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Employee Benefits Corner

IRS Provides Informal Guidance on Plan Qualification Issues via *"Issue Snapshots"*

By Elizabeth Thomas Dold and David N. Levine

Lately, the IRS is providing increased informal guidance on various plan qualification issues through what are called "Issue Snapshots." This informal guidance provides plan sponsors, as well as IRS examiners, educational assistance on qualification rules to be mindful of when maintaining a tax-qualified plan. The latest round of "Issue Snapshots" was posted in May 2018, and cover a wide variety of issues:

- Use of Forfeiture Account to Fund QNECs and QMACs;
- Available Vesting Schedules for Matching Contributions;
- Annual Contribution Limit for Short Limitation Year;
- Compensation Limit for Short Plan Year;
- Changing Interest Credits Under a Cash Balance Plan;
- Loan Limit for Multiple Plan Loans;
- Spousal Consent for Participant Loans; and
- Qualification rules for non-electing church plans.

These Issue Snapshots are briefly summarized below and should be kept handy if these issues arise for reference.

Defined Contribution Plans

1. Use of Forfeiture Account to Fund QNECs and QMACs

The IRS issued proposed regulations in January 2017, 82 FR 5477, that changed the definition of qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs) to provide for 100% vested at the time the amounts are allocated to the account. This change permits QNECs and QMACs to be funded by the forfeiture account, which can be relied upon even though the final regulations are still pending. The snapshot also considers how QNECs and QMACs can be used for pass non-discrimination testing—expressly Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) testing. It includes the following helpful example:

> Plan A is a traditional 401(k) plan with 100 participants, 20 of whom are highly compensated employees (HCEs). The Plan uses a six-year graded

vesting schedule for profit-sharing contributions, and the Plan provides for correction of an ADP test failures with QNECs. In the 2017 plan year, five employees terminated prior to becoming fully vested, resulting in $20,000 of forfeitures. Therefore, for the 2017 plan year, the Plan may provide that the $20,000 of forfeitures can be used as QNECs to the extent necessary for the Plan to pass the ADP test.

For audit tips, the snapshot includes the following issues, which plan sponsors should consider when correcting ADP and ACP testing:

- Determine if the plan needed to make either a QNEC, QMAC, or both to pass ADP/ACP testing.
- Determine if the plan provides for QNECs and/or QMACs as a corrective methodology.
- Review the plan language to determine the correct funding source for QNECs and QMACs.

2. Available Vesting Schedules for Matching Contributions

This snapshot sets forth the vesting schedules that are permissible for matching contributions, and includes several examples to permissible vesting schedules. Note that it does not cover non-electing church plans and governmental plans, as these plans have special rules. Chart 1 outlines these rules is set forth.

For audit tips, the snapshot focuses on identifying the applicable schedule and making sure it is permissible for the type of plan, and that all eligible employees receive the match.

- Review the plan to determine if it permits matching contributions.
- Identify the vesting schedule for the matching contributions.
- Is the vesting schedule permitted under Code Sec. 411(a)(2)(B) (see the "general rules" above)?
- Identify the employees who are eligible to receive matching contributions.
- In a traditional safe harbor 401(k) plan, are matching contributions that are intended to satisfy the ADP test safe harbor 100% vested at all times?
- In a QACA safe harbor 401(k) plan, are matching contributions that are intended to satisfy the ADP test safe harbor 100% vested after no more than two years of service?
- If a SIMPLE 401(k) plan, verify that all contributions are 100% vested.

3. Annual Contribution Limit for Short Limitation Year

For an initial, amended, or terminating plan year, the plan may have a short limitation year, which will impact the maximum annual additions permitted for the year under

CHART 1. VESTING SCHEDULES FOR MATCHING CONTRIBUTIONS

General Rules	Traditional ADP Safe Harbor Contributions	QACA ADP Safe Harbor Contributions	ACP Safe Harbor Contributions	Simple 401(k) Plan Contributions	Qualified Matching Contributions (QMACs)
At least (or faster): 3-year cliff (100% after 3 years), or 6-year graded (20% after 2 years, 40% after 3 years, 60% after 4 years, 80% after 5 years, and 100% after 6 years) 100% vested at normal retirement age, plan termination, and impacted participants on a partial plan termination.	100% vested at all times	100% vested after no more than 2 years of service	Follow the general rules, provided that the plan is an ADP safe harbor plan and the match: (1) does not take into account deferrals and/or employee contributions exceeding 6% of the participant's safe harbor compensation, (2) does not increase in rate as the level of elective deferrals and/or employee contributions increases, (3) if discretionary, does not exceed more than 4% of the participant's safe harbor compensation, and (4) for HCEs, is not made at a greater rate than that for any non-HCE at the same level of elective deferral and/or employee contributions.	100% vested at all times	100% vested when allocated to participant account (following the proposed regulations)

Code Sec. 415(c). Specifically, there are proration rules for determining the Code Sec. 415(c) dollar limitation for a short limitation year (*i.e.*, when the limitation year is less than 12 months), which typically results from an initial, amended, or terminating plan year. Proration of the limit is as follows:

[dollar limit for the calendar year in which the short limitation year ends]

×

[the number of months in the short limitation year divided by 12]

The snapshot also reviews the rules for participants that are eligible for only part of the limitation year—which does not involve proration of the limit—and the impact on the limit where there is a plan termination.

