Chapter 3

Intermediate Audit Techniques

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

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Overview

Introduction

This chapter will provide an in-depth look at specific audit issues, outline audit techniques that are designed to uncover potential issues, and provide suggestions for proper workpaper development.

Examination issues were chosen for development because of recent law changes and recurring plan operational failures found on examination. The following areas will be reviewed in depth: top-heavy, prohibited transactions and terminations. Additional miscellaneous issues will be covered briefly. Additional information on the topics can be found in the Internal Revenue Manual (IRM) cites provided.

Top Heavy

Overview

To be qualified under IRC 401(a), a plan must contain provisions that meet the requirements of IRC 416 and which will become effective if the plan becomes top-heavy. [See IRC 401(a)(10)(B)] Code section 416 provides that top-heavy plans must provide minimum benefits for non-key employees and that those benefits must vest under one of the top-heavy vesting schedules. Checking the operational compliance with Code section 416 is an essential part of the examination.

When verifying compliance with IRC 416, it is first necessary to determine if the plan is top heavy. When a plan is determined to be top-heavy, it is then necessary to determine that top-heavy minimum contributions have been provided and that the plan's top-heavy vesting schedule has been followed.

This section will describe the top-heavy rules under IRC 416 and the application of those rules when a plan is top-heavy.

General requirements

A defined benefit plan is top-heavy if, as of the determination date, the present value of the accrued benefits (PVAB) under the plan for the key employees exceeds 60% of the PVAB under the plan for all employees.

A defined contribution plan is top-heavy if, as of the determination date, the total of the accounts of the key employees under the plan exceeds 60% of the total of the accounts of all employees under the plan.

A top-heavy plan must provide non-key employees with a minimum benefit if it is a defined benefit plan, or a minimum contribution if it is a defined contribution plan. (See IRC 416(c))

A top-heavy plan must also provide a special vesting schedule:
a) 3-year 100% vesting schedule, or
6-year graded vesting schedule. (See IRC 416(b))

Determination date

The determination date is the last day of the preceding plan year, or in the case of a plan's first year, the last day of that plan year.

Top Heavy – Key Employees

Interview

At the interview the owners and their ownership percentages will be reviewed with the taxpayer or representative. Generally a table should be included in the workpaper to begin the review of key employees in the organization. TEQMS rates interview techniques including appropriate questions concerning the history and operation of the plan. The taxpayer or representative present at the interview should be queried about the top-heavy status of the plan and the method used to determine the top-heavy status.

Determination of key employees

The first step in verifying that the plan satisfies IRC 416 in operation is the determination of key employees in the plan. Review ownership interests to determine if the key employees have been designated correctly. The employee is a key employee if he meets at least one of four tests, three of which depend upon ownership interests. The fourth test is the officer test.

- **5% owner test.** The employee owns more than 5% of the employer (or a related employer.) No minimum level of compensation is required for the 5% owner test, but the individual must be an employee.

- **1% owner test.** The employee owns more than 1% of the employer or a related employer and has annual compensation greater than $150,000.

- **Top ten owner test.** The employee is one of the ten employees with the largest ownership and has annual compensation in excess of the dollar limit under Code section 415(c)(1)(A) {$35,000 for 2001} for the calendar year.

- **Officer test.** The employee is an officer and has compensation for the year exceeding 50% of the dollar limitation under Code section 415(b)(1)(A) {currently $70,000 for 2001}. The number of officers is limited to 10% of the employees, or 3, whichever is greater. In a large company, the number of officers designated as "key" is limited to 50 officers who had the largest annual compensation during the year of the determination date and the four preceding years. See IRM 4.72.5.2.4.1 for an in depth discussion of an officer's authority and employees excluded from the definition of key employee.

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Top Heavy – Key Employees, Continued

Determination of key employees after December 31, 2001

For years beginning after 12/31/2001, a key employee is any employee or former employee (including any deceased employee) who at any time during the plan year that includes the determination date was an officer of the employer having annual compensation greater than $130,000 [as adjusted under IRC 416(i)(1) of the Code for plan years beginning after December 31, 2002], a 5 percent owner of the employer, or a 1 percent owner of the employer having annual compensation of more than $150,000.

Compensation for key employee tests

For purposes of IRC 416, the definition of compensation used in determining who is a key employee has the meaning given by IRC section 414(q)(4). IRC section 414(q)(4) defines compensation as having the meaning given in IRC 415(c)(3). [See Code section 416(i)((1)(D), 414(q)(4) and 415(c)(3)}].

Elective deferrals are included in compensation prior to 1998 and will continue to effect the calculation of employee compensation for the key employee because of the 5 year rule. On audit, check to be sure the sponsor is including elective deferrals to determine key employee compensation. Prior to 1998, 415 compensation did not include elective deferrals except for determining highly compensated employee and thus key employee. Note that by following through the Code section definitions, the definition of compensation for the key employee is the same as that for the highly compensated employee.

Related employer

Compensation from all members of the controlled group or affiliated service group is aggregated for key employee determination. However, ownership percentages are not aggregated. For example, Company A and Company B are members of the same controlled group. An employee who owns 2% of Company A and 4% of Company B, will not meet the 5% rule. However, his compensation will be aggregated and if he earns more than $150,000 from one or both companies, he will meet the 1% ownership test.

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Top Heavy – Key Employees, Continued

Identification of "key" employees

Allocation schedules and account balances for the five years prior to the plan year must be reviewed for terminations, distributions and change in status from key employee to non key or non key to key.

For plan years beginning prior to 1/1/2002, have participants terminated and were distributions (including in-service distributions) made that need to be added back to the account balances of both key and non key participants for inclusion in the total account balances? If the plan is a defined benefit arrangement, check to make certain accrued benefits of terminated participants are included for all 5 years prior to the plan year being reviewed for top heavy status. Plan years beginning on or after January 1, 2002 need consider only the prior year; i.e. the plan year containing the determination date, for distributions on termination. However, for in-service distributions it is still necessary to check the 5 prior years.

Accounts and accrued benefits for key and non key participants who have not performed services for the employer within the prior five years are excluded. Plan years beginning after December 31, 2001, will exclude account balances and accrued benefits for those participants not performing services for one year.

Former key employee

If a former key employee becomes a non key, his account or accrued benefit must be excluded from the calculation of the total key and non key account balances or accrued benefits for the plan.

Additional rules for rollovers

Rollovers or transfers are only included for the top heavy calculation if they originated with a plan maintained by the same employer or employer group or the rollovers or transfers were not initiated by the employee.

Top Heavy – Aggregation

Required aggregation

Any plan in which a key employee participates and which the employer aggregates to permit a plan to pass coverage and discrimination, must be aggregated for top heavy testing.

The aggregate of the accounts in a defined contribution plan and the present value of the accrued benefits in a defined benefit plan, including any distributions made during the five year period ending on the determination date, to key and non-key employees is determined separately for each plan as of each plan's determination date.

A plan terminated within the same five year period, which, had it not been terminated, would have been aggregated must also be included.

Effective for plan years beginning on or after January 1, 2002, one year period is substituted for five year period.

The next step is to aggregate the plans by adding together the results for each plan as of the determination dates for such plans that fall within the same calendar year. The combined results indicate whether or not the plans as aggregated are top heavy. See Reg. 1.416-1, T-23.

Collectively bargained plans

Collectively bargained plans that include a key employee must be included in the required aggregation group.

Example of aggregation rules when plan years differ

An employer maintains Plan A and Plan B, each containing a key employee. Plan A's year is a fiscal plan year commencing July 1st and ending June 30th. Plan B's year is a calendar year. These plans are required to be aggregated. The determination date for Plan A for the plan year beginning July 1, 2000 is June 30, 2000. For Plan B, the determination date for the plan year beginning January 1, 2001 is December 31, 2000. Both determination dates fall within the 2000 calendar year. The present values of the accrued benefits as of each of these determination dates are combined for purposes of determining if the group is top heavy. The account balances of key employees are found to exceed 60 percent of the aggregate of the accounts of all employees. Plan A is top heavy for the plan year beginning July 1, 2000 and Plan B is top heavy for the plan year beginning January 1, 2001.

Top Heavy – Permissive Aggregation/Contributions

Permissive aggregation

In addition to the plans in the required aggregation group, the sponsor may aggregate any other plans with the group, but the group as a whole must pass coverage and discrimination.

Top Heavy-Calculation and contribution requirement

Calculation of the account balances and present value of the accrued benefit

For a defined contribution plan, the present value of the accrued benefit (PVAB) is found by adding the account balances on the most recent valuation date and additionally any contributions due as of the determination date.

For a defined benefit plan, the PVAB is determined using the accrual method used for all plans of the employer or the slowest accrual rate permitted under IRC section 411(b)(1)(C).

Minimum contribution requirements for top-heavy plans

Review the defined contribution plan to insure that each participant received a contribution equal to that of any key employee up to a maximum of 3% of compensation. The maximum compensation used for testing the allocation percentage for the key is the Code section 401(a)(17) limit. For the defined benefit plan, the employer must provide a minimum accrual of 2% a year each year the plan is top heavy for a maximum of 10 years.

Review allocation formula and service requirements

The hours of service and last day of the year rules are different for the DC and DB plans with regard to the top heavy minimums. There is no service requirement for a DC plan. If a participant is employed on the last day of the plan year, the participant is entitled to the top heavy minimum. Conversely, for the DB plan, if the participant meets the 1000 hours of service rule for the accrual computation period, the participant is entitled to the minimum accrual, regardless of whether or not the participant is employed on the last day of the plan year.

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Top Heavy-Calculation and contribution requirement, Continued

Review allocation formula and service requirements (continued)

Check DC plan language to determine if the plan incorporates a service requirement as a prerequisite for an employer contribution. Participants employed at the end of the plan year must receive a top heavy minimum regardless of any service requirement. Once an employee meets the eligibility requirements and participates in the plan, the participant continues to be eligible for the minimum contribution regardless of the number of hours of service if employment continues through the last day of the plan year. See Reg. 1.416-1, M-10.

. Alternately, for the DB plan, any participant who works 1,000 hours or more in the accrual computation period must receive a top heavy minimum. There is no requirement that the participant be employed on a specific day of the plan year. See Reg. 1.416-1, M-4.

Watch for eligible employees in the 401(k) plan that are not actually deferring, but who are counted in the coverage tests. They are also eligible for a top heavy contribution.

Minimum contribution requirement for 401k plans

Plans that provide elective deferrals under Code section 401(k) and/or matching contributions under Code section 401(m) are subject to the requirements of Code section 416(c). For plan years beginning on or after January 1, 2002, the sponsor may satisfy this requirement by counting the matching contributions for the top heavy minimum.

Elective deferrals of the key employees are taken into account in determining the top heavy percentage. However, non-key elective deferrals cannot be used to satisfy the minimum contribution requirement. The employer must meet the 3% or less requirement, depending upon the percentage contributed by the key with the highest deferral percentage up to 3% of compensation. QNECs may be used to satisfy the top heavy requirement.

Non-elective contributions to a 401(k) plan

Generally, for plan years beginning before January 1, 2002, the plan sponsor will need to make a non-elective contribution for each non key participant. The only exception to this will be where no key participant receives a benefit from elective, matching or non-elective contributions.

For plan years beginning on or after January 1, 2002, matching contributions can be used to satisfy the top heavy minimum requirements.

Top Heavy – General Requirements

Safe harbor 401(k) and 401(m) plans

Be sure to review safe harbor plans for their top heavy status. Safe harbor non-elective contributions made to a safe harbor 401(k) plan may be used to satisfy the top heavy minimum but safe harbor matching contributions may not be taken into account for this purpose. For plan years beginning on or after January 1, 2002, safe harbor plans that satisfy Code section 401(k)(12) and 401(m)(11) are exempt from any top heavy requirements. EGTRRA also permits the employer to adopt provisions that the minimum benefit requirement shall be met in another plan (including another plan that consists solely of a cash or deferred arrangement which meets the requirements of section 401(k)(12) of the Code and matching contributions with respect to which the requirements of section 401(m)(11) of the Code are met). The name of the plan providing the minimum benefit, the minimum benefit that will be provided under such other plan, and the employees who will receive the minimum benefit under such other plan should be spelled out in the plan document.

Vesting and distributions when a plan is top heavy

If the plan is determined to be top heavy, check the allocation schedule for use of the top heavy vesting schedule that is specified in the plan document. Any distributions for participants who terminated in a year when the plan is top heavy should follow the top heavy vesting schedule

Top Heavy-examination tips

Examination tips

Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees. For example:

a) If key employees make up a substantial percentage of the workforce, it is likely the plan will become top-heavy.
b) Be alert for top-heavy issues in older plans if key employees are near retirement age or the turnover rate for employees is high.
c) Plans of larger employers can also be top-heavy where the employer maintains separate plans for its divisions. If the smaller divisions employ a large number of highly-paid employees who are key employees, their plans may be top-heavy.

