" method. The project prorate calculation would be based on the floor (i.e. before) offset benefit.

In the DC plan, Eli has an account balance of $50,000, while Hanna has an account balance of $475. Assume all accounts are fully vested.

To convert the DC plan account balance to an annuity at NRA, the DC plan account balance is accumulated with interest to NRA then divided by the annuity purchase rate. Assume that the DB plan provides that the DC plan account balance conversion is based on 5% interest and 94 GAR mortality. These assumptions produce a monthly annuity purchase rate at age 65 of 141.529. Also assume that the plan defines that the accumulation of the DC plan account balance is based on 7% interest.

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Project Prorate -Example 3 (continued)

The table below provides the benefit provided to each employee at their current age from the DB plan before and after the offset is considered.

Calculation of DB Plan Accrued Benefit (all benefits are monthly)		
	Eli	Hanna
A. DB Plan "Floor"		
(1) DB plan floor benefit at age 65	\$2,000	\$400
(2) Accrued service	15	3
(3) Projected service	25	33
(4) Accrued benefit at age 65 = (1) x (2) /(3)	\$1,200	\$36
B. DC Plan		
(1) Current account balance	\$50,000	\$475
(2) Years to age 65	10	30
(3) Projected future value of DC account balance at 7%	= \$50,000 x $(1.07)^{10}$ = \$98,358	= \$475 x $(1.07)^{30}$ = \$ 3,616
(4) APR at age 65	141.529	141.529
(5) Annuity at age 65 = (3)/(4)	695	26
C. Net DB Plan benefit = A(4) – B(5)	\$505	\$10

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Project Prorate (incorrect method) Example 4

Note that in the example above, the "project prorate" factor was applied to the floor benefit **before** offset by the DC plan benefit.
It would be **incorrect** to apply the proration after the DC plan offset; as shown below;

	Eli	Hanna
1. DB Plan "Floor"	$2,000	$400
2. DC annuity at age 65	695	26
3. Net Benefit	1,305	374
4. Proration factor	15/25	3/33
5. Net Benefit = (3) x (4)	783 This is incorrect	34 This is incorrect
The amount below is the correct benefit from the table above.		
Correct net benefit	$505	$10

Accrued benefits – Incorrect method Example 5

Note that Rev. Rul. 76-259 provides the calculation of benefits before and after offset in terms accrued benefits and account balances. It is **not correct** to determine the offset benefit otherwise provided in the DB plan on a year-by-year basis.

For example, assume Eli's benefit accrued **during the year** equals the following (monthly benefits);

1. Floor benefit = $80 per year of service
2. Profit sharing contribution for current year converted to an annuity = $60
3. Potential net benefit = (1) – (2) = $20

This is **not** the correct way to determine the net benefit provided in the DB plan. The net benefit must be determined in terms of accrued benefits; not current year's annual benefits or DC plan contributions.

Cash Balance Plans

Cash Balance Plans[7]

Since many new defined benefit plans, including floor-offset arrangements, are cash balance plans, this section provides an overview of these types of plans.

Cash balance plans incorporate features of both DC and DB plans, but are technically DB plans.

To a participant, a cash balance plan looks like a DC plan:

- Each participant has an "account" that grows with annual credits.

These credits are:

Interest credits which are calculated based on the level of the participant's account and,

Principal credits, which are generally a specified as a set dollar amount or calculated as a percentage of the participant's pay.

In many plans, the participant is permitted to receive a lump sum distribution of the vested balance in his or her account upon retirement or separation from service at any age.

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[7] FY 2013 CPE – 1st Quarter – Overview of Hybrid plans.

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Cash Balance Plans (continued)

- However, cash balance plans are actually DB plans:
    - Participants "accounts" are recordkeeping accounts only and are referred to in the regulations as "hypothetical accounts"
    - The employer does not make contributions to accounts for individual participants. Instead, the employer makes contributions to the plan's trust based on the minimum funding requirements for DB plans in accordance with IRC §§ 430 and 412.
    - The interest credits are based on the plan's provisions, generally not the actual return on the plan's assets.
    - The employer (not the employee) assumes the responsibility for investment gains and losses.
- No actual assets are associated with participant accounts. Assets are pooled and as with any defined benefit plan, although accrued benefits may not be reduced upon plan termination if the plan terminates while it is under funded, trust assets may be allocated among participants in a nondiscriminatory manner in order to pay benefits to the extent funded (see Revenue Ruling 80-229).

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How a Cash Balance Plan Begins

Cash balance plans can come into existence in two ways:

- An existing DB plan can be converted to a cash balance plan with or without an opening balance in the hypothetical account, or
- The employer adopts a new cash balance plan.

Example 6- Principal Credit

Cornell Company's cash balance plan provides a principal credit of 4% x compensation for the plan year.
Leah's compensation during 2012 was $80,000.
Her principal credit for 2012 is $3,200 (4% x $80,000).

Example 7- Principal Credit

Duke's cash balance plan provides the following principal credit schedule based on the number of years of service:

- For 0 - 10 years = 3%
- For 11 - 20 years = 3.5%
- For 20 or more years = 4%

Mary's compensation for 2012 was $60,000 and she had 25 years of service in 2012. Based on her 25 years of service, her principal credit is 4% of pay.

Her principal credit for 2012 is equal to $2,400 ($60,000 x 4%).

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Interest Credit

An interest credit represents the hypothetical investment return each participant will receive based on the amount of their hypothetical account balance.

Plan Can Define Interest Credits as Various Rates

A plan can define interest credits as:

- A fixed interest rate,
- A variable outside index,
- The IRC § 417(e)(3) rate (applicable interest rate), or
- A combination of the above.

Example 8- Interest Credit

The Franklin Company's cash balance plan provides for a 4 percent interest credit to each participant.

This is an example of a fixed interest rate.

Example 9- Interest Credit

The interest credit provided to each participant will be the annual yield on a 1-year Treasury Constant Maturities plus 0.5 percent.

This is an example of a variable outside index.

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Calculate the Hypothetical Account Balance

Assume Leah's compensation increased to $85,000 in 2013. Her principal credit from the Cornell Company plan would be equal to $3,400 (4% x $85,000). Also assume that the plan provides a 4% interest credit, credited at the end of the year.

Leah's hypothetical account balance at the end of 2013 would be determined as follows:

(1) Principal credit for 2012	$3,200
(2) Interest at 4% on above at 12/31/13	128
(3) Principal credit for 2013	3,400
(4) Account balance at 12/31/13 (1+2+3)	$6,728

Accrued Benefits under Cash Balance Plans

Traditional DB plans define a participant's accrued benefit as an amount payable in a certain annuity form (*for example*, single life annuity) starting at a normal retirement age.

Because a cash balance plan is a DB plan, a cash balance plan is required to provide annuity benefits for those participants who do not elect another form of payment provided under the plan terms, such a single sum. These annuity benefits must be calculated as the actuarial equivalent of the participant's cash balance hypothetical account, based on actuarial assumptions defined in the plan.

First Step-Project the Hypothetical Account Balance

Leah's accrued benefit at age 65 is calculated by first projecting the hypothetical account balance to normal retirement age at the interest crediting rate (assume Leah is age 51 at this time):

$\$6,728 \times (1.04)^{14} = \$11,651$

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Next Step-Divide by the Annuity Purchase Rate

The next step is to divide by the age 65 annuity purchase rate based on plan provisions (141.60 in this example):

$11,651 / 141.60 = $82 per month, equals the accrued benefit payable monthly at normal retirement age.

Determining the Present Value of the Accrued Benefit ("Whipsaw")

Because cash balance plans are DB plans, a participant may receive a lump sum based on the **present value of the accrued benefit payable at NRA.** To determine this present value amount, prior to PPA '06, a plan sponsor had to use the IRC § 417(e) specified interest and mortality assumptions. Depending on the assumptions used under the cash balance plan, the present value of the annuity at NRA could, and often did differ from the hypothetical account balance. This is commonly referred to as "whipsaw."

Whipsaw occurs when the interest crediting rate in determining a participant's hypothetical account balance is higher than the interest rate used to determine the present value of the annuity beginning at normal retirement age under section IRC § 417(e).

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PPA'06 IRC § 417(e) Requirements

PPA '06 addressed the IRC § 417(e) requirement by adding IRC § 411(a)(13). Thus if a cash balance plan defines the hypothetical account balance as the present value of the accrued benefit then the requirements of IRC § 417(e) are deemed to be satisfied. By equating the hypothetical account with the present value of the accrued benefit, the requirements under IRC § 417(e) are satisfied without the need to specifically apply the IRC § 417(e) assumptions to determine the present value of the accrued benefit.

It is however important to note that if a cash balance plan document did contain language describing the whipsaw calculations, this language must have been amended from the plan prior to the end of the first plan year that began on or after January 1, 2009, in order to obtain relief from IRC § 411(d)(6) and no longer have to apply the whipsaw calculations to the entire account balance.