For the audit tips, the snapshot lists the following actions to ensure that the plan document reflects the short limitation year and there is compliance with Code Sec. 415(c) dollar limit, along with the proper compensation to be included for the short limitation year:

- Identify the limitation year used by a defined contribution plan maintained by the employer. Has the year changed?
  - Is there an amendment that reflects the change?
  - If not, is it required (for example, not required in the case of a plan termination that creates a short limitation year)?
- If the limitation year has been changed and a short limitation period is created, has a prorated Code Sec. 415(c)(1)(A) dollar limitation been used for the short limitation year? For the Code Sec. 415(c)(1)(B) compensation limit, has compensation earned only during the short limitation year been used to establish the maximum amount?
  - If the plan was terminated, other than at the end of a limitation year, did the plan use a prorated dollar limitation to determine maximum annual additions to the plan?

4. Compensation Limit for Short Plan Year

Code Sec. 401(a)(17) provides for a dollar limit on the compensation that can be taken into account under a qualified plan. This compensation limit is indexed for inflation. Moreover, this compensation limit is adjusted for a short plan year. A short plan year may include an initial plan year, an amended plan year, or when a plan is terminated. For a short plan year, the compensation limit is determined by the following formula:

[applicable dollar limit for the calendar year in which the short year begins]

×

[the number of months in the short plan year divided by 12]

The snapshot also includes a number of examples of short plan years that require a proration calculation, and also examples of the impact of new participants or participants that terminate employment mid-year that do not result in prorated compensation limit.

This informal guidance provides plan sponsors, as well as IRS examiners, educational assistance on qualification rules to be mindful of when maintaining a tax-qualified plan.

For the audit tips, they cover both the applicable limit for new participants entering a plan and plans with short plan years that need to follow the proration rules, as set forth below.

- Identify the plan year. Is there a short plan year?
- If there is a short plan year, what is the period for measuring compensation?
  - If compensation is measured on the basis of the short plan year, the Code Sec. 401(a)(17) limit must be prorated.
  - If compensation is measured on the basis of a full 12-month period during which the short plan year occurs, in the case of an ongoing plan, the Code Sec. 401(a)(17) limit is not prorated.
- How does the plan measure compensation for participants who enter the plan during the plan year? Was this formula followed in operation?
- In the case of a terminating plan that results in a short plan year, is the Code Sec. 401(a)(17) limit prorated for the short plan year?

Defined Benefit Plans

1. How to Change Interest Crediting Rates in a Cash Balance Plan

IRS/Treasury has issued guidance on the available interest crediting rates under a Cash Balance Plan.

This snapshot focuses on how to change an existing interest credited rate to a new rate, and includes a number of examples. It also provides information on compliance with Code Sec. 411(d)(6), to conform with anti-cutback protections. There are two common approaches that are used in this regard—either an "A plus B" approach or a "wearaway" approach—when a plan amendment reduces (or potentially reduces) the interest crediting rate. Some plan sponsors also simply elect to terminate the plan as a way to avoid the "wear-away" approach, but this raises *bona fide* termination issues in the event another cash balance plan is established shortly thereafter.

For the audit tips, they cover these cutback restrictions that apply with an interest crediting rate change under a cash balance plan:

- Review any plan amendments to see if they potentially decrease the interest crediting rate.
- If there are reductions in the interest crediting rate, make sure the plan protects the interest crediting rate "promise" in effect before the amendment. Either the A plus B or wearaway approach will accomplish this.
- Ensure that if the wearaway approach is used, the resulting rate does not exceed a market rate of return for participants who are not actively accruing benefits (*i.e.*, principal credits) as of the date of the amendment.
- If correction is needed, notify your manager and work with the field actuaries to develop a correction.

Defined Contribution and Defined Benefit Plans

1. Loan Limit for Multiple Plan Loans

Both ERISA and the Code provide limits on participant loans (which are more typical under a defined contribution plan). Under the Code, the rules are set forth in Code Sec. 72(p), which take into account plans within the controlled group, and provide special rules for loan refinancing. This snapshot provides a review of the application of these rules when a participant has more than one loan outstanding. It also provides examples that are instructive.