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Top Heavy-examination tips, Continued

Consequence of non-compliance with Code Section 416, 401(a)(10)(B)

On examination the plan language for Code section 416 must be reviewed. The plan must contain the top heavy provisions that automatically take effect if the plan is or becomes top heavy. Failure to incorporate these provisions can only be corrected through a Closing Agreement Program (CAP).

Operational failure to calculate the top-heavy status properly, to provide the minimum required benefit and to follow the top-heavy vesting schedule may be eligible for Employee Plans Compliance Resolution System.

Source documents

Review Form 5500, Schedule T for coverage information and aggregation of plans. Plans aggregated to pass coverage and discrimination, must be aggregated for top heavy testing. If the plan satisfies coverage by aggregating plans, Schedule T, Line 4b is answered "yes" and the section will be completed based upon this aggregation group. Line 4c provides the number of employees, excludable employees, non-excludable employees who are benefiting, total HCEs and number of HCEs who benefit. The ratio percentage for each disaggregated part is provided.

Review the plan document to insure that the language required by Code section 401(a)(10)(ii) is included. A plan is required to include provisions that take effect if the plan becomes top heavy.

To check ownership percentages and aggregation groups, review the plan document for the definition of "employer". Also check the appendix for the identification of affiliates
The IDRS command code "INOLEX" provides cross references for the EIN of the sponsor to the primary owner.

Check the sponsor's taxable return to determine ownership of the entity and officer compensation. Form 1120, Item #12 and Schedule E, provide compensation of officers, percent of time devoted to business and stock ownership percentage. Schedules J and K provide information on the relationships between controlled group members, subsidiaries and affiliated service groups. Review this information. It may impact aggregation groups. For Form 1120S and 1065, Schedule K, and K1, provide ownership information. Be alert to corporate names and different EINs on W-2s.

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Top Heavy-examination tips, Continued

Source documents (continued)

Review participant account statements (for defined contribution plans) or accrued benefit statements (for defined benefit plans) as of the determination date (which is the last day of the prior plan year for all years except the first plan year).

Distribution information for the 5 years prior to the plan year under examination must be available, including Forms 1099 and SSA. Termination of participants for the 5 prior years needs to be reviewed.

Workpaper development

Specifically for top heavy compliance, workpapers should include the following:

- Interview comments on top heavy status
- Owners and ownership percentage
- Source documents used to verify top heavy status
- Verification of the calculation of the minimum required benefit
- Review or test check to insure that all participants received a top heavy minimum regardless of hours of service
- Verification of application of the top heavy vesting schedule
- Review or test check of distributions to insure that top heavy vesting schedule is applied

Prohibited Transactions-overview and exam techniques

Overview

The examiner needs to be alert to the possibility of prohibited transactions (PT) on every audit. Generally, a PT does not disqualify the plan but excise taxes are imposed and correction needs to be completed. However, under certain circumstances, you may determine that the PT results in a violation of the exclusive benefit rule under Code section 401(a)(2) or the assignment and alienation rule under Code section 401(a)(13). Violation of these rules can result in disqualification.

Source documents

Review Form 5500, Schedule I, Part II for small plans and Schedule G and H for large plans. Prohibited transactions are disclosed on these schedules.

Schedule C lists the 40 most highly compensated service providers.

The tax return provides ownership information about individuals and relationships among the controlled group members.

All third party asset information should be reviewed with a concern about possible prohibited transactions. The following are examples of the documents that must be inspected:

- Bank and brokerage statements
- Mortgages, deeds, liens, land contracts
- Loan documents
- Appraisals
- Lease and rental agreements

Interview

At the interview, determine who are the trustees and fiduciaries of the plan. Request names of owners and their percentage of ownership. Inquire about types of investments and service providers used by the plan.

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Prohibited Transactions-overview and exam techniques,
Continued

Transactions identified on Form 5500

The Form 5500 series return contains several questions designed to determine if the plan has been involved in a prohibited transaction or party-in-interest transaction. (A party-in-interest is a defined term under Title I of ERISA that, in most instances, is parallel to a disqualified person.) The Form 5500 series requests "yes" or "no" answers to questions relating to plans investing in employer securities or employer real property, plan loans, sales, exchanges or leases of property, relationships between plan fiduciaries and service providers, and the purchase of non-publicly traded securities without a third party appraisal. The questions on the Form 5500 series returns are designed to identify potential problem areas.

Schedule E reports ESOP information.

Schedule I provides financial information for small plans. Part II requests "yes" or "no" answers to questions relating nonexempt transactions, non-cash contributions, loans and failure to transmit contributions timely to the trust.

Schedule H, Part IV for large plans provides similar questions and if the question on nonexempt transactions is answered "yes", Schedule G will also be completed, listing the nonexempt transactions.

Review the return as a first step in the examination process.

Examination steps

Inspect the Form 5500 series return to determine the nature of investments. Inspect the third party documents such as bank and brokerage statements, loan agreements, receipts and disbursements of the trust to verify that the amounts reflected on the Form 5500 agree with the third party documentation.

Review the investment powers governing the trust. Generally these will be found in the plan document or a separate trust instrument. If the trust instrument is silent as to investment powers, or the investments go beyond the instrument, determine whether the investments meet the law governing investments by employee trusts. For all plans covered by Title 1 of ERISA, state law does not apply. The main exception encountered by an agent will be when a corporate sponsor is wholly owned by an individual or his spouse and the plan covers only the owner and the owner's spouse. Then the plan will be subject to state trust investment law.

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Prohibited Transactions-overview and exam techniques,
Continued

Examination steps (continued)

Review disbursements and receipts. Be alert to any payments, transfer of property or insurance contracts to the employer, family members of the employer, employees and service providers. Review receipts and contributions to the plan for the addition of debt instruments, leases and property.

Review loan, lease and mortgage documents for parties involved and inquire about the family and ownership relationships between all individuals and entities that are involved in the transactions.

Insurance contracts need to be reviewed for the amounts and ownership of the contracts.

Prohibited transaction defined

Definition of prohibited transaction

A prohibited transaction means any direct or indirect transaction described in IRC 4975(c)(1) between the plan and a disqualified person. Prohibited transactions include

- sale or exchange, or leasing, of property,
- lending of money or extension of credit,
- providing goods, services or facilities,
- transfer to or use of the income or assets of the plan by the disqualified person,
- receipt of any consideration by a disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the assets or income of the plan.

Prohibited transactions--exemptions

Exemptions

However, certain transactions are exempt from the prohibited transaction rules. There are three types of exemptions. The first is statutory. Department of Labor (DOL) grants the other two. The exemptions are:

a. **Statutory Exemption.** Statutory Exemptions are provided in the Internal Revenue Code. An example of a statutory exemption is a participant loan that meets the requirements of IRC 4975(d)(1).

b. **DOL Individual Exemption.** An Individual Exemption offers relief only to the specific party requesting the exemption.

c. **DOL Class Exemption.** A class exemption furnishes relief to all parties who engage in transactions of the type covered by the ruling, provided the parties meet the stated terms and conditions.

Exemptions granted by DOL under section 408(a)

Per ERISA 408(a), DOL may grant an exemption from the prohibited transaction rules if the exemption is:

1. Administratively feasible,
2. In the interests of the plan and of its participants and beneficiaries, and
3. Protective of the rights of the plan's participants and beneficiaries.

Whenever you find a potential prohibited transaction, you need to check both the statutory and prohibited transaction exemptions (PTE) rulings before finalizing your conclusions.

A listing of DOL Class Exemptions can be found in Exhibit 4.72.11-1 of IRM 4.72.11.

Prohibited transaction—Defining disqualified person

Disqualified person

A disqualified person is an individual who, by virtue of their relationship to the plan, is in a position to self-deal. A disqualified person is defined in IRC 4975(e)(2).

Keep in mind that on audit you need to look for the interactions between the plan and owners, officers of the corporation, partners, employee organizations, fiduciaries {as defined in Code section 4975(e)(3)} of the plan and their family members. Also service providers such as lawyers, accountants, insurance agents and brokers are disqualified persons.

Unless financial transactions between these individuals and the plan fall under statutory or class exemptions from the Department of Labor, you may be looking at a prohibited transaction.

Defining fiduciary

The term fiduciary includes any person who exercises any authority or control regarding management or disposition of plan assets, exercises discretionary authority or control over plan administration or renders investment advice to the plan for a fee or any type of compensation. See IRM 4.72.11.3.5.

For example, persons who give advisory or consulting services to the plan, such as insurance agents or stockbrokers, may be fiduciaries to the plan although not formally named as such. Included within the concept of indirect benefit to a fiduciary is a benefit to someone in whom that fiduciary has an interest that would affect his/her fiduciary judgment. An example would be the retention by a fiduciary of his/her son to provide administrative services to the plan for a fee.

Constructive ownership rules

Be aware that there are complicated constructive ownership rules governing the definition of a disqualified person. These include persons who have a 50% or more interest (see IRC 4975(e)(2)(H) and (G)) and a member of the family of a fiduciary of any of these persons or individuals with a 10% or more interest (See IRC 4975(e)(2)(H) and (I)). IRM 4.72.11-2 and 11-3 provide charts showing the relationship between 50% control and 10% control for corporate and non-corporate employers and a disqualified person. Ownership must be carefully traced and documented for voting power and value of all stock, capital interest or profit interest in a partnership or beneficial interest of a trust or unincorporated enterprise.

Prohibited transaction-sale or exchange of property

Sale or exchange, or leasing of property

As a general rule, the sale, exchange or leasing of property, directly or indirectly, between a disqualified person and the plan constitutes a prohibited transaction whether the transaction was made from the disqualified person to the plan or from the plan to the disqualified person. The plan may not sell or exchange property, or lease property, to a disqualified person. Nor may the disqualified person sell or exchange property, or lease property to the plan. See IRC 4975(c)(1)(A).

Sale leaseback defined

A sale-leaseback occurs when employer property is sold to the plan and the plan turns around and leases the property to the employer. Absent a DOL administrative exemption, this transaction violates IRC 4975(c)(1)(A).

If a disqualified person transfers real or personal property—sale or exchange

If a disqualified person transfers real or personal property to a plan, that transfer constitutes a sale or exchange such as to make the transfer a prohibited transaction if:

a. The property is subject to a mortgage or lien which the plan assumes, or

b. The plan takes the property subject to a mortgage or similar lien that was placed on the property by a disqualified person within 10 years prior to the transfer. See IRC 4975(f)(3).

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Prohibited transaction-sale or exchange of property, Continued

PT exceptions – sale, exchange or lease

An ordinary blind purchase or sale of securities does not constitute a prohibited transaction where neither the buyer nor the seller nor the agent of either knows the identity of the other parties.

An exemption may be granted by DOL for a sale, exchange, or lease of property that falls within the purview of IRC 4975(c)(1)(A).

If a prohibited transaction falls within one of the following, the excise tax may not be applicable:

a. If securities held by the plan are subject to a privilege to convert those securities to other securities (e.g., from bonds to stock), the plan may exercise that privilege (to the extent provided in Treasury and Labor Regulations) so long as the plan receives adequate consideration under the conversion. See IRC 4975(d)(7).
b. Pooled Investments. A plan may purchase or sell an interest in a common or collective trust fund or a pooled investment fund maintained by a disqualified person which is a bank or trust company supervised by a State or Federal agency or between a plan and a pooled investment fund of an insurance company qualified to do business in a State so long as the bank, etc., receives no more than reasonable compensation for the purchase or sale or for the investment management of the pooled fund. Further, the transaction must be expressly permitted by the plan instrument or by a plan fiduciary, independent of the bank, trust company, or insurance company, who has authority to manage and control the plan assets. See IRC 4975(d)(8).
c. A plan may acquire, sell or lease qualifying employer securities or qualifying employer real property, under certain conditions. See IRC 4975(d)(13).

Exemption for office space-4975(d)(2)

IRC 4975(d)(2) provides, in part, that any contract, or reasonable arrangement, made with a disqualified person for office space which is deemed necessary for establishing or operating a plan may be statutorily exempt from the prohibited transaction excise taxes if no more than reasonable compensation is paid for such lease.

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Prohibited transaction-sale or exchange of property, Continued

PT exemptions-sale of insurance to the plan

Life insurance contracts on the life of the participant may be purchased by the plan from the participant or the employer; or may be sold to the participant, to a relative who is a beneficiary under the policy or to the employer. See DOL exemption PTE 92-5 and IRC 4975(d)(5).

Insurance transactions must involve consideration to the plan that places the plan in the same position after the transaction as it was in before the transaction. Examine the cash value of the insurance before and after the transaction to insure that the plan is neither over paying for a policy nor distributing more to a vested participant than he should receive.

This exemption also covers owner-employees of S corporations, partnerships and sole proprietorships.

Be aware that some plans contain sub-trust provisions, which provide for diversion of assets into irrevocable insurance contracts. As of January 2003, this issue is being reviewed by National Office.