Therefore, in the example above, because under the terms of the plan the hypothetical account balance is defined as the present value of the accrued benefit, Leah may be paid a lump sum of $11,651 and meet the requirements of IRC § 417(e).

Cash Balance Floor-Offset

A cash balance plan may also be the floor plan in a floor-offset arrangement. Under this approach, the floor plan must be determined on the basis of hypothetical account balances converted to the actuarially equivalent accrued benefit at normal retirement age. **Principal credits may not be offset on a year-by-year basis**.

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Invalid Offset

A cash balance plan provides the definition of principal credits as (a) – (b) where:

(a) = 10% of compensation

(b) = the employer discretionary allocation in the Profit Sharing Plan for the same plan year

This type of benefit offset is not allowed because per Rev Ruling 76-259, the offsetting accrued benefit has to be related to the account balance, **not** the annual allocation of the DC plan.

Valid Offset

A cash balance plan provides the definition of principal credits as 10% of compensation. However, the annuity benefit payable is defined as (a) – (b) where:

(a) = annuitized value of cash balance account

(b) = the actuarial equivalent of the vested account balance of the Profit Sharing Plan that is attributable to the discretionary employer contributions.

Coverage/Participation

Coverage[8]

The law[9] provides that an employee is treated as **benefiting** under a plan if the employee satisfies all of the applicable conditions for accruing a benefit but fails to have an increase in accrued benefit solely because the plan counteracts the employee's current benefit accrual under a floor-offset arrangement[10] (without regard to whether the offset is attributable to pre-participation service or past service).

Participation

Qualified DB plans must satisfy the additional participation requirements of IRC § 401(a)(26). In general, this means that a plan must benefit at least the lesser of

(i) 50 employees of the employer, or

(ii) the greater of

(I) 40% of all employees of the employer, or

(II) 2 employees (or if there is only 1 employee, such employee)

For example

	# 1	# 2	# 3
(a) Number of employees	200	10	2
(b) 40% of all employees	80	4	1
(c) Greater of (b) and 2	80	4	2
(d) Lesser of 50 and (c) – number that must benefit	50	4	2

For purposes of this chapter, we will refer to these participation requirements as the "50 employee/40% rule."

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[8] See EP Examinations Phase V Chapter 1
[9] Treas. Reg. § 1.410(b)-3(a)(2)(iii)(D)
[10] Described in Treas. Reg. § 1.401(a)(4)-3(f)(9)

Meaningful Benefit Requirements

In addition to the participation requirements described above, all plans must provide meaningful benefits. The law provides for the determination of whether an employee accrues a benefit and if the benefit is **meaningful** under a prior benefit structure.[11]

Whether a plan is providing meaningful benefits under a prior benefit structure, or whether individuals in the plan have accrued meaningful benefits, is determined on the basis of facts and circumstances. The relevant factors in making this determination include, but are not limited to, the following:[12]

1. the level of current benefit accruals;
2. the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan;
3. the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year;
4. the length of time the current benefit formula has been in effect;
5. the number of employees with accrued benefits under the plan; and
6. the length of time the plan has been in effect.

A plan does not satisfy this meaningful benefit requirement if the facts and circumstances indicate that the plan exists primarily to preserve accrued benefits for a small group of employees and functions more as an individual plan for the small group of employees or for the employer.

It is common in abusive plan designs, that the DB plan will provide no net benefits at all for participants other than certain HCEs.

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[11] Treas. Reg. § 1.401(a)(26)-3
[12] Treas. Reg. § 1.401(a)(26)-3(c)(2)

Meaningful Benefits – 0.5% Minimum Accrual

A June 6, 2002 memorandum (Exhibit 1), written by the Director, Employee Plans, Rulings and Agreements to the Manager, EP Determinations Quality Assurance, relates to a "Section 401(a)(26) Issue Arising in Cash Balance Determination Letter Applications." This memorandum introduced the threshold for meaningful accrual rates of less than 0.5% of compensation (per year of participation or service). In the example provided (see below for an illustration), questions existed of whether the plan, which provided accrual rates less than 0.5% of compensation for NHCEs, provided meaningful benefits and whether the plan existed primarily for the benefit of HCEs. The memo provides that plans with annual accruals of less than 0.5% should be further examined for meaningful benefit accruals when reviewing the determination letter applications.

Although this memo related focused on cash balance plans, the instructions relate to all DB plans.

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Example 10 – Meaningful Benefit Requirements[13]

The Yale Company Plan is a newly established cash balance plan (and is **not** part of a floor-offset arrangement). The annual principal credit is equal to;

(1) $55,000 for HCEs

(2) $100 for all NHCEs

As previously mentioned, under a cash balance plan, the accrual rate is determined by converting the account balance (or in this case, the annual allocation), to an accrued benefit payable at normal retirement age. This is done by projecting the hypothetical account using the interest crediting rate to the participant's normal retirement age, and converting the result to an actuarially equivalent benefit payable at normal retirement age.

Assume for this example that the interest crediting rate is 5% and the annuity purchase rate to convert a lump sum to a monthly benefit is 141.529 (based on 5% interest and 94 GAR mortality). NRA is age 65 for this example.

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[13] The meaningful benefits issue is also covered in a TAM dated June 23, 2005. This TAM relates to a cash balance plan, without offset, similar to the example above.

Example 10 – Meaningful Benefit Requirements[14] (continued)

The conversion of the principal credit to an annuity at NRA is shown below;

	HCE	NHCE1	NHCE2
(1) Compensation	$150,000	$30,000	$15,000
(2) Principal Credit	$50,000	$100	$100
Age	50	35	35
Years to NRA	15	30	30
(3) Accumulation factor at 5% for years to NRA	$(1.05)^{15}$ = 2.08	$(1.05)^{30}$ = 4.32	$(1.05)^{30}$ = 4.32
(4) Accumulation of Principal Credit to NRA at 5% = (2) x (3)	103,946	432	432
(5) Monthly Annuity Purchase Rate at NRA	141.529	141.529	141.529
(6) Annual annuity at NRA = (4)/(5) x 12	8,813	37	37
(7) Accrual (% of compensation) = (6)/(1)	5.9%	0.1%	0.2%

This plan would **not** meet the meaningful benefit structure since only 33% (1 out of 3) of the participants have at least a 0.5% accrual. Therefore, the allocation to at least one of the NHCEs would need to be increased. For example, NHCE1's cash balance principal credit can be raised to $500, so that the accrual would equal 0.5% of compensation. Then 66% of the population (2 out of 3) would have an accrual of at least 0.5%. This plan would then pass the 40%/50 employee threshold.

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[14] The meaningful benefits issue is also covered in a TAM dated June 23, 2005. This TAM relates to a cash balance plan, without offset, similar to the example above.

Meaningful Benefits Requirements (continued) Floor-Offset Plans (General Rule)

Floor-offset plans have additional requirements with respect to meaningful benefit requirements. The key issue is whether the meaningful benefit requirements need to be met **before or after** the offset.

The general rule is that an employee is treated as benefitting under a plan, if and only if, the employee would be treated as benefitting under the provisions of the coverage regulations of section 410(b). [15] These coverage regulations refer to the minimum coverage requirements which provide that an employee is treated as benefitting under a plan if the employee has an increase in the accrued benefit.[16] This means that the **net benefit** would have to increase. However, there is an exception to this general rule, described in the next section.

Continued on next page

[15] Treas. Reg. § 1.401(a)(26)-5(a)(1)
[16] Treas. Reg. § 1.410(b)-(3)(a)

Meaningful Benefits – Floor-Offset Plans (Special Rule)

There is an exception to the general rule testing on the net benefit basis for "concurrent" benefit offset arrangements. Concurrent means that the offset is accruing at the same time that the gross benefit is accruing. Under this exception, the meaningful benefit requirements are tested as if there were no offset, i.e., the **gross** benefit.

In order to meet this exception, the offset or reduction of benefits satisfies the requirements of this paragraph 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 formula being tested accrued under such other plan;

(2) The employees who benefit under the floor benefit plan also benefit under the offset contribution on a reasonable and uniform basis, and

(3) The contributions or benefits that are used to offset the benefits in the floor benefit plan are not used to offset or reduce that employee's benefits under any other plan or any other formula. [17]

Several examples follow after the discussion of the 2006 memo.

Continued on next page

[17] Treas. Reg. § 1.401(b)-(5)(a)(2)(iii)

Meaningful Benefits – Floor-Offset Plans (Special Rule) - 2006 Guidance

On June 6, 2006, the Director, Employee Plans Rulings and Agreements, provided an updated memo (Exhibit 2) to Managers, EP Determination and EP Quality Assurance regarding section 401(a)(26) as applied to offset plans. This clarified the memo provided in the June 6, 2002 memo on this topic, and addressed the floor-offset approach.

This 2006 memo outlined a three step process for possible 401(a)(26) violations:

(1) Determine if the gross benefit (prior to offset) is meaningful

(2) If the plan provides a meaningful gross benefit that is offset on a reasonable and uniform basis by another plan, then no 401(a)(26) issues.

