Issue 2012-1
March 20, 2012

employee plans news

PROTECTING RETIREMENT BENEFITS THROUGH EDUCATING CUSTOMERS

Internal Revenue Service
Tax Exempt and Government
Entities Division

A Publication of Employee Plans

Guidance

- New guidance to encourage retirement plans to offer participants lifetime income options
- Submit recommendations for next year's guidance plan by May 1, 2012
- EP Published Guidance

Determinations

- Employers must adopt their pre-approved defined benefit plans and file their determination letter applications (if desired) by April 30
- Check the status of your determination letter application on our Web page, by phone or fax, but the IRS can't respond by email
- New (Cycle A) Alert Guidelines to help you review plans
- EP Determination Letter Program Update phone forum (March 30)

Examinations

- Exam Director discusses 401(k) plan projects
- Initial results of LESE projects on real estate investments and loans
- EPCU focuses on domestic trust issues

Individual income taxes

- No exception to the additional 10% tax on early distributions from IRAs to satisfy a divorce court order
- How to report 2010 Roth rollovers and conversions on your 2011 return
- 401(k) plans usually apply the salary deferral limit uniformly to an employee's annual compensation

Governmental plans

- Subscribe to *Governmental Plan Updates* for recent developments
- Register for:
    - Town hall meeting on governmental plan proposed guidance in Cleveland, Ohio (May 3)
    - Phone forums
        - Indian Tribal Government retirement plans (April 24)
        - Governmental plan proposed guidance (May 15)
- Submit comments for public hearings by June 18 on proposed rulemaking for governmental plans (July 9) and Indian Tribal Governments (July 10)

PBGC publication, *Finding a Lost Pension*, can help you locate lost benefits

New on the Web

- Tax effect of plan disqualification
- *Choose a Retirement Plan for Employees of Tax Exempt and Government Entities*, Publication 4484
- A Plan Sponsor's Responsibilities (pdf)
- You can't amend your SIMPLE IRA plan mid-year
- We've updated the 401(k) Plan Fix-it Guide to help you determine if your plan meets recent law changes

Coming up

- Register for IRS Nationwide Tax Forums to attend over 40 presentations, including two on retirement plans
- Calendar of EP Benefits Conferences

In the News

- DOL Corner
- PBGC Insights

Exam Priorities…With Monika Templeman
Today’s Discussion: 401(k) Plans – What Else is Going On?

In each issue, Monika Templeman, Director of Employee Plans Examinations, responds to questions and offers insights on retirement plan topics uncovered during audits. You may provide feedback or suggest future topics for discussion by emailing her at: RetirementPlanComments@irs.gov.

On February 3, we posted the 401(k) Compliance Check Questionnaire Interim Report to share information from the responses with the retirement plans community. I shared my initial thoughts on the results and explained how you may use the data. In my presentations about the Interim Report, I mention our other 401(k) plan examination efforts. I’ll use this newsletter to give you more details about our work with 401(k) plans.

First, analyzing 401(k) plan compliance remains one of our top operating priorities. We’ll continue to monitor the top errors found on examination (along with errors submitted in the Voluntary Compliance Program) and share these with you so you can assist your clients in finding, fixing and avoiding these errors.

Next, we have LESE projects. These are small, quick projects focused on a specific plan feature and market segment. LESE stands for:

- **L**earn (about the compliance issues)
- **E**ducate (inform the retirement plans community about our results)
- **S**elf-correct (give plan sponsors an opportunity to correct errors through EPCRS)
- **E**nforce (expand the scope of the examination to others within the targeted group)

One LESE project was on top-heavy 401(k) plans. We examined about 50 small plans that may have been subject to the top-heavy requirements and found several errors. Most of these errors match the common mistakes listed in our 401(k) Plan Fix-It Guide, including failure to properly:

- cover all eligible employees
- recognize and distribute excess contributions timely
- deposit elective deferrals timely
- satisfy the top-heavy requirements

About 14% of the plans in this project failed the top-heavy requirements. Many of the plans didn’t test for top-heavy requirements, and so didn’t make the required minimum contributions. We also found instances of administrators not using the plan’s definition of compensation, which led to top-heavy minimum contribution allocation errors.

