Chapter 9

Verifying 404 Deductions for Defined Contribution Plans

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INTERNAL REVENUE SERVICE

TAX EXEMPT AND GOVERNMENT ENTITIES

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Overview

Introduction
On the surface, verifying defined contribution plan section 404 deductions would appear to be relatively simple. However, the law becomes a bit confusing when you consider the numerous Treasury Regulations, Revenue Rulings and Code sections that need to be considered when determining whether the employer’s contribution is deductible under section 404. This chapter will clarify some of that confusion in many common areas as well as reinforce the basic section 404 deductibility rules.

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

- Determine if contributions were made timely for purposes of section 404(a)(6) (deductibility);
- Determine the effect of section 404(a)(6) to section 401(k) and (m) plans;
- Determine the deduction limits under IRC section 404(a)(3) using pre-EGTRRA and EGTRRA law;
- Calculate earned income for self-employment purposes;
- Determine the effect nondeductible contributions have on the employer’s tax return and on related Forms 5330.
IRC Section 404(a)(6)

IRC section 404(a)(6) states:

"Time when contributions deemed made. For purposes of paragraphs (1), (2) and (3), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)."

The paragraphs in the above clause represent the following types of plans:

a. Pension trusts
b. Employees’ annuities
c. Stock bonus and profit-sharing plans

Defined Contribution Plans are addressed in subparagraph (3) - (IRC 404(a)(3)).

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The Service determined in Revenue Ruling 76-28 that in order for contribution payments made after the close of the tax year to be deductible on the prior year’s return, the plan must treat the payments as made for the prior tax year and the employer must either:

- Designate in writing to the plan administrator or trustee that the payment is applicable to the prior tax year, or
- Deduct the payment on the prior year’s tax return.

In the context of this ruling the word “treat” is synonymous with allocate. Thus, a plan must allocate the contribution as if it were received during the prior tax year. This decision is consistent with TR 1.415-6(b)(7)(ii) which provides that an employer contribution can be treated as an annual addition for a prior plan year if the contribution was paid to the trust no later than 30 days after the IRC 404(a)(6) period expires.

Accordingly, if an employer pays the contribution by the due date for filing his annual tax return and the plan allocates the contribution during the prior tax year and the employer deducts the contribution on the prior year’s tax return, the contribution is deductible.

Theoretically, an employer may determine the amount of any discretionary contributions up to the last day of the IRC 404(a)(6) period. There is no IRS requirement that an employer adopt an amendment or Board of Directors resolution prior to the end of the tax year to establish a liability.

This does not mean that the Employer must allocate a contribution made within the IRC 404(a)(6) period to a prior year nor does it mean that it must deduct a contribution allocated to a prior year on a prior years tax return. The next two examples in this chapter should clarify this concept.

Continued on next page
Example 1 - Tax Year Later Than Plan Year

**FACTS:**
- The Plan Year is 12-31-01
- The Tax Year is 6-30-02.
- The Employer’s Form 1120 is on extension to 3-15-03.
- On 4-1-03 the employer made a $150,000 contribution and allocated the entire contribution to the PYE 12-31-01 (the employer relied on T.R 1.415-6(b)(7)(ii) to make the allocation).

**CONCLUSION:**

The contribution can’t be deducted on the FYE 6-30-02 return since it was paid after the due date for filing the return. It must be deducted on the FYE 6-30-03 return.

Example 2 - Tax Year Later Than Plan Year

**FACTS:**
The facts are the same as the example above except that the contribution was made on 3-15-03.

**CONCLUSION:**

The employer now has an option regarding on which return (FYE 6-30-02 or FYE 6-30-03) to claim the $150,000 deduction.

The employer has a choice because the contribution was contributed within the 404(a)(6) period and was allocated to the 12-31-01 year under T.R 1.415-6(b)(7)(ii). Therefore, it may be deducted on the FYE 6-30-02 return. However, since it was paid during the FYE 6-30-03 the Employer may choose to deduct the contribution on that return.