Customer notes held by the employer

The employer may sell or contribute customer notes to the plan if the requirements of PTE 85-68 are satisfied. The note must be backed by tangible personal property, be an arm's length transaction, be guaranteed by the employer and constitute no more than 50% of the value of plan assets. Additionally, no more than 10% of the value of plan assets may be held in notes from one customer.

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Prohibited transaction-sale or exchange of property, Continued

Examination tips - sale, exchange or lease

1. Inspect the plan records to ascertain whether there have been any sales, exchanges or leases of property. If such a transaction has occurred, request back-up documents to determine if the transaction is prohibited. Documents which might be examined to ascertain whether a prohibited transaction has occurred include, but are not limited to:
   - Purchase-sales agreements
   - Mortgages
   - Land contracts
   - Liens
   - Deeds
   - Lease and rental agreements
   - Brokerage statements

2. Trace any unusual sales of plan assets or investments. For example, the sale of property by the plan to a third party where the third party turns around and sells the property to a disqualified person would be an indirect sale between the plan and the disqualified person.

3. Verify that any property owned by the plan is not being used by a disqualified person.

4. A common transaction is a sale-leaseback. In that situation there is a sale of property by a disqualified person to the plan followed by a lease of the property by the plan to the disqualified person. If an equipment lease to the employer is discovered, determine how the plan acquired the equipment. Generally, a sale (or sale-leaseback) between the plan and a disqualified person, in the absence of a DOL exemption, is a prohibited transaction.

5. If the plan leases office space from a disqualified person, the lease must meet the conditions of IRC 4975(d)(2) for a statutory exemption to exist:
   a. The terms of the lease must be as favorable to the plan as the plan might have obtained in an arms length transaction with an unrelated third person. Compare the leased space with any commercially leased space in the same building or obtain comparability data on similar office space from the local board of realtors.
   b. The length of the lease must be reasonable (especially in relationship to leases on similar property).
   c. The lease must be necessary for the establishment or operation of the plan.

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Prohibited transaction-sale or exchange of property, Continued

Contribution of property to a plan-deemed to be sale or exchange

A contribution of property is generally a prohibited transaction if there is an obligation to fund the plan. This would be the case for any plan that has a funding obligation under IRC 412 (i.e. defined benefit, target benefit or money purchase plans). {See Commissioner v. Keystone Consolidated Industries Inc., 508 U.S. 152 (1993)}

In addition, DOL's position is that any in-kind contribution to a defined contribution plan is prohibited under section 406(a)(1)(A) of ERISA (and with respect to defined contribution pension plans under Code section 4975(c)(1)(A)) if it reduces an obligation to make a contribution that is measured in terms of cash amounts, unless a statutory or DOL administrative exemption under section 408 of ERISA (or Code section 4975(c)(2) or (d)) applies.

For example, if plan terms require a profit sharing plan to make a specific contribution for a plan year equal to a set formula based on company profits, any in-kind contribution made to satisfy this liability would constitute a prohibited transaction (absent any statutory or administrative exemption). It would be advisable to review DOL Interpretive Bulletin 94-3 when encountering non-cash contributions during an examination.

Other than the case discussed in the preceding paragraph, contributions of property to a profit sharing or stock bonus plan does not constitute a prohibited transaction, as long as the property is not encumbered. See IRC 4975(f)(3).

Exemptions—employer securities

The employer may contribute its own securities to the plan or the plan may acquire securities from a disqualified person. As long as the provisions of ERISA 407 are followed, this transaction is exempt under ERISA 408(e) and does not constitute a prohibited transaction. Code section 4975(d)(13) exempts any transaction from excise tax that is exempt under ERISA 408(e).

Examine the employer securities held by the plan. The plan document must specifically provide for the acquisition of employer stock.

Employer securities may not exceed 10% of the value of plan assets immediately following the acquisition of the securities. There is an exception for individual account plans. Therefore the amount may exceed the 10% limit in profit sharing, 401(k), stock bonus plans and ESOPs.

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Prohibited transaction-sale or exchange of property, Continued

Exemptions—employer securities (continued)

Employer securities are not qualifying unless no more than 25% of the aggregate amount of stock of the same class issued and outstanding at the time of the acquisition is held by the plan, and at least 50% of the aggregate amount must be owned by persons independent of the issuer. Insure that any stock held by the plan meets these requirements.

Employer securities need to be carefully scrutinized. If you have any indication that the securities do not meet the requirements needed to make them qualified, the issue needs to be referred to the Department of Labor. See IRM 4.72.11.3.7 for a more extensive discussion of employer qualifying securities.

Qualifying employer real property

The plan may acquire parcels of land from the employer and then lease it back to the employer. However, the land must meet the geographically dispersed rule (there must be more than one property) and any improvements must make the land suitable for more than one use. The same 10% rule described in the previous paragraph applies to qualifying employer property. Identify the location of any property owned by the plan, determine its use and insure that the terms of the lease meet the requirements of an arm's length transaction and the value does not exceed 10% of total plan assets on the day after the acquisition. See ERISA 407(d)(4).

Be aware that qualifying employer real property can be confused with employer property leased to the plan. Any property owned by the employer and leased to the plan must be inspected to determine if it is a prohibited transaction.

Repayment of a loan with property or collateral

Generally, property used to repay a loan is a prohibited transaction. An exception would include a transfer of property that otherwise met a statutory or DOL administrative exemption. Repayment with property constitutes an exchange of property for the cancellation of the debt. See IRC 4975(c)(1)(A).

However, if a loan is secured with collateral and the loan goes into default, the plan can foreclose on the collateral. This does not constitute a prohibited transaction.

Prohibited transactions—loans

ESOP loans--exemptions

The employer may make a loan to an ESOP or guarantee a loan made to the ESOP from a third party to enable the ESOP to purchase employer securities. The loan must be without recourse against the ESOP. The proceeds must be used to acquire qualifying employer securities or to repay a current or prior exempt loan. The agent will verify this by checking dates, loan documents, and financial transactions associated with the loan and the valuation of the securities. See Reg. 54.4975-7.

Lending plan assets and other extensions of credit

Per IRC 4975(c)(1)(B), a plan may not lend or extend credit to a disqualified person nor may a disqualified person lend money or extend credit to the plan, either directly or indirectly.

Failure to timely transmit deferrals and participant contributions

DOL Reg. 2510.3-102 provides that participant contributions (including salary deferrals) become plan assets that they can reasonably be segregated from the employer's general assets, but in no event later than the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer.

An extension of credit occurs between the employer and the plan (indirect loan) when the employer fails to transmit salary deferrals or other participant contributions to the trust in a timely manner. As such, failure to timely deposit these contributions is a prohibited transaction under IRC 4975(c)(1)(B).

Prohibited transaction-Loan exemption

Exemption-interest free loans to the plan

A disqualified person can make an interest free loan to the plan for ordinary operating expenses or for a purpose incidental to the operation of the plan.

Review the time permitted for any interest free loan. DOL exemption PTE 80-26 does not permit a loan **for more** than three business days for incidental expenses, which include temporary overdrafts and crediting of interest and dividends where the money is not yet available. However, the three day limit does not apply to ordinary operating expenses, which include but are not limited to benefit payments, insurance premiums and provider fees.

Participant loan - exemption

A loan to a disqualified person who is also a plan participant is not a prohibited transaction if the loan satisfies the loan exemption requirements in IRC 4975(d)(1). Loans must be nondiscriminatory, meet the collateral and documentation requirements set forth in the plan and bear a commercially competitive rate of interest.

Participant loan—Exemption not available to shareholder-employees

Prior to 1/1/2002, participant loans are not permissible to shareholder-employees, by employees with a 5% or greater interest in an S Corporation, sole proprietors, partners owning more than 10% of the partnership interest or a corporation in which 50% or more of the total combined voting power or stock is owned by one of the above mentioned individuals. See IRC sections 401(c)(3) and 4975(f)(6). Participant loans are also not permissible to Family Members (as defined by IRC sections 318(a)(1) and 267(c)(4)). Prior to 1/1/2002 loans to these individuals are prohibited transactions.

However, this was changed by EGTRRA as of January 1, 2002. Shareholders of S corporations, partners and sole proprietors are now eligible for participant loans. Review the plan language to insure that the plan has been amended if the plan is offering loans to these individuals. (See IRC 4975(f)(6)(B)(iii).

Prohibited transaction-Furnishing of goods, services or facilities

Furnishing of goods and services

The plan may not furnish goods, services or facilities to a disqualified person nor may the disqualified person furnish services or facilities to the plan. There are exemptions to this provision enabling the plan to pay for office space necessary to establish or operate the plan and no more than reasonable compensation is involved and to pay service providers reasonable compensation for their efforts. See ERISA 408(b)(2).

However, full time employees and full time employees who are fiduciaries are not allowed to receive compensation from the plan except for direct expenses incurred as a result of providing services for the plan.

Prohibited transactions-self dealing, transfers and loans

Use of plan assets by the disqualified person—self-dealing

Per IRC 4975(c)(1)(D), income or assets of the trust cannot be transferred to or used by a disqualified a person for his own benefit, directly or indirectly. For example, transactions by the plan administrator to manipulate the value of a stock owned by a disqualified person constitutes a prohibited transaction.

Additionally, the disqualified person who is a fiduciary may not use assets or income of the plan in his own interest or for his own account. A fiduciary of the plan may not receive any consideration from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. IRC 4975(c)(1)(E) and (F).

Examination steps

Form 5500, Schedule C, for large plans, asks for information about the payments to service providers and administrative expenses. Review these expenses. Insure that the expenses are commensurate with the transactions involved and the value of the plan assets.

For small plans, Schedule I, Part I, Item 2h reports other expenses. If any unusual amounts are entered, inspect the names of the payees and ask the sponsor for justification of the expenses.

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Prohibited transactions-self dealing, transfers and loans,
Continued

Loans to the firm's clients

Loans to clients of the sponsor from the plan constitute a prohibited transaction (See Letter Ruling 9238001). Inspect any loan documents for the unusual relationships and if necessary ask for the firm's client list.

Transfers to the employer's checking account

The employer often acts as an agent for the trustee to disperse distributions to beneficiaries. Money is transferred to the corporate account and then paid to an eligible participant and the required withholding is transferred to the IRS. The IRS has expressed the opinion that this arrangement is not an appropriate function. Only money withheld and required to be transferred to the IRS should be deposited into an employer's account. However, it remains a common practice for the employer to act as a payer of plan distributions.

The agent needs to carefully inspect the timing of the deposits and the distributions. The money from the plan should be deposited to a non-interest bearing account and the employer should not receive any benefit from the deposits in these accounts, including a reduction in bank fees, computer software or a toaster. If any benefit accrues to the employer, even on a temporary basis, the transaction constitutes a prohibited transaction under IRC 4975(c)(1)(F).

Bank-trustee and loans to third parties

Examine any loans from the plan authorized by a bank-trustee which were extended to clients of the bank. The courts have found that if the proceeds from these loans are used to repay prior debt to the bank, the bank-trustee has entered into a prohibited transaction (See Letter Ruling 9424001). To determine if this type of transaction is involved, the agent needs to inquire about prior relationships between the bank and recipients of the loan proceeds.

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Prohibited transactions-self dealing, transfers and loans,
Continued

Securities transactions

DOL exemption PTE 86-128 allows certain fiduciaries to execute securities transactions under certain conditions. Under this class exemption, a fiduciary can pay a fee for executing the security transaction, act as the agent for both the buyer and the seller (a cross transaction), and receive a fee for the cross transaction. To be eligible for remuneration, the fiduciary cannot be a trustee, plan administrator or employer. The exemption permits the excluded individuals to complete the same transactions as long as they return any money received to the plan.

Use of a bank trustee's in-house discount brokerage service

Plans may purchase stock and bonds offered by a bank's brokerage service. The transactions must be authorized by the plan participants or the investment manager who is independent of the bank..

Bank float and sweep services

The bank that is a fiduciary of the plan is allowed to acquire bank float and sweep fees but there are requirements that must be followed. See DOL exemption PTE 81-8 for rules governing the float. In a float, the bank transfers idle cash from the plan to a general account earning interest. When the participant cashes a plan check, money is transferred to a plan account. -. Banks or the investment manager may perform sweep services where they transfer idle cash balances in employee benefit plan accounts into an overnight money fund. There may be a prohibited transaction if any additional fee for this service is charged based on the value of the funds swept into the overnight fund. Similar rules to PTE 81-8 must be followed. See DOL Opinion letter 88-02A.r.

Inspect bank statements carefully to determine if large amounts of cash are idle. The plan may be eligible for income from these services. Unless all the rules are followed, the bank fiduciary may have entered into self-dealing.

Financial institutions—statutory exemptions

IRC 4975(d)(4) permits investment of plan assets in the deposits of a bank that is the employer or the fiduciary of the plan. IRC 4975(d)(5) permits the same arrangement with an insurance company.