Another LESE project focused on potential 402(g) excesses in 401(k) plans. This project yielded different results; only one of 54 plans reviewed had excess 402(g) salary deferrals. There were, however, other plan errors that were unrelated to this project’s subject.

We also performed risk-based examinations on specific industries. The results from these examinations help us determine the most efficient use of audit and outreach resources. We performed 401(k) plan examinations in three market segments:

- Accommodation & Food Services Industry
- Administrative & Support, Waste Management & Remediation Industry
- Wholesale Industry

In each of these three projects, the two most common errors found were:

- ADP/ACP discrimination testing results
- untimely deposit of employee elective deferrals

Again, the 401(k) Plan Fix-It Guide contains information on these errors.

We also have a compliance unit (EPCU) that performs soft contact compliance checks with plan sponsors. One EPCU project focused on excess deferrals. It evaluated problems with reporting excessive elective deferrals in Box 12 of Form W-2. The project led to three of every four plan sponsors needing to correct their Forms W-2. Because of our contact, employers corrected software and administration errors that should prevent future problems and filed over 26,000 Forms W-2C, *Corrected Wage and Tax Statement*.

We also completed a 401(k) Untimely Deferral Deposit project. EPCU is finalizing their report and will post it when completed.

You may hear or read my comments about taking “other data” besides the Interim Report data to design and improve case strategies, to develop follow-up compliance projects, and to develop the appropriate outreach materials. This is some of the “other data” that we will consider when we complete these next steps.

Follow-up on Learn, Educate, Self-Correct and Enforce Projects

Employee Plans Examinations has identified two Learn, Educate, Self-Correct and Enforce projects for future follow-up or “Enforce” action. These projects involved examining returns with self-identified:

- investments in real estate and participant loans, and
- defaulted loans or uncollectible leases.

Investments in real estate and participant loans

This LESE project involved plans with less than $5 million in assets, investments in real estate, and either participant loans or a Schedule D (DFE/Participating Plan Information). Its results showed that in the plans reviewed:

- 25% had at least one prohibited transaction.
- 25% had real estate investments that weren’t valued at fair market value.

Problems with loans included:

- not following the plan loan provisions,
- not having a bona fide loan (no loan document and/or payments),
- not having a provision for loans in the plan document, but allowing participant loans, and
- not prohibiting loans to the employer and/or related entities.

Defaulted loans or uncollectible leases

The second LESE project focused on plans that indicated they had loans or leases that were in default or uncollectible. Over 10% of the plans reviewed had prohibited transactions.

We found issues in **both projects** with:

- not properly valuing assets at fair market value, and
- not timely amending the plan for law changes.

Another potential LESE project follow-up focuses on Form 5500 returns filed with invalid NAICS codes (returns using a four-digit code after the codes were expanded to six digits).

Read the complete reports for these and other LESE projects on our LESE page.

EPCU Project on Domestic Trusts Maintained By Foreign Employers

The Employee Plans Compliance Unit has completed its first international project to determine if:

- foreign entities are maintaining domestic trusts,
- these entities are complying with the domestic trust rules, and
- an employer whose EIN begins with 98 is a foreign employer or has a foreign affiliation.

The project also reviewed the employer's plan number, plan type and Form 5500 filing history.

Project process

EPCU sent contact letters to a sample of employers with an EIN beginning with the number 98 that had indicated on Forms W-2, *Wage and Tax Statement*, that their employees were covered by a qualified retirement plan. EPCU asked plan sponsors whether they were foreign employers and if the trust associated with their retirement plan was a domestic trust.