Of course, whether the amount is actually deductible on any particular year’s return is contingent on the deductible limits under section 404(a)(3).

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IRC Section 404(a)(6), Continued

Suspense Accounts

All employer contributions made during a plan year must be allocated to the extent IRC 415 is not violated. This is true regardless of whether the contribution is deductible. Except in limited circumstances such as a mistake of fact regarding a participant’s compensation, the employer may not refund the nondeductible portion. To do so may be considered an exclusive benefit violation. Furthermore, nondeductible amounts may not be placed in a suspense account since suspense accounts in a DC plan are only allowed for the following reasons: (See Revenue Ruling 80-155)

- To hold unallocated stock in a leveraged ESOP.
- To hold contributions or forfeitures that cannot be allocated due to IRC section 415 limits.

Therefore, an employer cannot maintain a suspense account for either IRC section 404 or IRC section 412 purposes. If a suspense account is maintained for either of these reasons, the terms of the plan have not been followed. Depending on various factors, such as the dollar amount involved, the number of years involved, and the reason why the error occurred (to avail excess monies protection from creditors vs. a mistake of fact), disqualification or the Closing Agreement Program (CAP) may be warranted.
401(k) and (m) Plans

Question

Would the conclusions reached in Examples 1 and 2 be different if the contribution payments were related to salary deferrals and matching contributions? What if the salary that the deferrals and matching contributions related to were paid after the tax year but within the plan year? To answer these questions the Service issued Revenue Ruling 90-105, Revenue. Ruling 2002-46, and Notice 2002-48.

The common principle in the rulings and notice is that (k) and (m) deferrals attributable to compensation paid after the close of the tax year may not be deducted on a prior years tax return. However, if the contribution was actually paid during the tax year as a prepaid contribution then the amounts are deductible subject to the section 404(a)(3) limits.

Revenue Ruling 90-105

The issue addressed in this ruling relates to contribution payments deducted by the employer on his FYE 6-30-89 return. The payments at issue consisted of elective deferrals and matching contributions attributable to compensation earned by plan participants after the end of the employer’s fiscal tax year but prior to the end of the 12-31-89 plan year.

Stated another way, the employer deducted all the contributions, both salary deferrals and matching contributions made during the 1989 calendar year (the plan year) on the FYE 6-30-89 tax return. Approximately one half of those payments were made during the subsequent tax year, the period from 7-1-89 to 12-31-89. Even though the payments were made within the IRC 404(a)(6) period (the employer’s return was on extension to 3-15-90) the Service found that the contributions were not deductible since the compensation that the contributions were based on was not paid during the tax year.

In order for IRC 404(a)(6) to apply, the contribution would have had to be considered a deductible contribution in the prior year if it had been paid during the prior year. IRC 404(a)(6) does not make nondeductible contributions deductible, it only deems that the contributions were paid during a prior year if certain conditions are met.

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Ordinary and Necessary

One condition is that the contributions be considered ordinary and necessary under IRC 162 or 212. The analysis showed that the contributions could not have been ordinary and necessary in the 6-30-89 tax year since the underlying compensation was not earned until after the tax year was over.

Allocated During Plan Year

Furthermore, Revenue Ruling 76-28 would prohibit the deduction on the 6-30-89 tax year since it requires that the contribution be treated (allocated) as if it was received during the 6-30-89 tax year. Once again, this requirement could not possibly be met. Even if the contribution was actually paid on 6-30-89, it could not have been allocated since the employer did not know how much each participant would earn or defer. By the same token, the matching contribution was also unknown and therefore unallocable as of 6-30-89.

IRC Section 461

The analysis also provides that IRC section 461 would further preclude an accrual based taxpayer from claiming the deduction because all of the events that would fix the liability, namely the payment of salary to which the contributions related to, did not occur by the end of the tax year. (This scenario differs from Examples #1 & #2 above in that all the events (payment of salary directly related to the contributions made) were fixed by the end of the tax year).