(3) If either condition above is not met, then further analysis is needed.

This memo was reissued and expanded upon on July 27, 2007 (Exhibit 3).

The 2007 memo added the caveat to the second step above that: "Of course, in order to satisfy the requirements of section 1.401(a)(26)-2 of the regulations, the requirements under 1.401(a)(26)-5(a)(2)(ii) or (iii) must be satisfied (relating to sequential or concurrent offset arrangements). **Note that these rules generally will not be satisfied if the offset applies for some participants** (usually non-highly compensated employees) but not all participants. These rules generally will be satisfied if the benefits under the offsetting plan are either a level percentage of pay, or a flat dollar amount, or an amount necessary to provide a uniform benefit (either flat dollar or level percentage of pay) in the plan being offset."

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Meaningful Benefits – Floor-Offset Plans (Special Rule) – Example 11

Assume Mary participates in a floor-offset arrangement. Her 2012 compensation was $ 40,000. The profit sharing offset is large enough that the net benefit from the DB plan is zero.

The table below provides the floor and net benefit change during the year.

	1/1/2012	1/1/2013	Increase		
Floor benefit	$800	$850	$50		
Profit sharing offset	$1,000	$1,030	$30		
Net benefit	$0	$0	$0		

If the three conditions in the 2006 and 2007 guidance and regulations are met with respect to the offset, then the plan would be tested on a **gross** basis. Since the gross benefit has increased from $800 to $850 per month, i.e. 1.5% of compensation ($50*12/$40,000), Mary would have accrued a meaningful benefit (satisfies the 0.5% threshold).

If the three conditions in the 2006 and 2007 guidance and regulations were **not** met, then the plan would need to be tested on a **net** basis. Since the net benefit did not increase, the plan would not meet the meaningful benefit requirements. In order to meet the meaningful benefit requirements, a minimum net benefit accrual of 0.5% of pay would need to be provided.

Continued on next page

Meaningful Benefits – Floor-Offset Plans (Special Rule) – Non-Uniform Offset Example 12

Assume the Dartmouth Company, offsets benefits provided in its cash balance plan by the benefits provided by the company's profit sharing plan and **this offset only applies to non-shareholders**.

The plan provides the following benefits;

(1) Company Shareholders – cash balance principal credit = 10% of pay

(2) Non-shareholders - cash balance principal credits = 1% of pay reduced by the monthly benefit provided by the profit sharing plan.

This plan design would **not** meet the special exception described above since the Shareholders do not have the offset (i.e. "The employees who benefit under the floor benefit plan also benefit under the offset contribution on a reasonable and uniform basis" – this is not met).

As a result, in order to test for meaningful benefits, the plan must be tested on a **net** basis. Depending upon the plan characteristics, the plan may not meet the meaningful benefit requirements, without the 0.5% of pay minimum accrual requirement.

The potential failures are:

- IRC 401(a)(26)
- Definitely determinable

Continued on next page

Meaningful Benefits – Floor-Offset Plans (Special Rule) - Non-Uniform Offset Example 13

Assume the Emory Company has a floor-offset arrangement. The offset is applied to **only to NHCE's.**

In this example, the offset is **not** uniform, because the offset to applies only to NHCE's. Therefore, the **net** benefit must be tested to see if it meets the 0.5% of compensation accrual.

Assume the Emory Company has five employees. Based on the calculations below, only 1 out of 5 (20%) employees benefits under the plan. Since the offset is not uniform, at least 40% of the employees must receive a 0.50% or higher **net** accrued benefits. In order to comply with the meaningful benefit requirements, at least one other employee must receive a net benefit of at least 0.5% of compensation (with a minimum net benefit of 0.50% of pay per year of service).

The plan has to include at least one more employee to have a benefit of at least 0.5% to pass participation.

	Floor Benefit	Offset	Accrued Benefit
Erynn (HCE)	100,000	0	100,000
Ted	35,000	38,000	0
Mitch	50,000	55,000	0
Ward	20,000	21,000	0
Liz	20,000	23,000	0

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Example 14 - Uniform Offset

Assume the Smith Company has a floor offset plan where the offset is applied to all participants. The floor plan provides a benefit of 1% of final average earnings times years of service, offset by the actuarial equivalent value of the profit sharing plan account balance. The following are the participants' annual accrued benefit:

	Floor Benefit	Offset	Net Accrued Benefit
Emily (HCE)	110,000	80,000	30,000
Lisa	32,000	28,000	4,000
Sue	50,000	55,000	0
Ann	20,000	22,000	0
David	20,000	25,000	0

Because the offset is uniform, the **floor** benefit must be tested to determine whether it meets the 0.5% of compensation accrual. Because the floor benefit is based on 1% of compensation, it clearly meets the 0.5% requirement.

The specialist confirmed the plan language complies with Treas. Reg. § 1.401(a)(26)-5; thus, there are no minimum participation or meaningful benefit issues.

Qualified Joint and Survivor Annuity

Qualified Joint and Survivor Annuity

Under the law, DB plans and DC plans are subject to the joint and survivor annuity rules of IRC § 401(a)(11).[18]

The regulations states that any plan that would not otherwise be subject to the survivor annuity requirements of IRC §§ 401(a)(11) and 417, whose benefits are used to offset benefits, will be subject to such requirements[19]. Therefore, if a stock bonus plan or profit sharing plan offsets benefits under a DB plan, such a plan is subject to the joint and survivor (as well as pre-retirement survivor) annuity rules.

[18] Treas. Reg. § 1.401(a)-20, Q&A 3(a)(3)
[19] Treas. Reg. § 1.401(a)-20, Q&A 5

Nondiscrimination

Non-Discrimination

All qualified pension plans must meet the requirements of IRC § 401(a)(4), which provides for nondiscrimination with respect to contributions or benefits in favor of highly compensated employees.

Defined benefit plans that are part of a floor-offset arrangement may be tested for nondiscrimination under either the general test or as a design-based safe harbor. Under the law,[20] for the plan to be considered a safe harbor, the following requirements must be met:

- Only employer-provided account balances and contributions may be taken into account for the offset
- The DB plan and the DC plan must benefit the same employees
- The offset under the DB plan must be applied to all employees on the same terms
- All employees must have available to them under the DC plan the same investment options and the same options with respect to the timing of pre-retirement distributions
- The DB plan satisfies the uniformity requirement design based safe harbor and safe harbor for unit credit plans on a gross benefit basis and the DC plan satisfies either a safe harbor test or the rate group test
- The DB plan satisfies either a safe harbor test or the rate group test on a gross benefit basis and the DC plan is a design based safe harbor plan and
- The DC plan may not be a IRC § 401(k) or IRC § 401(m) plan.

Continued on next page

[20] Treas. Reg. § 1.401(a)(4)-8(d)

Non-Discrimination – Example 15

The Dartmouth Company cash balance plan covers 2 owners and 400 call center assistants and excludes all other employees (including long term employees).

The cash balance principal credits are:

- 30% of pay for HCEs and
- 3% of pay for NHCEs.

The profit sharing plan contribution is allocated as:

- $50,000 (the 2012 IRC § 415 limit) for HCEs and
- 100% of pay for NHCEs.

The net cash balance plan accrued benefit is defined to be the actuarial equivalent of the projected cash balance account payable at NRA reduced by the actuarial equivalent of the projected profit sharing account balance.

Both plans provide participation upon the first day of hire.

A FDL (favorable determination letter) was issued in 2010 based on a Demo 6 that had indicated a testing date of December 31, 2008.

Upon EP examination, the agent found that no call center employees left the profit sharing plan with a vested benefit and accordingly all the allocations to the call center employees were completely forfeited.

The census indicated that call center employees received compensation ranging from $27 to $4,900 annually.

The cash balance plan passed nondiscrimination in coverage/benefits, by aggregating with the profit sharing plan, and participation, mathematically due to the extremely high accrual rate of the NHCE based on very small amounts of compensation.

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Non-Discrimination – Example 15, (continued)

Therefore, it appears that the Dartmouth Company has successfully contributed and deducted contributions to two plans that in essence solely benefit the two owners with **no other employees** receiving any benefit.

The issue to pursue is whether the plan provisions have been interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees.[21]

Short Service Abuses

Although not related to floor-offset plans, some employers may cover young and/or short service employees (such as day laborers) in their DB plan, while excluding most full time employees (other than HCEs and indeed many times other HCEs who tend to be related to the owner and receive extremely low amounts of annual compensation).

In these schemes, employers cover young and/or short service employees under the plan and provide small contributions or benefits to these employees, which amount to a high percentage of the employee's compensation. This creates “testing room” to provide generous benefits to the HCEs and enables the employer to exclude the full time NHCEs while still passing coverage and nondiscrimination by covering the day laborers. Excluding some HCEs from participation further helps the plan pass the numerical tests found in the regulations covering IRC §§ 401(a)(4) and 410(b).