Project results

Some of the employers we contacted confirmed they were foreign employers, while others said they were never foreign employers. Many of the employers who said they weren't foreign employers at some point had:

- foreign employees
- a foreign subsidiary
- foreign incorporators
- a foreign mailing address
- been acquired by a foreign employer
- previously been owned by a foreign employer
- used a foreign service provider or third party administrator to administer their plan

Almost all the employers sponsored 401(k) plans, but there were some that sponsored profit-sharing, money purchase pension, defined benefit and SIMPLE IRA plans. Regardless of whether they were foreign or not, the employers we contacted understood and complied with the requirements to maintain a domestic trust.

The plan sponsors required to file Form 5500, *Annual Report/Return of Employee Benefit Plan*, had timely and accurately filed their returns. We referred the small percentage of cases that appeared noncompliant to Employee Plans Examinations.

Overview of domestic trust rules

A trust is a domestic trust if:

- a U.S. court can exercise primary supervision over administration of the trust, and
- one or more U.S. persons have authority to control all of the trust's substantial decisions.

Plan requirements

In order to be an Internal Revenue Code section 401(a) qualified plan, a stock bonus, pension or other profit-sharing plan's trust must be a domestic trust.

Contact the EPCU

You will soon find the summary report of this project and more information about the work we do on the EPCU Web page. Email us your questions about this project and please include the words "Domestic Trust" in the subject line.

We're Glad You Asked! #1

Will I have to pay the 10% additional tax on early distributions if I am 47 years old and ordered by a divorce court to take money out of my traditional IRA to pay my former spouse?

Yes. Unless you qualify for an exception, you must still pay the 10% additional tax for taking an early distribution from your traditional IRA even if you take it to satisfy a divorce court order (see Internal Revenue Code section 72(t)). The 10% additional tax is charged on the early distribution amount you must include in your income and is in addition to any regular income tax from including this amount in income.

Unlike distributions made to a former spouse from a qualified retirement plan under a Qualified Domestic Relations Order, there is no "divorce" exception to the 10% additional tax on early distributions from IRAs.

The only divorce-related exception for IRAs is if you:

- transfer your interest in the IRA to a spouse or former spouse, and
- the transfer is under a divorce or separation instrument (see IRC section 408(d)(6)).

However, the transfer must be done by:

- changing the name on the IRA from your name to that of your former spouse (if transferring your entire interest in that IRA), or
- a trustee-to-trustee transfer from your IRA to one established by your former spouse. **Note**: an indirect rollover doesn't qualify as a transfer to your former spouse even if the distributed amount is deposited into your former spouse's IRA within 60-days.

Additional Resources:

- Retirement Topics - Divorce
- Publication 504, *Divorced or Separated Individuals*
- Publication 575, *Pension and Annuity Income*
- Publication 590, *Individual Retirement Arrangements (IRAs)*

We're Glad You Asked! #2

We have a 401(k) plan and some employees' compensation will exceed the annual compensation limit this year. Should we stop their salary deferrals when their compensation reaches the annual compensation limit? How do we calculate the employee's matching contribution?

Unless your plan terms provide otherwise, the salary (elective) deferral limit is applied uniformly to the compensation that the employee receives **throughout** the year.

Compensation and contribution limits are subject to annual cost-of-living adjustments. The 2012 annual limits are:

- salary deferrals - $17,000, plus $5,500 catch-up contributions if the employee is age 50 or older (IRC sections 402(g) and 414(v))
- annual compensation - $250,000 (IRC section 401(a)(17))
- total employee and employer contributions plus forfeitures - the lesser of 100% of an employee's compensation or $50,000, plus $5,500 catch-up contributions if age 50 or older (IRC section 415(c))

Example: Mary, age 49, whose annual compensation is $300,000 ($25,000 per month), elects to defer $1,417 per calendar month, up to $17,000 for the year. Mary may contribute to the plan until she reaches her annual deferral limit of $17,000 even though her compensation will exceed the annual limit of $250,000 in November.

Employer matching contributions

If your plan provides for matching contributions, you must follow the plan's match formula.

Example: Your plan requires a match of 50% on salary deferrals that do not exceed 5% of compensation. Although Mary earned $300,000, your plan can only use up to $250,000 of her compensation when applying the matching formula. Mary's matching contribution would be $6,250 (50% x (5% x $250,000)). Although Mary makes salary deferrals of $17,000, only $12,500 (5% of $250,000) will be matched. She must receive a matching contribution of $6,250 (50% x $12,500).