Accelerated 404(k) and (m) Deductions

The issue in Rev Rul 2002-46 is almost identical to the issue raised in Revenue Ruling 90-105 except the employer amended the plan to provide that a Board of Directors resolution would be adopted to set a minimum contribution for a plan year. The plan amendment provided that the minimum contribution would be allocated first toward elective deferrals and matching contributions, with any excess allocated to participants as of the end of the plan year in proportion to the compensation they earned during the plan year.

Continued on next page
Revenue Ruling 2002-46

The fact pattern in Rev. Rul. 2002-46 is as follows: The employer’s tax year is 7-01-00 through 6-30-01. The applicable plan year begins 1-1-01 and ends 12-31-01. On June 15, 2001 (within both the tax year and the plan year), the Board of Director’s adopted a resolution setting a minimum contribution of $8,000,000. By the end of the plan year (12-31-01), the entire $8,000,000 had been paid into the trust and allocated in accordance with the terms of the plan. $3,200,000 of the total $8,000,000 contribution was attributable to salary earned from 1-1-01 through 6-30-01 (during the tax year). The other $4,200,000 was related to salary paid from 7-1-01 to 12-31-01 (after the tax year). Rev Rul. 2002-46 provides that since the contributions were attributable to compensation earned by plan participants after the 6-30-01 tax year end they were not deductible in the 6-30-01 tax year.

Revenue Ruling 2002-46 found that the plan amendment and Board of Directors resolution were irrelevant in the context of IRC 404(a)(6). Since the compensation related to the contributions was unknown on 6-30-01, it would have been impossible for the plan to allocate the contributions. For salary deferrals and matching contributions to be allocated, the compensation must be known.

Worth noting is that Rev. Rul. 2002-46 found that the analysis made by the Service in Rev. Rul. 90-105 with respect to the contribution being ordinary and necessary as provided in T.R 1.404(a)-1(b) was erroneous. Rev. Rul 2002-46 provides that the language contained in 1.404(a)-1(b) is only relevant when determining if the contribution, when taken with all other compensation paid to the participant, is reasonable.
401(k) and (m) Plans, Continued

Notice 2002-48

Notice 2002-48 provides two variations on the fact pattern described in Revenue Ruling 90-105, neither of which involves application of the IRC 404(a)(6) grace period.

In the first scenario the employer makes a contribution to the plan prior to the end of the tax year. The contribution is intended to include salary deferrals and matching contributions that the employer anticipates will be made after the tax year end but before the end of the plan year.

The second scenario also involves a prepaid contribution and is combined with a guaranteed minimum payment as described in Revenue Ruling 2002-46.

Notice 2002-48 provides that “the Service will not challenge the deductibility of contributions described in this notice, provided actual payment is made during the taxable year and the amount deducted does not exceed the applicable limitation under IRC 404(a)(3)”.

In this case the Service has allowed the employer to deduct anticipated salary deferrals and matching contributions for the period following the end of the tax year but prior to the end of the plan year, because the employer contributed the estimated monies before the end of the tax year. These monies did not exceed the IRC 404(a)(3) limit calculated for the tax year.
IRC Section 404(a)(3)

Section 404(a)(3) provides the deductible limits for profit-sharing plans as well as stock bonus plans. For Pre-EGTRRA years (tax years beginning before January 1, 2002) the limitation was 15% of beneficiaries’ (plan participant) compensation. For tax years beginning on or after January 1, 2002, the limitation is 25% of beneficiaries’ (plan participant) compensation and applies to all defined contribution plans, including money purchase plans.

Prior to EGTRRA, IRC 404(a)(3) did not apply to money purchase plans. EGTRRA modified section 404(a)(3)(A)(v) to provide that a money purchase plan is treated in the same manner as a stock bonus or profit-sharing plans. Thus, under EGTRRA, the limit for any or all defined contribution plans is 25%. Not only did EGTRRA increase the limit from 15% to 25%, 401(k) deferrals are no longer to be considered part of the Employer Contribution when calculating the 25% limit per section 404(a)(12).