Continued on next page

Prohibited transactions-self dealing, transfers and loans,
Continued

Examination tips

- Inspect plan receipts and disbursements for the entire period under audit. Review of the beginning and end of year statements will not reveal some of the more complicated types of transactions that can lead to prohibited transactions.
- Attempt to determine if income or assets have been transferred to or used by, even on a temporary basis, a disqualified person.
- Examine checks, bank, statements, insurance contracts, loan agreements, security buy-sell statements.

Examination tips

- Verify stock quotations for large securities transactions.
- Review the Form 5500 and the appropriate schedules for the year under audit. Use the IDRS resources to review prior and subsequent years for sales of assets.
- Review employer securities and employer real property to insure they conform to all requirements.
- Review loans to insure that all loans meet the statutory requirements.
- On termination look for any loss. This may be an indication that property was sold to a disqualified person for less than its FMV.

Prohibited transaction-Calculation of excise tax

Excise tax on prohibited transactions

IRC 4975(a) and (b) impose a two level, nondeductible excise tax on each prohibited transaction entered into by a disqualified person.

Pending issuance of final regulations under IRC 4975, the excise tax on prohibited transactions is calculated in the same manner as the excise tax on self-dealing transactions with respect to private foundations. Because the terms "amount involved" and "correction" have not changed, this is the case even though the first level excise tax rates are now different.

An excise tax under IRC 4975 (a) is imposed on a disqualified person for each prohibited transaction within the plan.

- The tax imposed under IRC 4975(a) on the disqualified person is 10% for prohibited transactions occurring after August 20, 1996, and 15% for prohibited transactions occurring after August 5, 1997 of the "amount involved" with respect to the prohibited transaction for <u>each year</u> (or partial year) in the "taxable period".

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Prohibited transaction-Calculation of excise tax, Continued

Excise tax on prohibited transactions (continued)

- If the prohibited transaction is not corrected within the taxable period a second tier tax of 100% of the "amount involved" is imposed on the disqualified person under IRC 4975(b).
- Under IRC 4961, the second tier tax under IRC 4975(b) can be abated if the prohibited transaction is corrected during the taxable period.
- If more than one disqualified person is liable for the first or second level tax, then all such persons are jointly and severally liable to pay the tax..
- IRM 4.72.11 Exhibits 4.72.11-5 and 6 contain calculations of first and second level excise tax and the "amount involved" for a loan that is a prohibited transaction. These calculations are incorrect in the version that was printed on 6/14/2002. Corrected calculations are included in Exhibits 2 and 3 of this CPE chapter

Amount involved

The "amount involved" under IRC 4975(f)(4) is the greater of the amount of money and fair market value (FMV) of other property:

a. Given, or

b. Received.

The FMV for purposes of the first level tax (IRC 4975(a)) is measured as of the date the prohibited transaction occurred, or in the case of continuing transaction (i.e., a loan), the date the prohibited transaction is deemed to re-occur.

Where the use of money or other property is involved, the "amount involved" is the greater of the amount paid for such use or the FMV of such use for the period for which the money or other property is used.

When determining the "amount involved" for second level tax purposes, the first level tax guidelines may be used except that the "amount involved" is the highest FMV during the "taxable period". This provision is to insure that the person subject to the tax will not postpone correction of the prohibited transaction in order to earn income on such amounts.

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Prohibited transaction-Calculation of excise tax, Continued

Taxable period

The term "taxable period" means the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of the date on which:

a. Notice of deficiency is mailed under IRC 6212 with respect to the tax imposed by IRC 4975(a), or
b. The tax imposed by IRC 4975(a) is assessed, or
c. Correction of the prohibited transaction is completed.

Example- IRC 4975(a) & (b) tax calculations

Examples of excise tax calculations under IRC 4975 (a) & (b) for a loan from XYZ Corporation Profit Sharing Plan to XYZ Corporation are attached on Exhibits 2 and 3. Assume that a loan was made in the amount of $240,000 on 4/1/2000 from the plan to the employer at a stated interest rate of 10%.

Assume that no payments were ever made on the loan.

Assume that fair market interest rates are as follows:

- 10% on 4/1/2000
- 11% on 9/1/2000
- 9% on 1/1/2001
- 6% on 1/1/2002

Assume that 11% was the highest fair market interest rate over the life of the loan from 4/1/2000 through the date of the report (assumed to be 9/1/2003).

Note: For practical matters, the fair market interest rate is determined through the "date of the report". Statutorily, the fair market interest rate should be determined through the date of the issuance of the statutory notice of deficiency. Mandatory Review will update the interest rate at a later date, if necessary.

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Prohibited transaction-Calculation of excise tax, Continued

Technical guidelines for prohibited transactions-IRM 4.72.11

The following IRM sections for an extended discussion of the excise tax calculations and examples how correction of the prohibited transaction can be accomplished:

1. Taxable period: IRM 4.72.11.4.1.3
2. Amount involved first level: IRM 4.72.11.4.2
   a. Excess compensation: IRM 4.72.11.4.2.1
   b. Use of money or property: IRM 4.72.11.4.2.2
   c. Less than FMV received: IRM 4.72.11.4.2.3
3. Amount involved second level: IRM 4.72.11.4.3.
4. Correction methods: IRM 4.72.11.4.3.1 through 4.72.11.4.3.1.8
5. Statute of limitations: 4.72.11.6
6. List of granted DOL class exemptions: IRM 4.72.11, Exhibit 4.72.11-1.

Prohibited transactions-statute of limitations and workpaper development

Statute of Limitations

As soon as the agent determines that there is a prohibited transaction, the statute of limitations for each affected return must be reviewed. Control of the statutes is complicated and depends on the nature of the prohibited transaction whether it is discrete or continuing. A continuing transaction generally has more than one year that must be protected. The statute of limitations on a prohibited transaction is initially determined by the statute date of the Form 5500 filed for the plan year in which the prohibited transaction occurs or is deemed to occur. However, if it is necessary to extend the statute, the statute extension must be obtained from the disqualified person for the disqualified person's tax year. See IRM sections 25.6 and 4.72.11.6 for more details.

Workpaper development

IRM 4.71.5 provides a guide to the processing of Forms 5330.Documentation for a prohibited transaction that is unagreed needs to be extensive. Prohibited transactions often result in unagreed cases. Therefore it is imperative that the procedures in IRM 4.71.5.9 be followed closely.

The Case Chronology Record, Form 5464, must document all contacts and the matters discussed. All correspondence and the taxpayer's response to the correspondence must be kept in chronological order.

Plan Termination

Introduction

Examination of terminated plans provide the last chance for the Service to review a plan in form and operation. The agent must ensure that plan participants are receiving the benefit to which they are entitled. The information below reviews important issues to consider in carrying out this responsibility. The Objective for this section is to discuss the issues that must be reviewed for terminating plans to ensure that participant benefits meet all qualification requirements.

Plan Termination – Date of Plan Termination

Date of plan termination – plans subject to Title IV of ERISA

The agent should verify the date of plan termination. The termination date for a plan subject to Title IV of ERISA is the date under ERISA 4048. See IRM 7.12.1 for guidelines on the date you should use and the notice of intent to terminate requirements you should inspect.

Note that plans subject to Title IV are insured by PBGC. In some cases PBGC may change the proposed termination date.

Most defined benefit plans are subject to Title IV of ERISA. Defined benefit plans offered by professional service firms (such as doctors and lawyers) with fewer than 26 employees, by church groups or by federal, state or local governments usually are not subject to Title IV of ERISA and are not insured by PBGC.

Employers terminate pension plans subject to Title IV of ERISA in one of two ways:

1. **Standard termination.** In a standard termination, an employer ends a fully funded plan after showing PBGC that there is enough money to pay all benefits. The plan will provide the benefits owed either by purchasing an annuity from an insurance company which will provide periodic payments for life or, if the plan allows, all at once in a lump-sum. PBGC's guarantee ends when the employer purchases the annuities or otherwise pays you the value of your pension.

2. **Distress termination.** In a distress termination, an employer ends a plan that does not have enough money to pay all benefits owed. To do so, however, the employer must prove to PBGC that the business is financially unable to support the plan. PBGC takes over the plan as trustee and uses its own assets and any remaining assets in the plan to make sure that current and future retirees receive their pension benefits, within the legal limits.

Under certain conditions, PBGC may terminate a pension plan, on its own initiative. PBGC can take such action if, for example, a plan does not have sufficient assets to pay benefits currently due.

The termination date is important because the plan must follow all laws effective up through the date of termination. It must also be amended for all law changes through the date of termination.

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Plan Termination – Date of Plan Termination, Continued

Date of plan termination – plans not subject to Title IV of ERISA

For a plan not subject to Title IV of ERISA, the date of termination is the date voluntarily chosen by the employer maintaining the plan. As an examiner you must verify that the date specified by the termination resolution is in fact the actual termination date. This is important because the plan must follow all laws effective up through the date of termination. It must also be amended for all law changes through the date of termination.

Plan amendment to cease benefit accruals

A plan is not terminated simply because it is amended to cease future accruals. The plan must continue to meet all requirements of IRC 401(a) for the trust to retain its tax-favored status under IRC 501(a).

The plan must also be properly updated for all law changes through the date of termination. Failure to comply in operation or form can result in disqualification.

Plan Termination – Plan Document Issues

Plan document

The agent should review the last determination letter and verify that all required law changes subsequent to the last determination letter through the date of termination have been executed.

If the plan document has not been updated properly, and if the remedial amendment period has expired, See IRM 7.12.1.2.2.2 for applicable procedures.

GUST amendments

Most individually designed plans must be updated for all GUST requirements by February 28, 2002. There is an exception for entities operating below 14th Street in Manhattan. See Rev. Proc. 2001-55.

Volume, master and prototype plans have until September 30, 2003 per Revenue Procedure 2002-73. Plans from volume, master and prototype sponsors that are eligible for the extended remedial amendment period must have been submitted to the Service for an approval letter on or before December 31, 2000. This can be checked on the master and prototype list to verify that the sponsor submitted the master plan timely.

See Exhibit 1 for a GUST Remedial Amendment Period Worksheet.

EGTRRA amendments

All plans terminating after December 31, 2001, must be updated for the EGTRRA changes. See Notice 2001-57 for model amendments. Good faith amendments must be adopted no later than the later of (1) the last day of the 2002 plan year, or (2) the end of the GUST remedial amendment period to provide for an extended remedial amendment through the end of the 2005 plan year. See Notice 2001-42.

Plan Termination – Minimum Funding Requirements

Minimum funding requirements on termination

IRM 7.12.1.2.4 contains guidance related to minimum funding standards for terminated plans. A terminating plan is subject to the minimum funding standard of IRC 412 through the end of the plan year in which the plan terminates. In the case of a defined benefit plan, the charges and credits are ratably adjusted to reflect the portion of the plan year before the plan terminated. In the case of a defined contribution plan, the minimum funding standard charges will reflect the entire amount of any contributions due on or before the date of termination, but no contributions due after that date.

A plan subject to IRC 412 is not relieved of an accumulated funding deficiency by plan termination. The deficiency must be corrected within 8 ½ months after the end of the plan year or the plan will be subject to excise tax under IRC 4971. No tax under IRC 4971 will be imposed for plan years subsequent to the plan year in which the plan terminated.

Minimum Funding Example

You are examining the plan year ending 12/31/2001 for Alpine Corporation Defined Benefit Plan. The plan terminated on 12/31/2001 with an accumulated funding deficiency of $105,000. As of the date of your exam on 3/15/2003, the funding deficiency has not been corrected. The employer is subject to excise tax under IRC 4971(a) in the amount of $10,500 for 2001. The employer is also subject to excise tax under IRC 4971(b) in the amount of $105,000 for 2001 if correction is not made. No excise tax will be assessed for the 2002 plan year.

Plan Termination – Wasting Trusts

Timely distributions

Determine if the assets have been distributed on the proposed date of termination or within a reasonable time thereafter. Assets must be distributed as soon as administratively feasible. This is a facts and circumstances test, but is generally considered to require distribution of all trust assets within one year from the date of termination. If the plan administrator submits a timely application for a determination letter, distributions can generally be delayed until the letter is issued. See Rev. Rul. 89-87 and IRM 7.12.1.2.19.

Frozen or wasting trust

If the plan fails to meet the "as soon as administratively feasible" rule of Rev. Rul. 89-87, the plan has not terminated. The plan is considered a frozen or wasting trust. Therefore, it must be reviewed to determine if it meets the same standards as an ongoing plan under IRC 401(a). The plan document must continue to be updated for all required law changes within any remedial amendment period. Defined benefit plans must provide top-heavy minimums and any required accruals.

Review the plan document and benefit accruals and allocations. The plan must meet all 401(a) provisions except for minimum coverage and participation requirements under IRC 410(b) and 401(a)(26) in certain cases.