What does your plan say?

Although not common, a plan can specifically require that salary deferrals cease once a participant's compensation reaches the annual limit.

If your plan specifies that salary deferrals be based on a participant's **first** $250,000 compensation, then you must stop allowing Mary to make salary deferrals when her year-to-date compensation reaches $250,000, even though she hasn't reached the annual $17,000 limit on salary deferrals, and must base the employer match on her actual deferrals.

Additional Resources:

- Retirement Topics – Contributions
- FAQs: Contributions
- Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans*)

Tax Consequences of Plan Disqualification

When an Internal Revenue Code section 401(a) retirement plan is disqualified, the plan's trust loses its tax-exempt status and becomes a nonexempt trust. Plan disqualification affects three groups:

1. Employees
2. Employer
3. The plan's trust

Example: Pat is a participant in the XYZ Profit-Sharing Plan. The plan has immediate vesting of all employer contributions. In calendar year 1, the employer makes a $3,000 contribution to the trust under the plan for Pat's benefit. In calendar year 2, the employer contributes $4,000 to the trust for Pat's benefit. In calendar year 2, the IRS disqualifies the plan retroactively to the beginning of calendar year 1.

Consequence 1: General Rule - Employees Include Contributions in Gross Income

Generally, an employee would include in income any employer contributions made to the trust for his or her benefit in the calendar years the plan is disqualified to the extent the employee is vested in those contributions.

In our example, Pat would have to include $3,000 in her income in calendar year 1 and $4,000 in her income in calendar year 2 to reflect the employer contributions paid to the trust for her benefit in each of those calendar years. If Pat was only 20% vested in her employer contributions in calendar year 1, then she would only include $600 in her calendar year 1 income.

Exceptions: There are exceptions to the general rule (see IRC section 402(b)(4)):

- **If one of the reasons** the plan is disqualified is for failure to meet either the additional participation or minimum coverage requirements (see IRC sections 401(a)(26) and 410(b)) and Pat is a highly compensated employee (see IRC section 414(q)), then Pat would include all of her vested account balance (any amount that wasn't already taxed) in her income. A non-highly compensated employee would only include employer contributions made to his or her account in the years that the plan is not qualified to the extent the employee is vested in those contributions.

- **If the sole reason** the plan is disqualified is that it fails either the additional participation or minimum coverage requirements, and Pat is a highly compensated employee, then Pat still would include any previously untaxed amount of her entire vested account balance in her income. Non-highly compensated employees, however, don't include in income any employer contributions made to their accounts in the disqualified years in that case until the amounts are paid to them.

Note: Any failure to satisfy the nondiscrimination requirements (see IRC section 401(a)(4)) is considered a failure to meet the minimum coverage requirements.

Consequence 2: Employer Deductions are Limited

Once the plan is disqualified, different rules apply to the timing and amount of the employer's deduction for amounts it contributes to the trust. Unlike the rules for contributions to a trust under a qualified plan, if an employer contributes to a nonexempt employees' trust, it cannot deduct the contribution until the contribution is includible in the employee's gross income.

- If both the employer and employee are calendar year taxpayers, the employer's deduction is delayed until the calendar year in which the contribution amount is includible in the employee's gross income.

- If the employer has a different taxable year than the employee (a non-calendar fiscal year), the employer cannot take a deduction for its contribution until its first taxable year that ends after the last day of the employee's taxable year in which the amount is includible in the employee's income.

For example, if the employer's taxable year ends September 30 and a contribution amount is includible in an employee's gross income for the employee's taxable year that ends on December 31 of year 1, the employer cannot take a deduction for its contribution until its taxable year that ends on September 30 of year 2.

Also, the amount of the employer's deduction is limited to the amount of the contribution that is includible in the employee's income and whether a deduction is allowed depends on whether the contribution amount is otherwise deductible by the employer. Finally, if the plan covers more than one employee and it does not maintain separate accounts for each employee (as may be the case with a defined benefit plan), then the employer is not able to deduct any contributions.