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[21] §1.401(a)(4)-1(c)(2)

Short Service Abuses, (continued)

In a Memorandum dated October 22, 2004 (Exhibit 4), the Director, Employee Plans concluded that:

"A plan that uses plan formulas and/or hiring practices to provide substantial amounts to highly-compensated employees while severely limiting amounts payable to nonhighly compensated employees by targeting coverage to nonhighly compensated employees with short periods of service does not satisfy the nondiscrimination rules of section 401(a)(4) or the regulations."

This was confirmed in a follow up letter dated February 4, 2005 by the Director, Employee Plans to certain stakeholders. In this case the focus on the abusive plan designs was the inclusion of the lowest paid employees with short service. The combination of these characteristics has the greatest potential to be abusive. The benefits allocated to these lowest paid short service employees can be expected to be minimal.[22]

[22] These memos/letters were referred to in a TAM dated 06.12.2007, for an example.

Demo 8

Overview

Prior to certain dates in 2012, plan sponsors submitting applications for determination could include certain demonstrations regarding plan coverage. Per Announcement 2011-82, all Demo requests will no longer be accepted by the Service after February 1, 2012, for individually designed plans and May 1, 2012, for pre approved plans. The Service will review all Demo 8 requests received prior to the deadline. These demos are also a valuable source of information upon audit.

If a plan submitted for review contains a floor-offset arrangement that is intended to satisfy the safe harbor provisions, and the employer wants a determination on the arrangement, prior to 2012 it was necessary to submit a Demo 8.

The Schedule Q Demo 8 instructions require:

- A statement giving the name, employer identification number, and plan type of the other plan that is part of the arrangement, and
- An indication whether the other plan has received a determination letter or is requesting one simultaneous with the Demo 8 application.

An employee plans specialist assigned an application containing a Demo 8 should review the demo, application, and plan for compliance with the requirements expressed in this chapter.

Plan Language Used to Describe a Floor-Offset Arrangement

Introduction

The following section provides several examples of acceptable plan language.

Example Plan 1

If you receive benefits from another retirement plan, your company's retirement plan benefits will be reduced by an amount equal to the benefits you receive from another retirement plan (except the company's 401(k) plan) to which the company has contributed, provided that such plan bases its benefits on the same period of service counted as benefit service by this plan.

In no case will the company retirement plan be reduced so that the total benefit amount is less than if you had participated only in this plan. If both you and the company contributed to the other plan, the reduction in the company's retirement plan benefits will be calculated only on those benefits that represent the company's contributions.

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Example Plan 2

Article III- Normal Retirement Benefits

3.01 - Upon reaching the Normal Retirement Age, a Participant shall have a nonforfeitable interest in any benefit under the Plan. The benefit payable in the Normal Form at the Participant's Normal Retirement Date shall be equal to five-tenths percent (0.5%) of Compensation multiplied by the Participant's Years of Service as a Participant up to a maximum of ten (10).[23]

All benefits that are determined under this Section 3.01 **shall be offset by the** participant's vested account balance that is derived from employer contributions, other than salary reduction and matching contributions under the PS & 401(k) Plan. For purposes of determining a Participant's Accrued Benefit, the offset shall be applied after determining the Accrued Benefit without regard to the offset.

Article IX Severance and Distributions

9.08 - For the purpose of determining an Actuarially Equivalent Accrued Benefit under the Plan, the offset referred to in **Section 3.01** shall be determined based upon the following assumptions:

Pre-retirement interest: 8.5%

Pre-retirement mortality: NONE

Post-retirement interest: 8.5%

Post-retirement mortality: 1971 Group Annuity Mortality Table

Interest and Mortality Assumptions

The DB plan must include language that specifies the interest and mortality assumptions used to convert the contributions from the DC plan to an annuity. Otherwise, it fails definitely determinable in accordance to Rev. Rul. 76-259

[23] If this was a cash balance plan, the floor benefit described here would be the cash balance account.

Compliance with IRC § 415(b) Limits [24]

What Are the Basic Limitations?

IRC § 415(b) limits the annual benefit that can be accrued or paid to a participant under a DB plan to the lesser of:

A. $160,000, adjusted for cost of living pursuant to IRC § 415(d), or

B. 100% of the participant's average compensation (averaged over the three consecutive years that produce the highest average).

The "A" limitation above is usually referred to as the "dollar limitation" and the "B" limitation above is often referred to as the "percentage limitation" or the "compensation limitation."

The "A" limit increased from $200,000 in 2012 to $205,000 in 2013.

Annual Benefit

The limitations of this Code section apply to the **annual benefit payable** in a DB plan. Final regulations also clarify that the **annual benefit accrued** under the plan is also limited to IRC § 415, i.e. IRC § 415 should not only be complied with at distribution but also on an accrual basis.[25]

An annual benefit is an amount payable annually for the life of the participant. This is referred to as a life annuity or a single (or straight) life annuity.

Benefits payable in other forms must be adjusted to an actuarially equivalent single life annuity before applying the limitations. The exception is a qualified joint and survivor annuity for which no adjustment is required.[26]

For purposes of the limitations, it is assumed that the annuity begins between the ages of 62 and 65, inclusive. If the benefit is actually paid earlier than age 62 or later than that age 65, the dollar limit must be decreased or increased accordingly.

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[24] See EP Examinations Phase V Chapter 6 for more detail. Training 11305-002 (08-2010)
[25] §1.415(b)-1(a)(1)
[26] IRC § 415(b)(2)(B)

Compliance with IRC § 415(b) Limits, Continued

Application of IRC § 415 Limits to Floor-Offset Plans.

The IRC § 415(b) dollar limit applies to the benefit payable from the DB plan. The current approach is that the limit applies to the gross benefit (i.e. prior to offset).

For example, assume the following facts for 2013:

(1) Defined benefit payable based on plan formula, prior to offset = $220,000 per year.

(2) Offset due to profit sharing plan = $18,000

(3) Net benefit payable from DB plan = $202,000

(4) "A" Limit = $205,000

In this example, the $220,000 gross benefit would be limited to the dollar limit of $205,000 for 2013, with a net benefit of $187,000 payable ($205,000 - $18,000).

Compliance with IRC § 417(e)/Determination of Present Value[27]

Introduction

IRC § 417(e) impacts the amount that can be distributed to a participant from a qualified DB plan. Specifically, IRC § 417(e) mandates actuarial assumptions that must be used to determine certain actuarially equivalent payments from a DB plan. The most common application of IRC § 417(e) is to determine the minimum amount of a lump sum distribution that a participant must receive from the plan.

§ 417(e) and Floor-Offset Plans

As previously discussed, a floor-offset arrangement consist of two separate plans; a DB plan offset by the annuitized value of a DC plan account balance

The DB plan must specify the actuarial assumptions used to convert the DC plan account balance to an annuity. As shown in sample wording Example Plan 2, these assumptions may be different than those used under IRC § 417(e) to convert the net DB benefit to a lump sum.

The following sets of assumptions are not required to be the same:

- Conversion of cash balance account to an annuity at NRA
- Conversion of vested profit sharing account to an annuity at NRA
- Optional forms of payments

[27] See EP Examinations Phase V Chapter 5 for more detail.

Compliance with Required Minimum Distributions[28]

Introduction

The purpose of IRC § 401(a)(9) is to prevent qualified plans from being used as a mechanism to transfer wealth to the beneficiaries of plan participants, rather than being used for the intended purpose of providing retirement income.

The rules apply to who must begin to receive required minimum distributions (RMDs), when such distributions must begin, and how the amounts are calculated. The failure of a plan to follow these rules is a disqualifying defect.

What Is the RBD for a Non-5% Owner?

The required beginning date (RBD) for a participant that is **not** a 5% owner is April 1 of the calendar year following the later of :

- The calendar year the participant attains age 70 ½ or
- The calendar year in which the participant retires

A participant reaches age 70 ½ as of the date six calendar months after the 70th anniversary of the participant's date of birth.

What Is the RBD for a 5% Owner?

The RBD for a 5% owner is the April 1 of the calendar year following the calendar year in which he or she attains age 70 ½.

Who Is a 5% Owner?

In accordance with IRC §§ 401(a)(9)(C)(ii)(I) and 416(i)(1)(B)(i)(I) a 5% owner is generally defined as someone who owns *more* than 5% of the employer.

RMD's for Floor-Offset Arrangements

Since floor-offset arrangements are technically two separate plans, benefits must commence under both plans as required under applicable rules and each plan's RMD's must be determined separately[29]. At the RBD under the DB plan, the net accrued benefit must commence.

[28] See EP Examinations Phase V Chapter 7 for more detail.
[29] See appendix for Enrolled Actuary Q&A on this topic.