Frozen or Wasting Trust --Exception to coverage and participation requirements

Plans where no benefits (forfeitures, top-heavy minimums, required accruals due to an increase in average compensation.) are allocated or accrued may not be subject to the minimum coverage and participation requirements of IRC 401(a)(26) and 410(b). See 1.410(b)-(3) and 1.401(a)(26)-2(b).

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Plan Termination – Wasting Trusts, Continued

Wasting trust procedures (continued)

Review the date of termination and insure that benefits for plan participants are determined as of the date of termination. If the distributions were not completed within one year following the date of termination or following the receipt of the determination letter, the trust may not have been liquidated as soon as administratively feasible.

The determination is a facts and circumstances test and is deemed to have been made as soon as administratively feasible if the delay was caused by factors beyond the control of the plan administrator.

If the plan is determined to be ongoing, check to determine if any additional vesting, funding and benefit accruals are required. The plan is also responsible for information reporting requirements. The employer must continue to be file Form 5500 and all applicable schedules.

For more information on Wasting Trusts or Frozen Plan, see IRM 7.12.1.2.19.

Plan Termination – Calculations of Benefits/Account Balances

Defined benefit calculations

When examining a defined benefit plan that has been terminated, the following actions should be taken when reviewing participant accrued benefits:

- Review the calculations for the present value of the accrued benefit to insure that participants are receiving the benefit to which they are entitled on termination. This may require the review of prior plan documents to insure that changes in benefit formula have been followed and that there are no IRC 411(d)(6) decreases in the accrued benefit. For lump sum calculations see IRM 4.72.10.
- Consider sampling at the limits for a few participants to insure that participant years of service and vesting have been computed correctly. This requires checking original personnel records, payroll documents and state and federal tax forms.
- Check to insure that top-heavy minimums have been provided.
- Highly compensated employees need to be tested for IRC 415 limitations.

Defined contribution plan distributions

When examining a defined contribution plan that has been terminated, the following actions should be taken when reviewing allocations to participant accounts, account balances:

- Review the allocation schedule and statements of participant accounts.
- Also test-check personnel records, payroll documents and state and federal tax forms to review service and vesting for participants.
- Review Forms 1099-R and canceled checks or bank wire statements to determine distribution amounts.
- Check to insure that top heavy minimums have been provided.
- Verify that IRC 415 limits have not been exceeded when taking into account all defined contribution plans of the employer.

Plan Termination – Insurance Policies

Insurance policy distributions - Springing cash value life insurance contracts

If the plan is distributing insurance policies, question if any policies provide springing cash value contracts. A "springing cash value" life insurance contract is one purchased by a plan for an employee when the plan terminates. The stated case surrender value of the policy for a specified number of years (such as the first 5 years) is very low compared to the plan assets used to purchase the contract. At a time when the case surrender value is low, the policy is distributed to the employee. Following the end of the specified period, the cash surrender value "springs up", becoming greater than the total plan assets used to purchase the contract. If so, ask for information on the total policy reserve value instead of the stated cash surrender value. If the plan inappropriately uses the cash surrender value in valuing the amount distributed, the distribution could be treated, in part, as an employer reversion.

For further information, see IRM 7.12.1.2.21.

Fully Insured Contract Plans

The termination of a fully insured contract plan must be inspected for the following issues:

- Determine if the plan is distributing insurance contracts.
- Ensure the premium payments have been made timely.
- Verify no rights under the contract have a security interest, and
- Verify no policy loans are outstanding at any time during the plan year.

See IRM 7.12.1.2.22 for a description of requirements that this type of funding arrangement must meet.

Plan Termination - Discrimination

Discrimination

Discrimination in favor of highly compensated employees may result when a plan is terminated. Analyze all the information necessary to test for discrimination. See Reg. 1.401(a)(4).

The distribution to each plan participant upon termination of his/her account balance under a terminated defined contribution plan will not result in prohibited discrimination if the allocation formula and method of allocation has been nondiscriminatory up to the date of termination. However, amounts held in an IRC section 415 suspense account are not to be allocated if an excess allocation under IRC section 415 would result. Such amounts must revert to the employer. See Reg. 1.401(a)–2(b).

In a terminating defined benefit plan, determine whether the formula for computing benefits as of the date of termination would have been discriminatory if the plan had not terminated. If the formula would not have been discriminatory if the plan had continued, the guidelines set forth in Reg. 1.401(a)(4)–5 are applicable in determining whether the asset allocation is discriminatory upon termination.

If the value of assets in a defined benefit plan exceeds the present value of the accrued benefits as of the date of termination, the plan will not be considered discriminatory if such excess reverts to the employer or is applied to increase benefits in a nondiscriminatory manner. The new benefit structure must satisfy all requirements of the law (e.g., IRC section 411(d)(6), IRC section 415 and Reg. 1.401(a)(4)–(5).

If the value of plan assets is less than the present value of benefits as of the date of termination, assets must be allocated in accordance with ERISA 4044, regardless of whether the plan is covered by the PBGC. See ERISA 403(d)(1) and Reg. 1.411(d)–2(a)(2)(ii).

Plan assets allocated in accordance with the following priorities generally will be deemed to be nondiscriminatory:

a. Except as provided in d. below, the plan assets are allocated in accordance with ERISA 4044(a)(1), (2), (3), and (4)(A) of ERISA. PBGC has authority to approve this allocation.

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Plan Termination - Discrimination, Continued

Discrimination (continued)

b. Subject to the requirements of a. above, the assets are allocated, to the extent possible, so that the rank and file employees receive from the plan at least the same proportion of the present value of their accrued benefits (whether or not forfeitable) as employees who are highly compensated.
c. Notwithstanding any other paragraphs, any assets restricted by Reg. 1.401(a)(4)–5 maybe reallocated to the extent necessary to help satisfy b. above.
d. In the case of a plan establishing subclasses within the meaning of ERISA 4044(b)(6), the assets described in any paragraph of ERISA 4044(a) may be reallocated within such paragraph to the extent such reallocation helps to satisfy b. above.
e. Subject to a. through d., the assets shall be allocated in accordance with ERISA 4044(a)(4)(B), (5), and (6).

Plan Termination – Vesting

Termination - Vesting

A participant that separated from service without incurring five consecutive one-year breaks in service that did not receive a qualifying cash-out distribution prior to the plan terminating, must be 100% vested.

At termination, all participants with account balances must be fully vested. However, the 6^{th} Circuit Court arrived at a different position with respect to this issue in Borda v. Hardy 138 F.3d 1062 (6^{th} Cir. 1998), discussed below in further detail.

IRC 411(a)(6)(C) & GCM 39310

IRC 411(a)(6)(C) and GCM 39310 require that all former participants who were not fully vested who had not incurred sufficient breaks-in-services per IRC 411(a)(6)(C) (i.e., five consecutive one-year breaks in service after 12/31/84) or who had not received a cash-out distribution per IRC 411(a)(7) prior to the date of termination must be 100% vested.

Practically, if a participant has been terminated and receives, per plan terms, a cash-out (or "deemed cash-out") of the vested portion of his account balance prior to the date of termination, the participant will not become 100% vested. All other participants with account balances remaining in the trust on the date of termination must be fully vested.

Borda v. Hardy

The Service does not concur with the decision in Borda v. Hardy, 138 F.3d 1062 (6^{th} Cir. 1998). The 6^{th} Circuit found that Mr. Borda was not an affected employee for vesting purposes when the profit sharing plan in which he was a participant terminated. Mr. Borda had not incurred five consecutive one-year breaks-in-service at the date of termination. The employer dissolved and ceased operations prior to the date on which Mr. Borda would have incurred five consecutive one-year breaks-in-service. Therefore, the court held that there was no way for Mr. Borda to return to service and increase his vesting. Therefore, he was not an affected participant and not entitled to 100% vesting as required by IRC 411(a)(6)(C) and GCM 39310.

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Plan Termination – Vesting, Continued

Borda v. Hardy (continued)

The Service takes the position that Mr. Borda is an affected employee and should have been 100% vested upon plan termination. The Borda v. Hardy decision is applicable only where the principal place of business or office or agency of the employer maintaining the plan at issue is within the jurisdiction of the Court of Appeals for the Sixth Circuit (Michigan, Ohio, Kentucky and Tennessee). If the employer maintaining the plan is within Sixth Circuit jurisdiction then the Service will accede to the claim that nonvested participants are not entitled to full vesting on termination if the employer is no longer in business. But this ruling is only applicable in Michigan, Ohio, Kentucky and Tennessee.

Examination steps

Review the plan language to insure that the break-in-service rules are correct. Plans have been using language that permits the transfer of forfeitures to a "suspense account" after a single one-year break-in-service. This is a disqualifying provision because the required period is five consecutive one-year breaks-in-service.

Test check distributions for the 5 years prior to the date of termination. Check the dates of hire, dates of participation, dates of distribution, account balance, vesting, amount cashed out and verify that the amount remaining in the account is correct.

Plan termination—Partial termination

Introduction

To constitute a qualified trust, the plan of which such trust is a part must satisfy IRC section 411.

a. Upon a partial termination, the benefits of all affected participants accrued as of the date of the partial termination to the extent funded or the amounts credited to the participant's account, must be nonforfeitable. See IRC section 411(d)(3).
b. Reg. 1.411(d)–2(b) provides for a facts and circumstances test in determining whether or not a partial termination occurs. Such facts and circumstances include the exclusion of a group of employees who have previously been covered by the plan either by reason of a plan amendment or severance by the employer.

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Plan Termination – Vesting, Continued

Partial termination-based on facts and circumstances

When the accrual of benefits or the rate of employer contributions is reduced or the eligibility or vesting requirements under the plan are made more restrictive, facts and circumstances, other than the mere fact that benefits, employer contributions, etc. have been cut back, enter into the determination of whether there has been a partial termination. Be aware however, that such cutbacks of protected benefits may constitute violations of IRC section 411(d)(6) that must be remedied regardless of whether a partial termination has occurred.

Factors for partial termination

Reg. 1.411(d)–2(b)(2) sets forth an additional rule for defined benefit plans that cease or reduce future accruals. In such a case, a partial termination shall be deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer is created or increased. If no such potential for reversion is created or increased, a partial termination shall not be deemed to occur solely by reason of the cessation or decrease. Of course, a partial termination could occur because of factors other than such cessation or decrease, such as a reduction in plan participation.

The potential for reversion is a factor that may also be used in considering whether there is a partial termination in defined contribution plans. Forfeitures must be reallocated but reversions may occur for amounts held in the IRC section 415 suspense accounts that may not be reallocated. See Rev. Rul. 2002–42, 2002-28 I.R.B. 76. However, in such plans, potential reversion is part of the facts and circumstances test set out in Reg. 1.411(d)–2(b)(1).

Consideration of facts and circumstances in determining whether a partial termination has occurred include the exclusion of a group of employees who have previously been covered by the plan either by reason of a plan amendment or severance of employment initiated by the employer, or the reduction or cessation, of future benefit accruals under a plan that results in a potential reversion to the employer. See Reg. 1.411(d)–2(b)(2); Rev. Rul. 81–27, 1981–1 C.B. 228; and Rev. Rul. 73–284, 1973–2 C.B. 139.

All participant terminations are considered employer-initiated unless the employer can provide proof that the employee terminations were voluntary or on account of death, disability or attainment of normal retirement age.

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Plan termination—Partial termination, Continued

Factors for partial termination (continued)

The ratio of the number of employer-initiated terminations to the total number of plan participants during the applicable period is the turnover rate for the plan. See Tipton and Kalmback, Inc. v. Commissioner, 83 TC 154, 5 EBC 1976 (1984); and Weil v. Terson Co. Retirement Plan Committee, 750 F.2d 10, 5 ECB 2537 (2nd Cir. 1984).

If a partial termination has occurred and there was no full vesting

If there is a significant increase in the turnover rate for a period, or for other reasons a partial termination has occurred, and the employer failed to fully vest (to the extent funded), all affected participants upon partial termination of the plan, the plan was not qualified when it subsequently terminated.

Examples of partial termination

The following are examples of partial terminations:

1. Discharge by the employer of 95 of 165 participants under the plan in connection with the dissolution of one division of the employer's business. See Rev. Rul. 81–27, 1981–1 C.B. 228.
2. Discharge of 12 of 15 participating employees who refused to transfer to the employer's new business location when the old location was closed. See Rev. Rul. 73–284, 1973–2 C.B. 139.
3. Reduction in participation of 34% and 51% in consecutive years where adverse business conditions beyond the employer's control result in participation reductions. See Tipton and Kalmbach, Inc. v. Commissioner, 83 TC 154, 5 EBC 1976 (1984).
4. Relocation of two of an employer's 16 divisions resulting in the termination of over 75% of the employees in the affected divisions, and termination of 27% of the total plan participants. See Weil v. Terson Co. Retirement Plan Committee, 750 F.2d 10, 5 EBC 2537 (2nd Cir. 1984).