Due to the changes brought about by EGTRRA, very generous deduction limits are in place. One result of the increased limit will likely be a decline in the number of employers sponsoring money purchase plans. This is because the advantage of having a money purchase plan with a higher deductible limit (25% vs. 15%) is no longer present and the risk associated with money purchase plans (possible funding problems and associated penalties) can be great. Another result will be that very few employers will violate the deduction limits since few will be willing or able to make such a large contribution.

The next portion of this module will focus on the determination of the limitations under IRC 404(a)(3) when the plan year and tax year do not coincide. We will also cover the definition of compensation under IRC 404(a)(3).
IRC Section 404(a)(3), Continued

<table>
<thead>
<tr>
<th>Taxable Year Compensation is Utilized</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 404(a)(3)(A)(i)(I) states that the deduction limitation is:</td>
</tr>
</tbody>
</table>

"25 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the stock bonus or profit-sharing plan."

The important term to note in this section is “paid or accrued during the taxable year to the beneficiaries”. This means compensation used to calculate the limit is the compensation paid during the tax year, not the plan year.

<table>
<thead>
<tr>
<th>Accrual vs. Cash Deductions</th>
</tr>
</thead>
</table>
| As long as the contribution is paid by the due date for filing the employer’s taxable return, and the contribution is allocated during the plan year, the employer may consider the contribution paid by the end of the plan year. This holds true for both cash and accrual taxpayers.

<table>
<thead>
<tr>
<th>Revenue Ruling 65-295 and Includible Comp.</th>
</tr>
</thead>
</table>
| Only the compensation of employees who benefit under the plan should be included in this calculation. Participant compensation used to calculate the IRC 404(a)(3) limit must be limited to the IRC 401(a)(17) compensation limit in effect at the beginning of the taxable year for which the deduction limit is computed.

In Revenue Ruling 65-295, the Service reasoned that terminated employees that do not share in the contribution allocation because the terms of the plan require employment on the last day of the plan year are not beneficiaries since they did not benefit during the tax year. Thus, the compensation paid to such terminating employees in such taxable year may not be included in the total compensation paid or accrued during the taxable year for the purpose of determining the limitation on deductions provided in section 404(a)(3)(A).

The rational is that in order to be a beneficiary, the participant must receive an employer allocation. If the participant does not receive an allocation this means the participant is not a beneficiary and therefore his compensation may not be considered for IRC 404(a)(3) purposes.

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IRC Section 404(a)(3), Continued

Example 1 - Includible Comp.

Facts:

- The PYE 12-31-02 is under audit. The plan year and the tax year coincide.
- The plan is not top heavy.
- In order for a participant to receive a profit sharing allocation the participant must work 1,000 hours and be employed on the last day of the plan year.

Determine what compensation should be considered in the IRC 404(a)(3) computation.

Table to analyze Example 1

<table>
<thead>
<tr>
<th>PARTICIPANT</th>
<th>DATE OF TERMINATION</th>
<th>HOURS OF SERVICE</th>
<th>COMPENSATION</th>
<th>CONSIDER?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>6-23-02</td>
<td>1,200</td>
<td>$25,000</td>
<td>NO</td>
</tr>
<tr>
<td>B</td>
<td>N/A</td>
<td>750</td>
<td>$20,000</td>
<td>NO</td>
</tr>
<tr>
<td>C</td>
<td>N/A</td>
<td>2,000</td>
<td>$45,000</td>
<td>YES</td>
</tr>
<tr>
<td>D</td>
<td>N/A</td>
<td>865</td>
<td>$26,000</td>
<td>NO</td>
</tr>
<tr>
<td>E</td>
<td>N/A</td>
<td>2,000</td>
<td>$120,000</td>
<td>YES</td>
</tr>
<tr>
<td>F</td>
<td>N/A</td>
<td>2,000</td>
<td>$150,000</td>
<td>YES</td>
</tr>
</tbody>
</table>

Since participants A, B and D were not entitled to share in the allocation because they did not have enough hours or they were not employed at year end, their compensation should not be included.