Compliance with Top-Heavy Rules

Introduction

Previous training material has covered the basics of top heavy plans. Therefore, this section will provide a brief overview and focus more on floor offset plans and multiple plans.[30]

Top-Heavy

The basic objective of the law is that qualified plan benefits should not overly benefit **key** employees (generally owners and officers).[31] If a plan is determined to be top-heavy, then the plan must meet special rules for **non-key** employees with respect to;

(1) Faster vesting, and

(2) Minimum benefits

Faster Vesting

When a plan is top-heavy, vesting must be determined based on a vesting schedule that satisfies one of following two schedules[32]:

1. "3 year vesting" (100% upon completing three years of service)
2. "6 year graded vesting."

Minimum Benefits

When a defined benefit plan is determined to be top-heavy for a plan year, the accrued benefit (as of the end of that plan year) of each non-key employee shall equal or exceed the lesser of:

(i) 2% of average compensation times years of service, except for years during which the plan was not top-heavy, or

(ii) 20% of average compensation.

When a defined contribution plan is determined to be top-heavy, all eligible non-key employees must receive an employer contribution (including forfeitures) of at least 3% of compensation.

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[30] EP Examinations Phase 1 Chapter 10 and Phase V Chapter 4.
[31] IRC § 416 and Treas. Reg. § 1.416 –1. Note that these regulations were issued in 1984 and some provisions are not current (like IRC § 415(e)).
[32] IRC § 416(b)

Top-Heavy Ratios

The determination as to whether a plan is top-heavy is made by computing a "top-heavy ratio". [33] For a defined benefit plan, this is the ratio of;

(1) the sum of the present value of accrued benefits (PVABs) attributable to key employees, over

(2) the total PVABs of all participants in the plan.

When the PVABs attributable to key employees exceed 60% of the total, the plan is top-heavy. For a defined contribution plan, the calculation is based on the ratio of account balances, in place of PVAB.

Plan Aggregation – Required

Plans are "**required**" to be aggregated for top-heavy testing purposes[34], if;

(1) key employees participate in each plan of the employer (or participated in any of the prior four years), and

(2) plans that key employees participate in are aggregated in order to meet the nondiscrimination requirements for contribution/benefits under IRC § 401(a)(4) or minimum participation standards under IRC § 410.

In other words, if plans are aggregated for nondiscrimination purposes, they also must be aggregated for top-heavy purposes.

The same key employee does not need to participate in the DB and DC plans.

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[33] IRC § 416(g)(1)(A)
[34] Treas. Reg. § 1.416 –1, T-9

Plan Aggregation – Required –

If a required aggregation group is top-heavy and one plan satisfies the top-heavy vesting/minimum benefit requirements, each plan must contain the top-heavy provisions. However, only one plan needs to provide the top-heavy minimum benefit requirements. It is not required for both plans to provide the top-heavy minimum benefits. Each plan document should specify which plan would apply the top-heavy provisions.[35]

If all the plans are defined contribution plans, only one plan need satisfy the 3% of pay contribution requirement with respect to any non-key employee who participates in more than one of the plans. If all the plans are defined benefit plans, only one plan need satisfy the 2% minimum benefit formula with respect to any non-key employee who participates in more than one of the plans. However, in the case of non-key employees who do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such employee.

Plan Aggregation – Permissive

Plans may be "permissively" aggregated.[36]

The same code section permits certain plans of an employer or related employer to be aggregated in computing the top-heavy ratio. These plans form a "permissive aggregation group." This type of aggregation is generally done to avoid top- heavy status. If the aggregated plan is not top-heavy, then neither plan would be considered top-heavy.

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[35] Treas. Reg. § 1.416 –1, T-9
[36] Treas. Reg. § 1.416 –1, T-7

Plan Aggregation – Permissive

If a permissive aggregation group is top-heavy, only those plans that are part of the **required** aggregation group will be subject to the top-heavy requirements. Plans that are not part of the required aggregation group will not be subject to these requirements. Thus, if an employer wishes to demonstrate that the plans maintained by the employer are not top-heavy, the employer need consider only the required aggregation group. If, after considering the required aggregation group, it is determined that the plans are not top-heavy, the faster vesting/minimum benefit requirements will not apply to any of the plans.

If, on the other hand, the plans required to be aggregated are top-heavy, the employer may wish to determine whether there are any plans that may be permissively aggregated to demonstrate that the plans are not top-heavy. Assuming that there are plans that are eligible for permissive aggregation, the employer may take these plans into consideration. If, after taking such plans into consideration, the net result is that the entire group is not top-heavy, the top-heavy requirements do not apply to any plan in the group. This means that the employer may include a third plan in the aggregation testing group; which may result in the group (and each plan) not being top-heavy.[37]

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[37] Treas. Reg. § 1.416 –1, T-11

Non-Key Employees Participating in More than One Plan[38]

In the case of non-key employees participating in both the DB and DC plans of the employer, the rules are a bit more complicated. The law does not require the top-heavy minimum benefits in both plans (to avoid duplication of benefits).

There are four safe harbors allowed;

(1) Provide the minimum benefit under the DB plan (the rationale in the regulations is that the DB plan generally provides a more valuable benefit than the DC plan);

(2) Use a floor-offset approach, where the DB plan minimum is provided in the DB plan and is offset by the benefits provided by the DC plan (note that the DC plan would also **not** required to provide the 3% of pay minimum);

(3) Prepare a comparability analysis providing that the plans are providing at least the DB plan minimum (this is much more complicated); or

(4) Provide a "safe haven" DC plan minimum of 5% of compensation (based on contributions and forfeitures).

The plan document must specify the method above being used and must be amended if the method changes.

[38] Treas. Reg. § 1.416 –1, M-12

Terminating Floor-Offset Plans

Form 6088 and Attachment

During the Form 5310 review, the specialist verifies that the plan language complies with the floor-offset requirements. Additionally, the Form 5310 determination requires the specialist to apply knowledge of how a floor-offset arrangement operates. The specialist must confirm the terminating plan distribution complies with the floor-offset rules. To accomplish this, Form 6088, Distributable *Benefits from Employee Pension Benefit Plans*, or attachment, must include each participant's (or if a large case, a sample of participants') calculation of:

- Gross DB benefit based on plan assumptions,
- Defined contribution annuity equivalency conversion, and
- The resulting DB plan payable accrued benefit.

The participants' benefits from the DB plan must comply with IRC § 417 and IRC § 415 limits.

If the DC account annuity equivalent is greater than or equal to the DB gross benefit, the participant's benefit paid from the DB plan termination is zero.

If the DC account annuity equivalent is less than the DB gross benefit, the participant's benefit paid from the DB plan termination is the difference of the two.

Participation

Usually, it is only during a Form 5310 review that the specialist will have the opportunity to confirm if the number of employees benefiting comply with minimum participation requirements. This is the "50 employee/40%" rule previously discussed.

The structure of a floor-offset plan may result in a small group of employees receiving a benefit from the DB plan because the majority of the employees' benefit was offset by the DC plan. This raises the probability of the plan failing minimum participation, unless the plan meets the requirements discussed here.

Summary

Key Points

- A floor-offset plan is a DB plan whose benefit is reduced, or offset, by the benefits provided under a DC plan. This allows the employer to guarantee a "floor" benefit, regardless of the amount of benefit provided from the DC plan.
- A DB plan must satisfy the minimum participation and meaningful benefit requirements.
- Treas. Reg. § 1.401(a)(26)-5 defines when an employee is treated as benefiting under a plan for a plan year.
- Floor offset DB plans meeting Treas. Reg. § 1.401(a)(26)-5(a)(2)(ii) or (iii) pass IRC § 401(a)(26) and Treas. Reg. § 1.401(a)(26)-3.
- The specialist must confirm that the DB plan language includes the assumptions used to convert the DC account balance to an annuity.
- To qualify as a floor-offset arrangement, the DB and DC plans must meet certain conditions related to type of plan and plan provisions.
- Floor offset plans must be tested for Top-Heavy.
- A Form 6088 must include the gross benefit and DC account conversion calculations.

Exhibit 1 – June 6, 2002, Memorandum

MEMORANDUM FOR MANAGER, EP DETERMINATIONS QUALITY ASSURANCE

FROM: Paul T. Shultz, Director
Employee Plans, Rulings and Agreements

SUBJECT: Section 401(a)(26) Issue Arising in Cash Balance Plan Determination Letter Applications

Questions have been raised about whether certain newly established defined benefit plans with cash balance formulas provide "meaningful benefits" for employees. It has come to our attention that certain cash balance plans provide vastly different benefits for shareholder and non-shareholder employees (e.g., (1) an annual hypothetical allocation of $45,000 for the shareholder and $100 for the non-shareholder employees, or (2) an annual hypothetical allocation of $45,000 for the shareholder and 1 ½ % of compensation for the non-shareholder employees). The issue is whether such plans satisfy section 401(a)(26) of the Code. More specifically, the issue is whether the plans provide meaningful benefits as required under section 1.401(a)(26)-3 of the regulations.

