DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

Tax Exempt and Government Entities Division

October 22, 2004

MEMORANDUM FOR DIRECTOR, EP EXAMINATIONS
DIRECTOR, EP DETERMINATIONS REDESIGN

FROM: Carol D. Gold
Director, Employee Plans

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

Background

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

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

As discussed in this memorandum, these plans may violate the nondiscrimination requirements of the Code even though they ostensibly satisfy certain provisions in the nondiscrimination regulations. In addition, arrangements similar to those discussed in this memorandum may, in the case of defined benefit plans, raise related issues under

section 401(a)(26). These related issues were discussed in a prior memorandum from Paul Shultz, dated June 6, 2002.

Law and Analysis

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

Section 1.401(a)(4)-1(a) also provides that the regulations under section 401(a)(4) set forth the exclusive rules for determining whether a plan satisfies section 401(a)(4), but §1.401(a)(4)-1(c)(2) provides that the provisions of §§1.401(a)(4)-1 through 1.401(a)(4)-13 must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of highly compensated employees.

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

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

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

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

Employer M is a corporation which is solely-owned by Individual A. Employer M is not part of a controlled group of corporations under §414(b), is not under common control with another trade or business under §414(c), is not part of an affiliated service group under §414(m), and has no leased employees under §414(n).

Employer M maintains Plan X, a defined contribution plan, intended to be qualified under §401(a). Plan X is the only plan maintained by Employer M. Under its terms, Plan X provides immediate participation and covers only the highly-compensated employees of Employer M and a group of nonhighly compensated employees defined by Plan X. Plan X provides that the highly-compensated employees receive an annual allocation of 20% of compensation (subject to the limits of §415). The other covered employees receive an allocation of 5% of compensation.

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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