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Plan termination—Partial termination, Continued

Examples of partial termination (continued)

In the above situations a significant percentage of employees were, in effect, excluded from participating in the plan. There is no fixed turnover rate that determines whether a partial termination occurred, but the rate must be substantial. The facts and circumstances must be considered in each case and may include the extent to which terminated employees are replaced, and the normal turnover rate in a base period. The base period ordinarily should be a set of consecutive plan years (at least two) from which the normal turnover rate can be determined, and should reflect a period of normal business operations rather than one of unusual growth or reduction. Generally, the plan years selected should be those immediately preceding the period in question.

Partial termination – turnover rate

The turnover rate is determined by dividing the employer-initiated terminations by the sum of the total participants at the start of the period and the participants added during the period.

a. Employer-initiated terminations are generally all terminations other than those attributable to death, disability retirements and retirement at normal retirement age.
b. In certain situations, the employer may be able to prove that other terminations were also not employer-initiated.

In general, the Service’s position is that fully vested terminated employees are included in determining whether there has been a partial termination. This position was upheld in Weil v. Terson Co. Retirement Plan Committee, 82 Civ. 8468 (S.D.N.Y. 6/15/1988). Terminations are counted even if caused by an event outside the employer’s control, such as terminations due to depressed economic conditions.

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Plan termination—Partial termination, Continued

Processing steps

When reviewing for possible partial terminations:

1. Determine the turnover rate and collect other relevant information. Specifically, obtain information as to the turnover rate in other years and the extent to which terminated employees were actually replaced.

2. Consider whether the new employees performed the same functions, had the same job classification or title, and received comparable compensation.

3. Turnover rates in excess of 20% may indicate that a partial termination has occurred but lesser rates may also constitute partial terminations where the facts and circumstances so indicate.

Discontinuance of contributions

Discontinuance of contributions

IRC section 411(d)(3) requires that, in the case of a plan to which IRC section 412 does not apply, upon complete discontinuance of contributions under the plan, the rights of all affected employees to benefits accrued to the date of such discontinuance, to the extent funded as of such date, or the amounts credited to the employees' accounts, must be nonforfeitable. See Reg. 1.411(d)–2(a)(1)(ii).

a. A determination that contributions have been discontinued and the date upon which such discontinuance occurred requires consideration of all the relevant facts and circumstances.
b. A discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. See Reg. 1.411(d)–2(d).
c. If the employer has failed to make substantial contributions in 3 out of 5 years, and there is a pattern of profits earned, consider the issue of discontinuance of contributions.

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Discontinuance of contributions, Continued

Discontinuance of contributions (continued)

If the employer has failed to make significant contributions in years prior to the proposed year of termination, consider whether an earlier discontinuance has occurred.

a. Prior to the TRA '86, (or if the contributions are limited to the employer's profits), the employer must have had sufficient profits (as defined by the plan) for the years under consideration to make contributions.
b. For plan years beginning on or after 1/1/1986, profits are no longer required for making contributions to a profit-sharing plan. See IRC section 401(a)(27).

A temporary cessation of contributions in a profit sharing or stock bonus plan may not constitute a discontinuance of contributions. However, if this becomes a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit sharing plan, if a single employer plan.

In the case of a profit-sharing plan maintained by more than one employer, the discontinuance is effective not later than the last day of the plan year following the plan year within which the last substantial contribution was made by any employer. See Reg. 1.411(d)–2(d).

Plan Termination – Reversion of Assets

Reversion of excess assets

IRC section 401(a)(2) provides that in a qualified plan it must be impossible for any part of the trust to be used for purposes other than the exclusive benefit of the employees or their beneficiaries until all plan liabilities have been satisfied. However, multi-employer plans are entitled to reversion by reason of mistake of law or fact or return of any withdrawal liability payment. Other plans may have a reversion because of a mistake of fact.

Under Reg. 1.401–2(b), the employer may reserve the right to recover, at plan termination, any balance left in the trust after satisfaction of all liabilities, to the extent that the balance is due to an erroneous actuarial computation.

- Such an amount due to an erroneous actuarial computation may arise where the value of the assets at termination exceeds the present value of plan liabilities upon termination within the meaning of IRC section 401(a)(2), and the excess value has not been the result of a change in plan provisions other than the mere termination of the plan.

- If in the case of an employee stock ownership plan, upon an employer reversion from a qualified plan, any applicable amount is transferred from such plan to an employee stock ownership plan described in IRC 4975(e)(7), such amount shall not be treated as an employer reversion (or includible in the gross income of the employer) if certain requirements are met. {See IRC section 4980(c)(3)}.

- In a defined contribution plan, amounts that may not be allocated due to the limitations on contributions in IRC section 415 must revert to the employer. In addition, forfeitures in a money purchase pension plan must be reallocated to the extent permissible without violating IRC section 415. If the plan provides that forfeitures will be used to reduce future employer contributions, it first must be amended to provide for reallocation of the forfeitures in a nondiscriminatory manner. Only those amounts held in the IRC section 415 suspense account may revert to the employer. See Rev. Rul. 2002–42 and 2002-28.

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Plan Termination – Reversion of Assets, Continued

Reversions and GUST

The employer is not entitled to a reversion merely because the GUST law changes resulted in an excess of assets after all liabilities are paid. The increase in assets cannot be considered to be due to an erroneous actuarial computation.

Requirements for a reversion of excess assets

For any assets to revert to the employer upon plan termination, the plan must provide for a reversion.

For plans subject to Title IV, ERISA 4044(d)(1)(C) provides that any plan language providing for a reversion or having the effect of increasing the amount that may revert to the employer may not be made effective before the end of the 5th calendar year following the date of the adoption of the provision. (This rule does not apply in the case of a plan in effect fewer than 5 years that has provided for a reversion since the plan's effective date.)

Tax on reversion

A 50% excise tax on the amount of any employer reversion from a qualified plan is imposed on the employer maintaining the plan on account of reversions occurring after 9/30/1990. See IRC section 4980. If participants in a terminating plan are provided with additional benefits, with a replacement plan, or the employer is in bankruptcy liquidation, the excise tax is reduced to 20%.

To have the 20% reversion tax rate applied to the amount of the reversion rather than the higher 50% rate, the employer must demonstrate that they:

a. Was in Chapter 7 bankruptcy liquidation (or similar proceeding under state law) on the date of plan termination; or

a. Amended the plan prior to termination to provide immediate pro rata benefit increases (with a present value equal to at least 20% of the amount that would have otherwise reverted) to all qualifying participants; or

b. Transferred 25% of the terminating plan's excess assets directly to a replacement plan before any amount reverted to the employer. The amount transferred to the replacement plan should not have been included in the employer's income, deducted by the employer, or treated as a reversion.

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Plan Termination – Reversion of Assets, Continued

Tax on reversion (continued)

The tax under IRC section 4980 is reported on Form 5330 and is due on the last day of the month following the month in which the reversion occurs. See IRC section 4980(c)(4).

Examination steps

The following examination steps should be taken when an employer is receiving a reversion from a defined benefit plan:

1. Check the plan language to insure that reversions are permitted. An ERISA plan is subject to the five year rule. The language must be in the plan document five years prior to the date of termination.

2. Verify that reversions were the result of an erroneous actuarial computation.

3. Review the final Form 5500. If the item is checked indicating assets have reverted to the employer, determine if the IRC 4980 excise tax has been paid timely. The Form 5330 is due no later than the last day of the month following the month in which the reversion occurred.

4. Review the employer's tax return. The reversion must also be reported as income on the employer's tax return for the year of the reversion.

Plan Termination – Illiquid Assets

Illiquid assets

Plan assets may be difficult to sell or there may be disputes between trustees about distributions. Therefore, the Service has provided two mechanisms to resolve this problem. The nonqualified liquidating trust is approved for assets that cannot be disposed of quickly. Plans holding employer stock when the company is sold must place some of the proceeds in escrow. Participants ultimately receive distributions from the escrow account and receive special tax treatment for these distributions.

The liquidating or wasting trust can be used for illiquid assets such as real estate, limited partnerships, or insurance contracts. The plan sponsor can create a separate nonqualified trust to hold the assets. Plan participants receive a distribution of the assets that can be distributed. They also receive a certificate of participation in the nonqualified trust. The income and proceeds are ultimately distributed to the holders of the certificates.

When the stock of a corporation is sold, an escrow account is established to cover undisclosed liabilities. If the selling corporation's stockholders consist of its qualified plan, the plan's investment in employer stock will be sold and placed in the escrow account. Upon termination, plan participants will receive their benefit under the plan plus the interest in the stock subject to the escrow agreement.

Review 3rd party documentation and appraisals to verify the value of assets placed in nonqualified trusts or escrow accounts.

Plan Termination – Mergers and Spin-offs

Mergers and spin-offs

Defined benefit and defined contribution plans may be merged or spun-off. The provisions relating to mergers or consolidations of plans or transfers of assets or liabilities from one plan to another are contained in IRC 401(a)(12) and 414(l) and ERISA 208A. These transactions frequently occur as a result of the purchase or sale of an ongoing business.

Implementation guidelines

A termination/reestablishment occurs when an existing defined benefit plan is terminated and the previously covered employees are transferred to a new defined benefit plan, while any excess assets revert to the employer.

A spinoff/termination involves a defined benefit plan that is split into two or more plans. For example, one plan for active employees and one for retirees. One or more plans are then terminated, causing all or a portion of the "excess assets" to revert to the employer.

Implementation Guidelines for Termination of Defined Benefit Pension Plans were issued to provide that any attempt to recover surplus assets in a termination/reestablishment, or spin-off/termination will be treated as a diversion of assets for a purpose other than the exclusive benefit of employees and their beneficiaries unless certain conditions are met. See Treasury News dated 5/24/1984, as supplemented by a teletype dated 6/1/1984, and entitled "Processing Employee Plan Cases that Terminate with Reversion of Surplus Assets to the employer."

The approach taken by the Implementation Guidelines is to treat a spin-off/termination as if the entire plan had been terminated since the substance of the termination is similar to a termination of the entire plan followed by creation of a second plan.

In general, a plan involved in a spin-off/termination or termination/reestablishment is considered to have satisfied the Implementation Guidelines only if:

a. The benefits of all employees (including those covered in the ongoing portion of the plan) are vested as of the date of the termination.

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Plan Termination – Mergers and Spin-offs, Continued

Implementation guidelines (continued)

b. All benefits accrued by all employees as of the date of the termination (in the ongoing plan) are provided for by the purchase of annuity contracts or, for properly electing participants and spouses that are eligible to receive an immediate distribution, single-sum payments.

c. All employees who were covered by the original plan are given advance notice of the transaction as if the entire original plan were being terminated.

d. In a termination/reestablishment, the future amortization period for the unfunded past service liability for the new plan is the lesser of 30 years or the weighted average future working lifetime of all covered employees. The employer must request and obtain Service approval for this change in funding method.

e. In a spin-off/termination, the funding method for the ongoing plan must be changed on the date of termination by combining and offsetting amortization bases in accordance with IRC section 412(b)(4). The amortization period for this base will be the lesser of the combined amortization period and the weighted average future remaining working lifetime of all covered employees. The employer must request and obtain Service approval for this change in funding method.

In general, an employer may not attempt to receive a reversion in a termination/reestablishment or spin-off/termination earlier than 15 years following any previous such transaction. If it is determined that a spin-off/termination or termination/reestablishment is not part of an integrated transaction subject to the Implementation Guidelines, technical advice must be requested to resolve the case. See Rev. Proc. 2002–5, 2002–1 I.R.B. 173 (revised annually).

IRC section 414(l)(2) essentially provides that in the case of a spin-off/termination (or other similar transaction) involving defined benefit plans within a controlled group, excess assets must be allocated proportionately among spun-off plans. IRC section 414(l)(2) is generally applicable to transactions occurring after 7/26/1988.

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Plan Termination – Mergers and Spin-offs, Continued

Implementation guidelines (continued)

If IRC section 414(l)(2) and the Implementation Guidelines are not satisfied, neither the terminated nor the ongoing portions of the plan shall be considered qualified. Further, an employer statement that a particular vesting schedule or benefit level will be provided in a future plan is not sufficient to give the employees an enforceable right under Title I of ERISA. Consequently, determination letter requests for the ongoing and terminated plans must be submitted simultaneously.

Examination steps

The following exam steps should be taken:

1. Determine whether a spin-off termination or a termination-reestablishment subject to the Guidelines has occurred. To determine if it is appropriate to apply the substance over form doctrine to a spin-off termination, consider various factors, including the reason for the spin-off, the reason for the termination, and the length of time between the spin-off and the termination. If it is determined that it is inappropriate to apply the Guidelines to a spin-off termination, the case must be submitted for technical advice.

2. If a spin-off termination is found, make sure the requirements of the Guidelines for such a termination and IRC section 414(l) are satisfied.

3. If a spin-off termination or a termination/reestablishment has occurred, make sure the funding method and amortization periods have been changed as required by the Guidelines.