Relevant Law

A qualified defined benefit plan must satisfy section 401(a)(26) of the Internal Revenue Code (Code). To satisfy section 401(a)(26), a plan must benefit at least the lesser of (i) 50 employees of the employer, or (ii) the greater of 40 percent of all employees of the employer, or 2 employees (or if there is only 1 employee, such employee). For these purposes, a plan may exclude from consideration employees described in paragraphs (3) and (4)(A) of section 410(b) of the Code. See Code sections 410(b)(3) and 410(b)(4)(A) and regulation section 1.410(b)-6 for definitions of excludable employees.

Section 1.401(a)(26)-3(a) of the Income Tax Regulations provides that a defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c) with respect to its prior benefit structure. A plan's prior benefit structure satisfies that 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. A plan will satisfy this requirement if at least 50 employees or 40 percent of the employer's employees currently accrue meaningful benefits under the plan, or 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.

Continued on next page

A newly established defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c). Section 1.401(a)(26)-
3(c)(2) of the regulations provides that 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 plan does not satisfy the meaningful benefit requirement if the facts and circumstances indicate that the plan exists primarily to preserve accrued benefits for a small group of employees and functions more as an individual plan for the small group of employees or for the employer.

Section 1.401(a)(26)-5 of the Income Tax Regulations provides that, generally, 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 regulations section 1.410(b)-3(a), without regard to section 1.410(b)-3(a)(iv). A former employee is treated as benefiting for a plan year if and only if the former employee would be treated as benefiting under the rules in section 1.410(b)-3(b).

Section 1.401(a)(26)-5(a)(2) of the Income Tax Regulations provides for the determination of whether a plan provides meaningful benefits in the case of a benefit offset arrangement. In this case, however, the requirements under 1.401(a)(26)-5(a)(2)(ii) or (iii) must be satisfied (relating to sequential or concurrent offset arrangements).

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Application of Relevant Law

If a plan is a newly established defined benefit plan, there are no prior rates of accrual under the plan with which to compare current benefit accruals. Thus, when such a plan applies for a determination letter, whether the plan satisfies the meaningful benefit requirements of section 401(a)(26) of the Code and section 1.401(a)(26)-3(c) of the regulations must be determined by taking the benefits provided under the plan in the first plan year into consideration. For this purpose, the accrued benefits under a cash balance plan should be tested on a benefits basis (by crediting the hypothetical accounts with the hypothetical interest to the participant's normal retirement age, and

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converting the resulting hypothetical account balance to an actuarially equivalent annuity benefit commencing at the same age). In the following examples, the effect of the type of formulas about which questions have been raised on the accrual rates of a group of participants is demonstrated. The accrual rates are calculated by dividing the participant's annuity benefit at normal retirement age by the participant's compensation. These examples are similar to actual cases in which this issue has been raised.

PLAN	SHAREHOLDER ALLOCATION	SHAREHOLDER ACCRUAL RATE (% of Comp.)	ALLOCATIONS FOR OTHER ELIGIBLE EMPLOYEES	OTHER EE'S ACCRUAL RATE RANGE (% of Comp.)
X	$45,000	5.99%	$100	0.03% - 0.37%
Y	$45,000	4.55%	1.25% of pay	0.24% - 0.60%

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Some cash balance plans that have been submitted contain a provision that offsets the benefit provided under the cash balance plan by the benefit provided under a profit sharing plan maintained by the same employer. Under this kind of arrangement, there may be participants who do not receive any allocation to their hypothetical account balance (especially during the early years of the cash balance plan) because their accrued benefit under the cash balance plan is completely offset by their benefit under the profit sharing plan. It will be necessary to insure that the requirements of sections 1.401(a)(26)-5(a)(2)(ii) or (iii) of the regulations are satisfied prior to applying section 1.401(a)(26)-5(a)(2) to determine whether the cash balance plan provides meaningful benefits. Note that these rules will not be satisfied if the offset applies for some participants (usually non-highly compensated participants) but not all participants.

Conclusion

The extremely low accrual rates for all of the non-shareholder employees in Plan X and the majority of the non-shareholder employees in Plan Y suggest that Plan X and Plan Y do not provide meaningful benefits for the non-shareholder employees. The wide difference in the accrual rates for the shareholder and the non-shareholders suggest that the plans exist primarily to provide accrued benefits for the shareholder(s) and function more as an individual plan for the shareholder.

In general, where a defined benefit plan that is tested on a benefits basis is found to provide much larger benefit accruals to shareholders (or other principals) and benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees, the questions of whether the
plan provides meaningful benefits and whether the plan exists primarily to benefit shareholders should be raised when reviewing determination letter applications.
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The facts and circumstances of each case must be taken into consideration. Determination cases with this issue should be processed in the area offices, taking the facts and circumstances into account to determine whether the plan provides meaningful benefits to at least the lesser of (1) 50 employees, or (2) the greater of 40 percent of all employees or 2 employees (1 employee if there is only 1 employee). (For these purposes, fractional parts of a number of employees are rounded up to the next whole number: e.g., 5.2 employees are rounded to 6 employees.) Technical advice may be requested in accordance with the usual procedures if deemed appropriate.

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Additional Comments

Although this memorandum focuses on cash balance plans, questions of whether a plan provides meaningful benefits and whether a plan exists primarily to benefit shareholders should also be raised when reviewing determination letter applications for defined benefit plans that do not have cash balance formulas but provide much larger benefit accruals for shareholders (or other principals) and, when tested on a benefits basis, have benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees.

If you, or members of your staff, have questions regarding this memorandum, please contact Martin Pippins at (202) 283-9698 or Ann Trichilo at (202) 283-9695.

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Exhibit 2 – June 6, 2006, Memorandum

6/6/2006

MEMORANDUM FOR MANAGER, EMPLOYEE PLANS DETERMINATIONS AND MANAGER, EMPLOYEE PLANS DETERMINATIONS QUALITY ASSURANCE

FROM: Director, Employee Plans Rulings & Agreements
(signed) -Andrew E. Zuckerman -

SUBJECT: Section 401(a)(26) as applied to offset plans

This memorandum provides instructions on how to process determination letter requests that have potential issues with respect to the application of section 401(a)(26) of the Internal Revenue Code as it applies to defined benefit plans where there is an offset by other plans of the employer. It clarifies and modifies the instructions given in the June 6, 2002, memorandum (copy attached) from the previous Director, Employee Plans Rulings and Agreements.

The 2002 memorandum addressed certain issues that arise under section 401(a)(26) of the Code in the context of cash balance plans. It stated that a cash balance plan had to provide a meaningful benefit to at least the lesser of (1) 50 employees, or (2) the greater of 40 percent of employees or 2 employees (1 employee if there was only 1 employee). It also indicated that, when reviewing determination letter applications, the issue of providing meaningful benefits should be raised when the plan provides much larger benefit accruals to shareholders (or other principals) and benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees. Although the memorandum focused on cash balance plans, the instructions pertained to all defined benefit plans.

The prior memorandum observed that some cash balance plans that had been submitted contained provisions that offset the benefit otherwise provided under the cash balance plan by the benefit provided under a profit-sharing plan maintained by the same employer. Under this type of arrangement there may be participants who do not receive any allocation to their hypothetical account balance in the cash balance plan. In these cases, it will be necessary to insure that the requirements of sections 1.401(a)(26)-5(a)(2)(ii) or (iii) of the regulations are satisfied prior to applying section 1.401(a)(26)-5(a)(2) to determine whether the cash balance plan provides meaningful benefits. The memorandum noted that these rules will not be satisfied if the offset applies for some participants (usually non-highly compensated participants) but not all of them.

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Recently, a number of technical advice requests have been submitted that raise issues regarding the application of section 401(a)(26) in situations where the defined benefit plan is a cash balance plan that is offset by the benefit provided under a profit-sharing plan. In processing these requests, we have found, in coordination with TEGE Division Counsel that, in light of current statutory and regulatory provisions, clarification of the regulations may be appropriate. Until this is resolved, the following steps should be taken with respect to the application of section 401(a)(26) to plans that provide benefits that are offset by the benefit provided by another plan:

(1) Review the plan to determine whether it provides a gross benefit (prior to the offset) that is a meaningful benefit as set forth in the 2002 memorandum so as to satisfy section 401(a)(26).

(2) If the plan does provide a meaningful gross benefit to enough employees to satisfy section 401(a)(26), then issues under section 401(a)(26) with respect to offset should not be raised. Thus, if the plan provides a meaningful gross benefit that is offset on a uniform basis by another plan it is not necessary to further consider whether employees benefit under the other plan on a "reasonable and uniform basis."

(3) If the plan does not provide a meaningful gross benefit to enough employees to satisfy section 401(a)(26), then issues under section 401(a)(26) with respect to offset should be raised.

Please share this memorandum with your employees.