In our example, assuming both the employer and Pat are calendar year taxpayers, the employer's $3,000 deduction in calendar year 1 and $4,000 in calendar year 2 would be unchanged because that is when Pat would include these amounts in her income. However, if Pat were only 20% vested, then the employer would only be able to deduct $600 in calendar year 1 (the vested part of her employer contribution) which is the amount Pat would include in her calendar year 1 income.

Consequence 3: Plan Trust Owes Income Taxes on the Trust Earnings

The XYZ Profit-Sharing plan's tax-exempt trust is a separate legal entity. When a retirement plan is disqualified, the plan's trust loses its tax-exempt status and must file Form 1041, *U.S. Income Tax Return for Estates and Trusts* (instructions), and pay income tax on trust earnings.

Revenue Ruling 74-299 as amplified by Revenue Ruling 2007-48 provides guidance on the taxation of a nonexempt trust.

Consequence 4: Rollovers are Disallowed

A distribution from a plan that has been disqualified is not an eligible rollover distribution and can't be rolled over to either another eligible retirement plan or to an IRA rollover account. When a disqualified plan distributes benefits, they are subject to taxation.

Consequence 5: Contributions Subject to Social Security, Medicare and Federal Unemployment (FUTA) Taxes

When an employer contributes to a nonexempt employees' trust on behalf of an employee, the FICA and FUTA taxation of these contributions depends on whether the employee's interest in the contribution is vested at the time of contribution. If the contribution is vested at the time it is made, then the amount of the contribution is subject to FICA and FUTA taxes at the time of contribution. The employer is liable for the payment of FICA and FUTA taxes on them. If the contribution is not vested at the time it is made, then the amount of the contribution and its earnings are subject to FICA and FUTA taxation at the time of vesting. For contributions and their earnings that become vested after the date of contribution, the nonexempt employees' trust is considered the employer under IRC section 3401(d)(1) who is responsible for withholding from contributions as they become vested.

Calculating Specific Plan Disqualification Consequences

Calculating the tax consequences of plan disqualification depends on the type of retirement plan. For example, the tax consequences for a 401(k) plan differ from the consequences for a SEP or SIMPLE IRA plan.

How to Regain Your Plan's Tax-Exempt Status

Generally, if a plan loses its tax-exempt status, the error that caused it to become disqualified must be corrected before the IRS will re-qualify the plan. You may correct plan errors through the IRS Voluntary Correction Program. However, if your plan is under examination by the IRS, you must correct the errors through the Audit Closing Agreement Program.

Note: This is a general overview of what happens when a plan becomes disqualified for failure to meet qualification requirements (see IRC section 401(a)). These examples provide general information and you should not rely on them as legal authority as they do not apply to every situation. For more information, see Rev. Rul. 74-299 and Rev. Rul. 2007-48 (and the law and regulations discussed in those rulings).

Can I amend or terminate my SIMPLE IRA plan in the middle of the year?

No. You can't amend or terminate your SIMPLE IRA plan mid-year. A SIMPLE IRA plan must be operated for the entire calendar year (or the remainder of the calendar year if started after January 1). Additionally, once you have given employees the annual notice describing the plan features for the coming year, you can't change any of those features during the year.

Example 1: On January 30, 2012, Acme Company decided it would like to change its SIMPLE IRA plan matching contributions from 3% to 1%. Acme's SIMPLE IRA plan notice to employees (given on November 2, 2011) stated that the match would be 3% for 2012. Acme must contribute 3% for 2012. The earliest effective date for Acme's change in matching contributions would be January 1, 2013. Acme must notify its employees during 2012 that it will reduce the matching contribution to 1% in 2013.