For audit tips, the IRS focuses on compliance with these rules:

- Does the plan document allow loans? If so, does it allow multiple loans?
- Does the employer sponsor any other qualified plans? If so, does the participant have any loans from those plans?
- If a participant has multiple loans from this plan or other plans of the employer, are all loans considered to calculate the Code Sec. 72(p)(2)(A) limit, or if lower, a plan-imposed limit?
- Does a participant have two or more loans outstanding during a one-year period? If yes, review Field Memorandum dated July 26, 2017, and determine if the plan has computed "the highest outstanding balance," for purposes of applying the Code Sec. 72(p)(2)(A) limit, in one of two ways described in said memorandum. One of which looks at the single highest outstanding balance of all loans during the one-year period. The other looks at the total of the highest outstanding balance of each loan during the one-year period.
- What is the participant's vested account balance in the plan (or plans, if applicable)?
- Secure a copy of the loan document for each participant loan and review the amount, date, and repayment schedule of each loan.
- Check to see if the plan permits refinancing of plan loans. If so, check whether the refinancing of loans satisfies the requirements in Reg. §1.72(p)-1, Q&A-20.

2. Spousal Consent for Participant Loans

Typically, spousal consent for various purposes is permitted to be provided within 180 days. This snapshot addresses the applicable period for a spouse to consent to a plan loan where the plan is subject to Code Sec. 417(a)(4)—that is for plans that offer a qualified joint and survivor annuity (*e.g.*, a defined benefit plan, a money purchase pension plan). The Pension Protection Act of 2006 ("PPA") largely amended the Code to extend the time periods from 90 days to 180 days for various purposes, but PPA did not expressly amend Code Sec. 417(a)(4). Code Sec. 417(a)(4) continues to provide for a 90-day period for spousal consent to a loan. In 2008, proposed regulations were issued, 73 FR 59575, that would extend this period to 180 days, but the regulations still have not been made final. This snapshot provides that plan sponsors can apply either a 90-day or 180-day period, provided that the period used is set forth in the plan document.

For audit tips, for plans that require spousal consent for a loan in accordance with Code Sec. 417(a)(4), either a 90- or 180-day period is permitted, but the plan must be operated in accordance with its written terms.

3. Qualification Requirements for Non-Electing Church Plans Under Code Sec. 401(a)

This snapshot provides a summary of the qualification requirements under ERISA (and pre-ERISA) that apply to a non-electing church plan. A non-elective church plan is a church plan under Code Sec. 414(e) that did not make a Code Sec. 410(d) election to be subject to ERISA. The following requirements of Code Sec. 401(a) apply (subject to special rules):

- 401(a)(1)—Contributions to the plan must be for employees.
- 401(a)(2)—Exclusive benefit rule.
- 401(a)(4)—Non-discrimination testing (but see Notice 2001-46, which provides that the regulations under Code Secs. 401(a)(4), 401(a)(5), 401(l), and 414(s) will not apply to non-electing church plans until further notice. Until such notice is provided, non-electing church plans must be operated in accordance with a reasonable, good faith interpretation of these statutory provisions.).
- 401(a)(5)—Special non-discrimination rules, including those relating to salaried and clerical employees, permitted disparity, contributions and benefits that bear a uniform relationship to compensation, and plan aggregation rules (but see Notice 2001-46, noted above).
- 401(a)(8)—Forfeitures in defined benefit plans.
- 401(a)(9)—Minimum distribution requirements (but see Code Sec. 401(a)(9)(C)(iv) for special rules applicable to certain church plans).
- 401(a)(10)(B)—Top-heavy requirements (*see also* Code Sec. 416).
- 401(a)(16)—Limitation on contributions and benefits under Code Sec. 415 (*see also* Code Sec. 415).
- 401(a)(17)—Limitation on compensation.
- 401(a)(25)—Requiring that actuarial assumptions be specified in the plan.
- 401(a)(26)—Additional participation requirements.
- 401(a)(27)—Determinations as to profit-sharing plans.
- 401(a)(30)—Limitation on elective deferrals under Code Sec. 402(g).
- 401(a)(31)—Direct transfer of eligible rollover distributions.
- 401(a)(36)—In-service distributions permitted to participants who have attained age 62.
- 401(a)(37)—Death benefits under USERRA.

Note that these plans are subject to the requirements for participation, coverage and vesting that were in effect on September 1, 1974, prior to the enactment of ERISA.

For audit tips, compliance with the special qualification rules, and review of any ERISA elections, are key:

- Is the plan a non-electing church plan?
- Review the plan document, applications for prior determination letters, prior determination letters, and Form 5500 (if any).
- Determine if a statement was filed pursuant to Reg. §1.410(d)-1(c).