Exhibit 3 – Reissued July 7, 2007 Memorandum

MEMORANDUM FOR MANAGER, EMPLOYEE PLANS DETERMINATIONS AND MANAGER, EMPLOYEE PLANS DETERMINATIONS QUALITY ASSURANCE

FROM: Director, Employee Plans Rulings & Agreements

SUBJECT: Section 401(a)(26) as applied to offset plans

This memorandum provides instructions on how to process determination letter requests that have potential issues with respect to the application of section 401(a)(26) of the Internal Revenue Code as it applies to defined benefit plans where there is an offset by other plans of the employer. It explains the instructions given in the June 6, 2002, memorandum (copy attached) from a previous Director, Employee Plans Rulings and Agreements.

The 2002 memorandum addressed certain issues that arise under section 401(a)(26) of the Code in the context of cash balance plans. It stated that a cash balance plan had to provide a meaningful benefit to at least the lesser of (1) 50 employees, or (2) the greater of 40 percent of employees or 2 employees (1 employee if there was only 1 employee). It also indicated that, when reviewing determination letter applications, the issue of providing meaningful benefits should be raised when the plan provides much larger benefit accruals to shareholders (or other principals) and benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees. Although the memorandum focused on cash balance plans, the instructions pertained to all defined benefit plans.

The prior memorandum observed that some cash balance plans that had been submitted contained provisions that offset the benefit otherwise provided under the cash balance plan by the benefit provided under a profit-sharing plan maintained by the same employer. Under this type of arrangement there may be participants who do not receive any allocation to their hypothetical account balance in the cash balance plan. In these cases, it will be necessary to insure that the requirements of sections 1.401(a)(26)-5(a)(2)(ii) or (iii) of the regulations are satisfied prior to applying section 1.401(a)(26)-5(a)(2) to determine whether the cash balance plan provides meaningful benefits. The memorandum noted that these rules will not be satisfied if the offset applies for some participants (usually non-highly compensated participants) but not all of them.

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Recently, a number of technical advice requests have been submitted that raise issues regarding the application of section 401(a)(26) in situations where the defined benefit plan is a cash balance plan that is offset by the benefit provided under a profit-sharing plan. In processing these requests, we have found, in coordination with TEGE Division Counsel that, in light of current statutory and regulatory provisions, clarification of the regulations may be appropriate. Until this is resolved, the following steps should be taken with respect to the application of section 401(a)(26) to plans that provide benefits that are offset by the benefit provided by another plan:

(1) Review the plan to determine whether it provides a gross benefit (prior to the offset) that is a meaningful benefit as set forth in the 2002 memorandum so as to satisfy section 401(a)(26).

(2) If the plan provides a meaningful gross benefit that is offset by a benefit under another plan under which the employees benefit on a reasonable and uniform basis we will treat the plan as satisfying section 401(a)(26). Of course, in order to satisfy the requirements of section 1.401(a)(26)-2 of the regulations, the requirements under 1.401(a)(26)-5(a)(2)(ii) or (iii) must be satisfied (relating to sequential or concurrent offset arrangements). **Note that these rules generally will not be satisfied if the offset applies for some participants (usually non-highly compensated employees) but not all participants.** (emphasis added) These rules generally will be satisfied if the benefits under the offsetting plan are either a level percentage of pay, or a flat dollar amount, or an amount necessary to provide a uniform benefit (either flat dollar or level percentage of pay) in the plan being offset.

(3) If the plan does not provide a meaningful gross benefit to enough employees to satisfy section 401(a)(26), the plan does not satisfy 401(a)(26) of the Code.

Please share this memorandum with your employees.

Attachments (1): Copy of June 6, 2002 memorandum

Exhibit 4 – Short Service

MEMORANDUM FOR DIRECTOR, EP EXAMINATIONS
DIRECTOR, EP DETERMINATIONS REDESIGN

FROM: Carol D. Gold
Director, Employee Plans

SUBJECT: Short Service Employees and Other Meaningful Benefit Schemes and Abuses

Background

We have become aware of certain schemes which effectively limit the amounts payable under a retirement plan to a small number of highly compensated employees by limiting participation under the plan to highly compensated employees and to rank and file employees with short periods of service (such as periods of a few weeks or even a few days). These plans, in the form of defined contribution plans, defined benefit plans, or combinations of both, attempt to satisfy the requirements of various Code sections (e.g. sections 401(a)(4), 401(a)(26), and 410(b)) by allocating amounts to the sponsor's lowest paid employees which, while perhaps significant relative to the employee's compensation, are actually small in amount because of the employees' small amount of compensation. Thus, these plans provide little or no actual benefits to these employees.

The sponsors of these plans use plan designs and hiring practices that limit the nonhighly compensated employees who accrue benefits under the plan primarily to employees with very small amounts of compensation. By combining these elements, these sponsors contend that the lowest paid employees may be treated as benefiting under the plan thereby satisfying the Code's nondiscrimination rules. These sponsors further contend that the qualification requirements of the Code and the regulations are satisfied even though the dollar amounts actually accrued by the lowest paid employees are nominal and even though these employees may never vest in their benefit.

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As discussed in this memorandum, these plans may violate the nondiscrimination requirements of the Code even though they ostensibly satisfy certain provisions in the nondiscrimination regulations. In addition, arrangements similar to those discussed in this memorandum may, in the case of defined benefit plans, raise related issues under section 401(a)(26). These related issues were discussed in a prior memorandum from Paul Shultz, dated June 6, 2002.

Law and Analysis

Section 401(a)(4) provides that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees (within the meaning of section 414(q)). Section 1.401(a)(4)-1(a) of the regulations provides a plan must be nondiscriminatory both in form and in operation.

Section 1.401(a)(4)-1(a) also provides that the regulations under section 401(a)(4) set forth the exclusive rules for determining whether a plan satisfies section 401(a)(4), but §1.401(a)(4)-1(c)(2) provides that 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 highly compensated employees.

The nondiscrimination rules of section 401(a)(4) and the regulations thereunder are designed to ensure that amounts paid under a plan are not provided to highly compensated employees in a discriminatory manner. **A plan that uses plan formulas and/or hiring practices to provide substantial amounts to highly-compensated employees while severely limiting amounts payable to nonhighly compensated employees by targeting coverage to nonhighly compensated employees with short periods of service does not satisfy the nondiscrimination rules of section 401(a)(4) or the regulations.**

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For example, the nondiscrimination requirement is violated by a plan design that satisfies the nondiscrimination general test by using cross-testing under §1.401(a)(4)-8 where (1) the plan excludes most or all permanent nonhighly compensated employees, (2) the plan covers a group of nonhighly compensated employees who were hired temporarily for short periods of time, (3) the plan allocates a higher percentage of compensation to the accounts of the highly compensated employees than to those of the nonhighly compensated employees covered by the plan, and (4) **the compensation earned by the nonhighly compensated employees covered by the plan is significantly less than the compensation earned by the nonhighly compensated employees not covered by the plan.**

This plan design does not interpret §1.401(a)(4)-8 in a "reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees" as required by §1.401(a)(4)-1(c)(2) **because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to nonhighly compensated employees hired temporarily for short periods of time.**

The following is an example of a plan design that violates §1.401(a)(4)-1(c)(2):

> Employer M is a corporation which is solely-owned by Individual A. Employer M is not part of a controlled group of corporations under §414(b), is not under common control with another trade or business under §414(c), is not part of an affiliated service group under §414(m), and has no leased employees under §414(n).
>
> Employer M maintains Plan X, a defined contribution plan, intended to be qualified under §401(a). Plan X is the only plan maintained by Employer M. Under its terms, Plan X provides immediate participation and covers only the highly-compensated employees of Employer M and a group of nonhighly compensated employees defined by Plan X. Plan X provides that the highly-compensated employees receive an annual allocation of 20% of compensation (subject to the limits of §415). The other covered employees receive an allocation of 5% of compensation.

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In 2003, Employer M employed 55 employees. These 55 employees included five highly-compensated employees. The remaining 50 employees included 15 employees who were employed on a permanent basis and whose annual compensation ranged from $20,000 to $50,000. These 15 employees were not included in the group of nonhighly compensated employees covered by Plan X. The other 35 employees were temporarily hired for short periods of time and were included in the group of nonhighly compensated employees covered by the plan. None of these 35 employees received compensation in excess of $1000 in 2003 and they all received allocations under the plan of 5% of compensation. Plan X intended to satisfy the nondiscrimination in amount general test by using cross-testing under §1.401(a)(4)-8 of the regulations.

Plan X fails §1.401(a)(4)-1(c)(2) because it satisfies the nondiscrimination test of §1.401(a)(4)-8 by covering a group of nonhighly compensated employees who were hired temporarily for short periods of time and who received small amounts of compensation while at the same time it excludes all higher paid, permanent nonhighly compensated employees and allocates a higher percentage of compensation to the accounts of highly compensated employees than to those of the covered nonhighly compensated employees. This plan design does not interpret §1.401(a)(4)-8 in a "reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees" as required by §1.401(a)(4)-1(c)(2) because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to nonhighly compensated employees hired temporarily for short periods of time. The conclusion would be the same if the allocation rates were inflated through the use of an entry date for plan participation that occurs shortly before the end of the plan year in conjunction with plan provisions limiting compensation, for allocation purposes, to the period of participation.