4. Determine whether this is the second spin-off termination or termination/re-establishment within 15 years. If yes, technical advice must be requested.

Plan Termination - Forfeitures

Forfeitures

A trust forming part of a defined benefit pension plan is precluded from using forfeitures to increase benefits prior to plan termination. See IRC section 401(a)(8) and Reg. 1.401–7.

Funds in a stock bonus, profit-sharing or, for years beginning after 12/31/1985, money purchase plan arising from forfeitures must be allocated to the remaining participants. See Rev. Rul. 2002–42, 2002-28 I.R.B. 76. However, such allocations must not result in prohibited discrimination. See Reg. 1.401–4(a)(1)(iii).

When forfeitures are allocated on the basis of account balances, the likelihood of discrimination is increased. See Rev. Rul. 81–10, 1981–1 C.B. 172.

Variations in contributions or benefits may be provided so long as the plan does not discriminate in favor of highly compensated employees. See Reg. 1.401(a)(4)–5.

If the allocation formula, method of allocating contributions and, where applicable, forfeitures would not be discriminatory on an ongoing basis, a distribution of the account of each participant will not result in discrimination.

Terminations – Workpaper Development

Workpaper Development

- Workpapers for terminations must be complete.
- Access IDRS and include print outs and analysis of the information available through the internal system.
- Comment on the Form 5500 and applicable schedules. Reconcile any discrepancies uncovered on audit.
- Inspect the plan document and all amendments since the last the determination. Verify timely adoption of the GUST amendments. If the plan terminates after December 31, 2001, the plan must adopt all applicable EGTRRA provisions. Provide a detailed explanation in your workpapers.
- Sample beneficiaries "at the limits" to verify timely participation, correct vesting and correct calculations of benefits. Inspect personnel records, dates of hire, payroll records, third party verification of contributions and distributions. Is person a rehire? Has the plan followed its break-in-service rules? Is vesting correct? If the employer is a member of a controlled group, test employees who move from one company to another and verify their benefit.
- Analyze the calculations for the Present Value of Accrued Benefit. Comment on IRC 411(d)(6) issues.
- Asset verification must be documented in the workpapers. Do not rely on the administrator's report. Third party documentation must be reviewed and included in your analysis. Ask for primary source documents including bank and brokerage statements, loan agreements, deeds, insurance contracts, certified audits and appraisals for real estate and employer stock. Inspect accountant's work papers showing how earnings, expenses, capital gains and unrealized gains were determined for plan under examination. Account for all assets. Trust assets must all be distributed to the plan participants in the process of the plan termination or the employer has a reversion and the concomitant tax consequences of the reversion.
- Sample and report on the trust's Forms 1099R for distributions, verification of payments for withholding, and documents to support the dates and payments. Verify in your workpapers that the plan is in compliance at the date of termination with all IRC 401(a) requirements and has been updated for all IRC 401(b) requirements.

Miscellaneous Issues—ESOP and S Corp Issue

ESOPs and S corporation stock

In 1996, Congress enacted legislation to allow ESOPs to own S corporation stock for tax years beginning after December 31, 1997. These law changes have opened the door to a number of possible abuses. Be alert to the following arrangements.

- Single-member ESOPs—A wealthy individual creates an S corporation that is wholly owned by the ESOP, in which the individual is the sole participant. All S corporation income is allocated to the ESOP and effectively deferred until the sole participant receives distributions. This arrangement was eliminated by EGTRRA.
- Deferral by a group of owners—A group of business "partners" creates an S corporation that is 100% owned by the ESOP. The owners remain the true owners of the S corporation through restricted stock under IRC section 83 or other deferred ownership rights. The restriction on the stock lapses in 5 years, but permits the "partners" to defer income for 5 years.
- High turnover of employees—The ESOP provides that employees attain a certain age and be employed for a certain period of time in order to vest. In essence the plan provisions will serve to exclusively benefit a few high level participants at the expense of the remaining employees.

EGTRAA anti-abuse provisions

EGTRRA added IRC section 409(p) to rectify the possible abuses arising from the earlier law changes. This is a very complicated area of the tax law. Most S corporations impacted by this section will be subject to excise taxes under IRC section 4979A. Consultation with the S Corporation Technical Advisor and the S Corporation Issue Specialist will be needed. However, the general effective date of the anti-abuse provisions is for ESOP years that begin after December 31, 2004. There is a special effective date of March 14, 2001 that is applicable to a corporation that converted to S status or established an ESOP after March 14, 2001.

Miscellaneous Issues—ESOP and S Corp Issue, Continued

EGTRAA anti-abuse provisions

Section 409(p) prohibits S corporation ESOPs from allocating ESOP stock to disqualified persons. Such allocation will be treated as a distribution to the disqualified person and subject the corporation to a 50% excise tax for the amount of the prohibited allocation under IRC section 4979A. (Review IRC section 409(p)(4) for the definition of disqualified person.)

Potential abuses to circumvent EGTRRA

Two general methods have been developed to circumvent the new EGTRRA provisions.

- Grandfathered single-member ESOPs—This arrangement attempts to circumvent the special effective date of March 14, 2001. A promoter establishes "shell" S corporations and has ESOPs established for these "shell" corporations prior to the March 14, 2001. The promoter then markets these "shell" corporations to wealthy individuals.

- Management company ESOP—The owners of an existing business establish a management company and elect S corporation status. The S corporation establishes an ESOP. An alternative to this arrangement is to have employees of the operating company moved into the S corporation. In both cases the stock of the S corporation has little value and the operating company manages to shift all income to the S corporation, which is owned by the ESOP so that it pays no taxes. This arrangement allows the deferral of S corporation income to the stockholders until actual distributions are received from the ESOP.

IRC 409(p) effective dates

As a general rule these provisions are effective for tax years commencing after December 31, 2004 for ESOPs established on or before March 14, 2001. If the ESOP was established after March 14, 2001 or if the employer was not an S corporation on such date, these provisions are effective with respect to plan years ending after March 14, 2001.

Rev. Rul. 2003-06 established certain anti-abuse rules to preclude an S corporation from obtaining a benefit from the deferral provisions when the ESOP was not established to provide a substantial benefit to the initial purported plan participants.

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Miscellaneous Issues—ESOP and S Corp Issue, Continued

Examination techniques

Compliance is attempting to identify promoters and monitor K-1 transcription data with ESOP in the name. However plans that have any of the following characteristics should be reviewed for potential problems:

- Form 5500s with small numbers of participants
- S corporation returns with little or no wages
- S corporations with excessive deferred compensation
- S corporations established on or after March 15, 2001 and owned by an ESOP

Miscellaneous Topics - Sampling Techniques

Gear sampling to uncover issues

The first step—pick the right universe. With respect to employee plan issues, picking every 10th or 50th participant does not uncover issues unless the universe has been properly defined. For example, to examine eligibility, in a 500 person plan, picking every 10th person will not uncover an issue if all of the 50 participants chosen have more than 2 years of service. Thus, to look at eligibility, the agent must start by defining the universe of participants who are relevant to the particular issue that is being examined.

For example, you are examining a 500 person plan. You determine that 200 participants have less than 2 years of service. The focus should be on those 200 participants—or those participants who would be entering the plan in the plan year under examination.

For eligibility, you should focus on those people who have been hired in the last 2 years to see if they are eligible to participate and have received allocations. You may also want to review participants with a little more service, such as 3 years, to see if they participated in the plan on a timely basis by verifying their prior year allocations. However, participants with 5 years of service will usually not reveal an issue with respect to eligibility.

To check for compliance with Code section 401(a)(9), you should focus on those individuals who are over 70 ½ and who received no distributions for that year. Also, you want to look for active participants who are over 70 ½ and who have not received a distribution for that year.

For vesting, the agent will review the vesting schedule. If the plan provides for a 5 year cliff schedule, the focus of the examination is to identify people with 5 years of service who terminated employment in that year and did not receive a distribution. The sampling technique that you use should not look for people with more than 5 years of service.

If the plan has a 3-7 graded vesting schedule, you would want to focus on those terminating employees with 3-7 years of service to determine if the vested percentage was calculated correctly when distributions were made.

The point with all of these examples is that you want to be "biased" in order to search for issues. You have to gear the sample that you are looking at in order to find these issues.

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Miscellaneous Topics – Sampling Techniques, Continued

Sampling at the limits

One way to determine if the plan is being administered properly is to sample "at the limits". If the plan is being properly administered "at the limits", then the plan is most likely being properly administered in other more usual situations. With this procedure, you are really "testing" plan administration and determining how the administration is handled with respect to difficult situations.

"At the limits" means the plan has unusual or non-routine situations in which plan administration would be difficult. If the plan administration is proper in those difficult situations, then you can conclude that the administration is being done properly in less difficult situations.

For example, suppose the employer has multiple plans with different eligibility features and employees move back and forth between the plans. If you test these employees that move back and forth and the eligibility provisions are being properly administered, there is a strong likelihood that the plan is being properly administered for the employees that simply stay in one plan.

Another difficult situation would be if the employer was part of a controlled group and some of the subsidiaries were not covered by the plan. However, to determine vesting service, all service with all subsidiaries is counted. Thus, if you have employees who have transferred to a participating subsidiary and their vesting was calculated correctly, chances are that vesting for employees who were always in the participating subsidiary was also counted correctly. However, if you find an employee with 7 years of service who transferred to a participating subsidiary and then terminated without a distribution, years of service with the non-participating subsidiary may not have been counted.

Miscellaneous Topics—Required Beginning Date

Required beginning date -IRC section 401(a)(9)

IRC section 401(a)(9) requires that the plan provide for minimum distributions that commence on or before the required beginning date (RBD). Prior to 1997, the required beginning date for participants who reached age 70 ½ after 1988 was April 1st of the calendar year following the calendar year in which the participant attained 70 1/2. SBJPA (Small Business Job Protection Act of 1996) became effective after 1996 and the RBD was amended to allow non 5%-owners to defer distributions until the later of the April 1st following the calendar year in which the employee attains 70 1/2 or retires.

A 5%-owner is an owner as defined by IRC section 416. The RBD for a 5% owner continues to be April 1st of the calendar year following the calendar year in which the owner attains 70 ½.

Application of RBD rules for defined benefit plans

In a defined benefit plan, if a participant retires after the calendar year in which the participant attains 70 ½, the accrued benefit must be actuarially increased to take into account the period after age 70 ½ in which the participant was not receiving any benefits under the plan. This adjustment must be provided for the period starting on the April 1 following the calendar year in which the participant attains age 70 1/2. However, if an employee attained age 70 ½ prior to 1996, the starting date for the actuarial increase is January 1, 1997. Actuarial equivalence is determined using the plan's assumptions for actuarial equivalence. [See IRC section 401(a)(9)(C)(iii)]

Required Distributions under IRC section 401(a)(9)

To satisfy the minimum distribution requirements, the entire interest of a participant must be distributed:
1. Not later than the RBD, or
2. In installments beginning not later than the RBD

The installments must be paid over:

1. The life of the participant, or

2. A period not extending beyond the life expectancy of the participant or the participant and the designated beneficiary.

Continued on next page

Miscellaneous Topics—Required Beginning Date, Continued

Calculation of the installments

The required distribution for the calendar year is determined by the following fraction:

$$\frac{\text{The participant's account balance}}{\text{The applicable distribution period}}$$

Prior to 2002, the distribution period is the applicable life expectancy determined under Table V and VI of Regulation section 1.72-9. Starting in 2002, the applicable table is contained in Regulation section 1.401(a)(9)-5.

IRC 401(a)(9) issue

The recent law changes add to the complexity of administering the minimum distribution rules. Possible operational failures in providing the required distributions must be considered on examination. The new law changes have provided more flexibility for these distributions, but plans must be amended to permit administrators to offer the new options to participants.

Administrators are generally knowledgeable about the requirements for terminating employees, but may fail to follow the requirements for participants who remain employed after age 70 ½.

Participants may choose to leave their benefit in the plan instead of taking a distribution and rolling the money into an IRA after separating from service. Often plans fail to monitor participants who are no longer employees of the company. The employer may respond that the responsibility for the required distributions rests with the former participant. However, if timely distributions are not made from the plan, the employer is not following the plan terms, which is a qualification issue.

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Miscellaneous Topics—Required Beginning Date, Continued

Plan amendments for changes to the RBD

The plan may give an employee the option to defer commencement of benefits until the new RBD even if the plan has not been amended to provide this option. However, the plan must amend retroactively to conform the plan to its pre-amendment operation. Under Rev. Proc. 97-41, the retroactive amendment must be adopted by the end of the remedial amendment period, which for individually designed plans is February 28, 2002 and for master, prototype and volume plans submitted by the sponsor on or before December 31, 2000 to the Service is the later of September 30, 2003 or a year after the issuance of their advisory/opinion letter. However, Rev. Proc. 2003-10 extended the time for DB plans to amend for 401(a)(9) to the end of their EGTRRA remedial amendment period, but only if the employer adopts the good faith EGTRRA timely; i.e., by the end of the GUST remedial amendment period.