Example 2: The Bear Company's SIMPLE IRA plan contributions are deposited at a designated financial institution, as described in its Form 5305-SIMPLE document. On February 5, 2012, Bear Company decided it would like to change its SIMPLE IRA plan document to a Form 5304-SIMPLE so that plan contributions would no longer be sent to the designated financial institution but would be sent to SIMPLE IRAs at other financial institutions selected by plan participants. This change is an amendment to the Bear Company's SIMPLE IRA plan and can't be made mid-year. The earliest that this amendment can be effective is January 1, 2013.

To amend the plan, Bear Company should:

- complete and sign Form 5304-SIMPLE;
- indicate in Section VII of the form that the effective date will be January 1, 2013; and
- notify the employees by November 2, 2012, that they will need to select a financial institution to serve as the trustee, custodian, or issuer of their SIMPLE IRA.

Terminating a SIMPLE IRA Plan

If your SIMPLE IRA plan no longer fits your business needs and you'd like to terminate it, notify the SIMPLE IRA plan financial institution that you won't be contributing the next calendar year. You must also notify your employees by November 2 that you will discontinue the SIMPLE IRA plan effective the first day of the next calendar year. You don't need to notify the IRS that you have terminated the SIMPLE IRA plan.

Example 3: Acme Company decided on November 18, 2011, to terminate its SIMPLE IRA plan as soon as possible. The earliest effective date for the termination would be January 1, 2013. Acme must notify its employees during 2012 that it won't sponsor a SIMPLE IRA plan for 2013.

Additional Resources:

- FAQs: SIMPLE IRA Plans
- Terminating a SIMPLE IRA Plan
- Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*
- Publication 4334, *SIMPLE IRA Plans for Small Businesses*

PBGC Insights

Premium penalty relief - A new PBGC policy statement, published on February 9, 2012, allows pension plans that have never paid required PBGC premiums to do so without penalty for a limited period. After this time period ends, PBGC will step up enforcement efforts against such plans and resume penalty charges. This is an outgrowth of PBGC's ongoing review of its regulations consistent with Executive Order 13563.

Premium filing amendments - On December 22, 2011, PBGC published a policy statement that applies to certain amended premium filings.

Premium e-filing reminders

- Plan Year 2012: You can access premium filing due dates, addresses, illustrative forms and detailed instructions for plan years beginning in 2012, on the Premium Instructions and Addresses page of our website.

- E-Filing Options: You can use My PAA to create, sign and submit your filing or use private-sector software to create your filing and then import or upload it to the PBGC. Import means to transfer the filing data into the My PAA editing screens for updating, signing and submission. Upload means to submit an xml file, containing one or more fully completed filings, to the PBGC "as is" (the file is not opened in My PAA). Only screen-prepared filings and imported filings are validated in My PAA and provided a detailed receipt that reflects the filing data submitted.

- Payments: You may pay premiums through MyPAA or outside of My PAA. To pay them through My PAA, enter your ACH or electronic check information on the My PAA payment screen. PBGC then pulls the funds from your account. For outside of My PAA, select your payment method and initiate the payment by sending a check or requesting your bank to send an electronic funds transfer to the PBGC.

- Submissions: To complete the e-filing process, click the "submit" button and verify you have received confirmation of the date/time that PBGC received your filing/file.

- E-Filing Questions: Click the Instruction links on the My PAA screens and review the information on the Online Premium Filing with My PAA page of our website. For premium staff assistance, send an email to premiums@pbgc.gov or call (800) 736-2444 and select the "premium" option.

ERISA section 4010 filing - The ERISA section 4010 filing due date for the 2011 information year is April 16, 2012. The plan's contributing sponsor and each member of the sponsor's controlled group must make a 4010 filing if any of the following conditions are met (assuming no waivers or exemptions apply):

1. Any plan maintained by a member of the controlled group has a funding target attainment percentage of less than 80%;

2. Any member of the controlled group fails to make a required payment to a plan and, as a result, conditions for an IRC section 430(k) lien have been met and required payment is not made within 10 days after its due date;

3. Any plan maintained by a member of the controlled group has been granted one or more minimum funding waivers under IRC section 412(c) totaling in excess of $1 million and any portion of those waivers is still outstanding.

See 4010 Reporting for more information.