Depending on the circumstances, the nondiscrimination requirement may also be violated in cases where one of the enumerated elements is not present. For example, the nondiscrimination rules may be violated even though the same percentage of compensation is allocated to the highly compensated and to the nonhighly compensated employees, where the nonhighly compensated employees covered by the plan are hired for short periods of time and there is no reasonable business reason for hiring these employees on a short-term basis.
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Exhibit 4 – Short Service, Continued

n the absence of questionable hiring practices, a violation may also occur where the employer uses a plan design to limit benefits to a select group of highly compensated employees and to the lowest paid of the nonhighly compensated employees. The following is an example of such a plan design:

> Employer M is a corporation which is solely-owned by Individual A. Employer M is not part of a controlled group of corporations under §414(b), is not under common control with another trade or business under §414(c), is not part of an affiliated service group under §414(m), and has no leased employees under §414(n).
>
> Employer M maintains Plan X, a defined contribution plan, intended to be qualified under §401(a). Plan X is the only plan maintained by Employer M. Under its terms, Plan X provides immediate participation but covers only Individual A and the "Lowest paid group of employees." The "Lowest paid group of employees" is defined to include the employees with the lowest compensation for the plan year and is limited to the minimum number of these employees needed to satisfy the coverage requirements of section 410(b). Plan X provides that Individual A receives an annual allocation of 20% of compensation (subject to the limits of §415). The other covered employees receive an allocation of 5% of compensation.
>
> In 2003, Employer M employed 55 employees. These 55 employees included Individual A and four other highly-compensated employees. Under the terms of Plan X, Individual A received an allocation of 20% of compensation and the seven lowest paid employees of Employer M each received an allocation of 5% of compensation. Each of the lowest paid group of employees received an allocation of less than $100. The remaining 43 nonhighly compensated employees and four highly compensated employees received no allocation under the plan. Plan X intends to satisfy the nondiscrimination in amount general test by using cross-testing under §1.401(a)(4)-8 of the regulations.

Plan X fails §1.401(a)(4)-1(c)(2) because it satisfies the nondiscrimination test of §1.401(a)(4)-8 by (1) covering a group of nonhighly compensated employees who received small amounts of compensation, (2) excluding all higher paid, nonhighly compensated employees and (3) allocating a higher percentage of compensation to the account of the sole shareholder of the employer. This plan design does not interpret

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§1.401(a)(4)-8 in a “reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees” as required by §1.401(a)(4)-1(c)(2) because the results of the general test are distorted through the use of allocation rates produced by the allocation of small amounts to the lowest paid group of nonhighly compensated employees.

The examples provided in this memorandum are not intended to limit the situations where a plan design may be found to be an unreasonable interpretation of the regulations under section 401(a)(4). Additional situations with similar facts may also violate the requirement of §1.401(a)(4)-1(c)(2) that the regulations under section

401(a)(4) must be interpreted in a reasonable manner. Also, additional factors may also be considered in determining whether the plan discriminates in favor of the highly compensated employees.

Conclusion

Section 401(a)(4) requires that, under a qualified retirement plan, contributions or benefits provided under the plan must not discriminate in favor of highly compensated employees. The regulations under 401(a)(4) set forth various objective criteria for determining whether the nondiscrimination rules of the Code are satisfied, but the regulations also provide that they must be interpreted in a reasonable manner consistent with the purpose of preventing this discrimination. Thus, the regulations cannot be interpreted to permit an unreasonable disparity in the benefits paid to highly compensated employees over those paid to nonhighly compensated employees.

In accordance with this memorandum the following actions should be taken regarding the arrangements identified here and other arrangements where the principles set forth here may be violated:

● Adverse determination letters should be issued with respect to plan designs similar to those identified in this memorandum as violating §1.401(a)(4)-1(c)(2).

Continued on next page

Exhibit 4 – Short Service, Continued

● Other arrangements where employers use hiring practices and/or plan formulas to discriminate in favor of highly compensated employees and which may violate the nondiscrimination rules notwithstanding that the plans may otherwise appear to satisfy the regulations under section 401(a)(4) should be addressed on a case-by-case basis.

● If deemed appropriate, technical advice may be requested in accordance with the established procedures.

If you, or members of your staff, have questions regarding this memorandum, please contact Martin Pippins at (202) 283-9698 or Rob Walsh at (202) 283-9537.

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Exhibit 5 – February 2005 Response

February 4, 2005
Brian H. Graff, Esq., Executive Director/CEO
American Society of Pension Professionals and Actuaries
4245 North Fairfax Drive, Suite 750
Arlington, VA 22203

Edward Ferrigno, Vice President of Washington Affairs
Profit Sharing/401(k) Council of America
20 N. Wacker Drive, Suite 3700
Chicago, IL 60606

Paula Calimafde, Esq., Chair
Small Business Council of America
P.O. Box 1229
Wilmington, DE 19899

Dear Sirs and Madam:

This responds to your letter of December 22, 2004, regarding my memorandum of October 22, 2004, to the Directors of EP Examinations and EP Determinations Redesign regarding certain plan designs and short service employees. Your letter states that you have concerns regarding some language in the memorandum and that you would appreciate clarification of this language.

Specifically, your letter states that you have concerns with the language beginning with the second paragraph on page four of the memorandum that provides, "[i]n the absence of questionable hiring practices, a violation may also occur where the employer uses a plan design to limit benefits to a select group of highly compensated employees and to the lowest paid of the non-highly compensated employees." Your letter further states that you believe this language would render invalid a number of plan designs that have long been considered acceptable by the Service through the issuance of prior determination letters.

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The memo of October 22, 2004, focuses primarily on plan designs which are intended to satisfy the nondiscrimination tests of section 401(a)(4) only by allocating amounts to the sponsor's lowest paid employees who may have very short periods of service. Generally, we are focused on designs that provide allocations to the lowest paid employees who also happen to be short service employees. It is this combination of characteristics — lowest paid employees with short service — that we believe has the potential to be abusive. Under this plan design, and as reflected in the two examples in the memo, the amounts allocated to the sponsor's lowest paid employees can be expected to provide minimal actual benefits to these employees.

The language you quote from the memo was not intended to set forth a separate rule where short service employees are not an issue. Instead, the language was intended to indicate that questionable hiring practices are not a required element to a finding of discrimination. As the memo's discussion and examples demonstrate, the intent of the October 22, 2004 memorandum is to focus upon plans that attempt to satisfy the nondiscrimination tests by using nominal contributions or benefits for the lowest paid non-highly compensated employees where the nominal contributions or benefits result from very short periods of service. We believe that attempts to satisfy the nondiscrimination tests should and will fail where virtually all of the plan contributions or benefits, except for nominal contributions or benefits for these lowest-paid employees, are accrued by the highly compensated employees. The memo should be construed in light of this intent. We understand that some may question whether we are reversing positions on certain plan designs that the Service may previously have looked at favorably. However, the memorandum of October 22, 2004, is not intended to suggest that plan designs that have been consistently and repeatedly approved by the Service are now in question. That memorandum is also not intended to address any possible concerns raised by this plan design under section 401(a)(26).

I hope this letter resolves any questions you may have regarding our memorandum of October 22, 2004.

Sincerely,
/s/
Carol D. Gold
Director, Employee Plans

1998 QUESTION #32

Other DB Issues: Offset for Payments from Profit Sharing Plan
Instead of the usual floor-offset arrangement with a qualified profit-sharing plan in which the net defined benefit plan benefit (DB) is determined at normal retirement age or benefit commencement date, can the gross DB be determined at commencement of benefits and have the profit-sharing plan pay that amount until the account balance is exhausted and then have the DB plan start paying the full amount? For example, if the gross DB is $500 per month, can the profit sharing plan begin to pay $500 each month until that plan's account balance is exhausted and then have the full $500 per month be paid from the DB plan each month thereafter?

RESPONSE
No. Since the floor-offset arrangement constitutes two plans, benefits must commence under both plans as required under applicable rules.

1994- QUESTION #27

Minimum Distributions Under Floor-Offset Arrangement -- 401(a)(9)
Are the section 401(a)(9) minimum distribution requirements for a floor-offset arrangement based on the gross defined benefit or are they determined separately based on the net DB and defined contribution amounts?

Consider the following example:

Year	Age	Gross Benefit	Annuitized Offset Amount	Net Benefit
1	70.5	$1,000	$900	$100
2	71.5	$1,050	$1,110	$0

RESPONSE:
The minimum distribution requirements are determined for each plan separately. If the defined benefit plan states that the minimum distribution under the plan is equal to the accrued benefit for the year, the payment from that plan can drop to $0 in the second year. The minimum distribution in the DC plan would also change from year-to-year based on the current account balance and the employee (and beneficiary) life expectancy.

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