Elimination of old RBD

Under the final Regulations, an amendment to eliminate the 70 ½ distribution option is permitted to apply to employees who attain age 70 ½ in or after the calendar year specified in the amendment that begins after the later of December 31, 1998 or the adoption date of the amendment. (See Q & A 10 of section 1.411(d)-4) An amendment to eliminate the old RBD cannot be retroactive.

Documentation to verify compliance with IRC section 401(a)(9)

On audit the examiner will need to ask specifically for this information.

- Review plan language to insure that the plan's operation complies with the plan provisions.
- Review birth dates for all participants.
- If the plan eliminates the old RBD for participants who remain in the employ of the sponsor, make certain the elimination of the option was not prior to the 1999 calendar year.
- Review ownership interests for the 5% requirement.
- Inspect allocation statements.
- Review PVAB calculations.
- Check lump sum distributions and installments for compliance with the appropriate table. Prior to January 1, 2002 use Table V or VI in Regulation section 1.72-9. After January 1, 2002 apply the table in Regulation section 1.401(a)(9)-5.

Continued on next page

Miscellaneous Topics—Required Beginning Date, Continued

Failure to comply with IRC section 401(a)(9)

Verify that distributions under IRC 401(a)(9) have been calculated correctly and that the distributions are timely. Failure to comply with these requirements or plan language defects will constitute a plan qualification failure. The plan may be eligible for EPCRS or the sponsor may be offered the option of a closing agreement.

Continued on next page

Miscellaneous Topics—Compensation

Compensation

Compensation may be defined differently for benefits and testing. As a company grows larger, it may offer different types of compensation packages or offer different types of compensation. As an example, the plan may use several definitions of compensation, such as one definition for allocations, another definition for 415 testing and yet another for ADP testing.

Review the plan document to insure that the definition for compensation for benefits is not discriminatory and the definition for IRC section 415 complies with current law. SBJPA changed IRC section 415. Inspect the plan language to insure that it has been updated correctly. If the plan document utilizes different definitions of compensation, you may want to test check to determine that the compensation definitions are applied correctly.

Compensation for IRC section 415 limitations—before SBJPA

A definition of compensation within the meaning of IRC section 415(c)(3) must be used to determine whether the maximum permissible contributions or benefits have been exceeded. Thus, for years beginning prior to 1998, compensation for section 415 testing purposes does not include amounts that are deferred and not included in gross income under IRC sections 125, 401(k) and 457.

Compensation for IRC section 415 limitations—after SBJPA

SBJPA added section 415(c)(3)(D) to the Code which provides that a participant's compensation includes (i) any elective deferral (as defined in section 402(g)(3)), and (ii) any amount which is contributed or deferred by the employer at the election of the employee and which is not included in the gross income of the employee by reason of section 125 or 457.

This section applies to years beginning after December 31, 1997. The definition now includes elective deferrals to 401(k) plans and other similar arrangements, elective contributions to nonqualified deferred compensation plans, and salary reduction contributions made to a cafeteria plan. The effect of this provision is to increase the amounts that can be contributed to a defined contribution plan.

Miscellaneous Topics— Compensation, Continued

Compensation for HCEs—before and after SBJPA

Compensation for determining the status of a HCE included salary deferrals prior to 1998. Prior to SBJPA the definition of compensation under 414(q)(4) read as follows:

IRC-HIST, 2002-CODE-VOL, Sec. 414, DEFINITIONS AND SPECIAL RULES. Subsec. (q), HIGHLY COMPENSATED EMPLOYEE.—

4) COMPENSATION.--For purposes of this subsection--

(A) IN GENERAL.--The term "compensation" means compensation within the meaning of section 415(c)(3).

(B) CERTAIN PROVISIONS NOT TAKEN INTO ACCOUNT.--The determination under subparagraph (A) shall be made--

(i) without regard to sections 125, 402(e)(3), and 402(h)(1)(B), and

(ii) in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b).

Compensation for key employee—before and after SBJPA

For purposes of IRC 416, the definition of compensation used in determining who is a key employee has the meaning given by IRC section 414(q)(4) and therefore, 415(c)(3). Therefore, prior to 1998, compensation for key employee followed the same rules as for HCE; i.e., it included elective deferrals to 401(k) plans and other similar arrangements, elective contributions to nonqualified deferred compensation plans, and salary reduction contributions made to a cafeteria plan. After SBJPA, compensation continues to include these deductions.(See Code section 416(i)((1)(D), 414(q)(4) and 415(c)(3))

Miscellaneous Topics—Sub-trust Issue

Sub-trust arrangement

Plans have been found to contain provisions permitting the establishment of a sub-trust. The language is usually embedded in the section on trust management or insurance. This arrangement permits the plan to use assets to buy insurance policies and place the policies in an irrevocable sub-trust. Someone other than the trust of the plan or the plan's trustees owns these policies. The beneficiaries are generally family members or business partners, not plan participants or their spouses.

There are currently three Tech Advices pending in National Office. Agents have questioned this arrangement as an alienation and assignment of a retirement benefit, resulting in a violation of IRC section 401(a)(13). Also at issue for plans subject to IRC 412 is the diversion of assets, which may cause the plan to fail to fund the survivor benefit and result in a violation of IRC section 401(a)(11).

Examination tips

- Determine if the plan has been substantially over funded in the past. Complete a cursory review of all the pages of an individually designed plan and the amendments.

- Review the ownership of insurance policies.

- Check IDRS for large decreases in asset value that do not correlate with decreases in the number of participants.

Miscellaneous Topics—Workpaper Development and TEQMS

Overview of intermediate examination procedures and TEQMS

Topics for the chapter have been selected because of issues found on examination and because of recent law changes that plan administrators may fail to implement correctly. To assist agents in meeting the TEQMS standards for developing issues, knowledge of current issues is essential. The review of the sampling techniques and the revised Form 5500 has been provided to assist agents in completing the pre-planning and efficiently developing test checks. However, all efforts go to waste unless they are documented in the work papers. The following paragraphs provide reminders of the information that must be provided for the reviewer to properly follow the examination techniques utilized and the conclusions reached by the examiner.

Examination planning

Utilize the Form 5500 to prepare the IDR attached to the 1346 Letter. Entries on the information return can also be a guide to target your internal search of IDRS and to prepare appropriate questions for the interview.

Examination scope and examination techniques

Familiarity with prohibited transactions, top heavy, termination issues and required minimum distributions will help to define the scope of the examination. Only material issues on the income/expense/balance sheet should be pursued. All of these issues require the evaluation of multi-year and related returns to determine if the plan has operational problems in prior and subsequent years. Be sure to comment on the results of your analysis.

Workpapers

Work papers must be developed with care and consideration for the reviewer reading the report. For each issue examined, the work papers must provide the plan provisions, the source documents, the test checks completed, the audit trail, the analysis and the conclusion reached citing the relevance to the Code.

Issues that hold the potential for going unagreed must follow the rules of the Administrative Record. This requires additional correspondence with the taxpayer and detailed reporting of action on the case chronology record.

Continued on next page

Miscellaneous Topics—Workpaper Development and TEQMS, Continued

Timeliness

The requirements for action under TEQMS are strict. Knowledge of proper exam techniques will assist in meeting these time frames. The agent will be able to pursue the relevant issues that are potential qualification issues or prohibited transactions and dismiss issues that are not material. Carefully document research and issues considered. Field audits must meet the following time frames.

Procedure	Time Frame
Start the examination—status 12 to first appointment	45 days
Significant activity required	45 days
Agreed or No change case	10 days to close
Unagreed case—from final closing conference or date closing conference was declined	20 days to close

Customer Relations/ Professionalism

The criteria for providing customer relations has been defined more precisely in recent years. Agents need to record their efforts to meet this standard. Advise the taxpayer of his rights on all examinations. Often contact is only made with the representative. Review the rights with the representative and ask that the information and the Publication 1 be provided to the taxpayer. Document your attempts to explain these rights on every examination. All contacts with the taxpayer/representative and the issues discussed need to be noted. Summarize your conversations, addressing issues with the taxpayer/representative, discussing findings and requesting information and keeping the taxpayer apprised of the status of the case throughout the examination.

Exhibit 1

WORKSHEET FOR GUST REMEDIAL AMENDMENT PERIOD
CALENDAR PLAN YEAR END

Yes	No	
☐	☐	1. Was an executed certification of intent to adopt submitted? If "no" go to item 6.
☐	☐	2. Was the executed certification of intent to adopt signed on or before 2/28/02?
☐	☐	3. Was the basic plan document for the prototype or volume submitter sponsor listed on the certification of intent to adopt submitted on or before 12/31/2000? (The list of approved volume submitter and prototype sponsor plans submitted on or before 12/31/2000 is available on the inter/intra net).
☐	☐	4. Was the GUST plan document or adoption agreement signed on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?
☐	☐	5. Was the GUST plan document or adoption agreement submitted on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?

If items 1 through 5 are answered "yes", the plan is timely for the RAP.

If items 1, 2 3 and 4 are answered "yes" but item 5 is answered "no" and there are no disqualifying features, the plan is not a late amender.

Yes	No	
☐	☐	6. Was the prior plan document or adoption agreement (the plan document or adoption agreement that was in effect on 2/28/02) submitted along with the advisory or opinion letter? If "no" go to item 10.
☐	☐	7. Was the GUST volume submitter or prototype plan submitted on or before 12/31/2000?
☐	☐	8. Was the GUST plan document or adoption agreement signed on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?
☐	☐	9. Was the GUST plan document or adoption agreement submitted on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?

If items 6 through 9 are answered "yes", the plan is timely for the RAP

If items 6, 7 and 8 are answered "yes" but item 9 is answered "no" and there are no disqualifying features, the plan is not a late amender).

Yes	No	
☐	☐	10. Was alternative evidence of eligibility for the extended RAP (see the memo from Robert P Bell dated November 13, 2002) submitted?
☐	☐	11. Was the GUST volume submitter or prototype plan submitted on or before 12/31/2000?
☐	☐	12. Was the GUST plan document or adoption agreement signed on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?
☐	☐	13. Was the GUST plan document or adoption agreement submitted on or before 9/30/03 or 12 months after the date of the GUST opinion or advisory letter?

If items 10 through 13 are answered "yes", the plan is timely for the RAP

If items 10, 11, and 12 are answered "yes" but item 13 is answered "no" and there are no disqualifying features, the plan is not a late amender).

Additional question?

☐ ☐ 14. Was the GUST plan document or adoption agreement signed after the date of the advisory or opinion letter.

Exhibit 2

XYZ Corporation
Calculation of IRC 4975(a) Tax
Exhibit 2

Prohibited Loan from XYZ Corporation Profit Sharing Plan to XYZ Corporation
Date of Loan: 4/1/2000
Date Corrected: Not Corrected
Loan Amount: $240,000
Loan Interest Rate: 10%

Beg. Date	Beginning Loan Balance	Greater of Fair Market Rate or the Loan Rate of 10%	Time	Amount Involved	Tax Year End 12/31/00	Tax Year End 12/31/01	Tax Y En 12/3
04/01/00	$240,000.00	10.0000%	0.75	$18,000.00	$2,700.00	$2,700.00	$2
01/01/01	$258,000.00	10.0000%	1	$25,800.00		$3,870.00	$3
01/01/02	$283,800.00	10.0000%	1	$28,380.00			$4
				Total IRC 4975(a) Tax:	$2,700.00	$6,570.00	$10

Computation of tax is equal to the appicable tax rate times the amount involved for each year: 10% for transactions occurring after 08/
15% for transactions occurring after 08/

Exhibit 3

XYZ Corporation
Computation of IRC 4975(b) Tax
Exhibit 3

Taxable Period Begin Date	Ending Date	Beginning Loan Balance	Highest Interest Rate of Period	Time	Amt Involved
4/1/00	12/31/00	$240,000.00	11.00%	0.75	$19,800.00
1/1/01	12/31/01	$259,800.00	11.00%	1	$28,578.00
1/1/02	12/31/02	$288,378.00	11.00%	1	$31,722.00
			IRC 4975(b) Tax		$80,100.00

IRC 4975(b) tax is 100% of the amount involved.

Assume a loan interest rate of 10%, but a high fair market interest rate of 11% on 9/1/2000.

For purposes of IRC 4975(b) tax, the amount involved in each loan is calculated by applying the greater of the stated rate or the greatest fair market rate of interest over the entire period of the loan.

The fair market rate is determined from the beginning of the taxable period until the statutory notice is issued. In this example, 11% applies for each year.

IRC 4975(b) is applied in the last year for which IRC 4975(a) tax is due (2002 in this example).

IRC 4975(b) tax is $36,750 (the sum the amounts involved for all years in which IRC 4975(a) is being assessed).