Example 2 - Includible Comp.

The facts are the same as in the preceding example but the plan is top heavy. The compensation of participants B and D should now be included in the IRC 404(a)(3) computation since they would have been entitled to a top-heavy minimum contribution.

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IRC Section 404(a)(12), Continued

Section 404(a)(12) was added by EGTRRA and states:

"For purposes of paragraphs (3), (7), (8), and (9) and subsection (h)(1)(C), the term “compensation” shall include amounts treated as “participant’s compensation” under subparagraph (C) or (D) of section 415(c)(3)."

This means that any elective deferrals whether from a 401(k) plan, a SIMPLE-IRA, a SARSEP, a section 125-cafeteria plan, or transportation fringes under 132(f) are considered part of total compensation.

Caution Regarding Comp. Amount

Compensation used to calculate the deductible limit is not necessarily compensation used for allocation purposes. The differences are primarily due to two reasons:

- The definition for allocation purposes does not always include all compensation. For example, for allocation purposes the plan might exclude compensation during the plan year when the employee was not a participant, such as in the case of a participant who enters the plan in the middle of the year. Another example would be when the definition of compensation for allocation purposes excludes certain types of compensation such as bonuses and overtime.
- The plan year and the tax year differ.

Continued on next page
IRC Section 404(a)(3), Continued

Example 3 -
Plan Year and
Tax Year are
Different

FACTS:

- The plan is a profit sharing plan.
- The plan year end is 12-31-01
- The tax year end is 9-30-02
- Participants A, B and C became participants on January 1, 2002.
- The plan requires a participant to complete 1,000 HOS and be employed on the last day of the plan year to receive a contribution allocation.

CONCLUSION:

The compensation of participants A, B and C would not be included in computing the 404(a)(3) limit for the tax year end 9-30-02 since they did not receive an allocation for that tax year.

Only the compensation of participants that received a contribution allocation for the plan year end 12-31-01 may be considered since they would be the only employees benefiting during the 9-30-02 tax year.

Assuming participants A, B and C are still employed on 12-31-02 and had more than 1,000 hours of service they would receive an allocation on 12-31-02. Since this date falls in the 9-30-03 tax year, they can’t be considered benefiting during the tax year end 9-30-02. They would be considered benefiting for the tax year end 9-30-03. This is true even if they terminated employment on January 1, 2003.

Continued on next page
Example 4 - Plan Year and Tax Year are Different-facts

FACTS:

- The plan year end is 12-31-02.
- The tax year end is 03-31-03.
- The Plan requires a participant to have 1,000 HOS and to be employed on the last day of the plan year to receive an allocation of the employer’s profit sharing contribution. Furthermore, only compensation for the portion of the plan year that the participant was an active participant is considered for allocation purposes (if a participant enters the plan on 7-1, only the compensation earned from 7-1 to 12-31 is considered for allocation purposes).
- The plan had three participants. Participants A and B earned $150,000 and $75,000, respectively. Both had been participants for several years. Participant C earned $50,000 ratably over the 2002 plan year. He entered the plan on 7-1-02.
- A discretionary contribution of $20,000 was made and allocated for 2002.
- The contribution allocation for Participant C is as follows: He received a contribution allocation of $2,000 ($25,000/$250,000 (150 + 75 + 25) * $20,000). Note, only $25,000 of C’s $50,000 of compensation was considered for allocation purposes.
- The percentage for IRC 404(a)(3) purposes is 8% ($20,000 / $275,000 (150 + 75 + 50)), which is well under the 25% IRC 404(a)(3) limit. Note that the full amount of C’s $50,000 of compensation is used for deduction purposes.

Example 4, conclusion

For purposes of determining eligible compensation for the tax year end 3-31-03, we must look to see who was benefiting. Since the plan requires that a participant be employed on the last day of the plan year to receive an allocation it would stand to reason that only participants that were employed on 12-31-02 need to be considered. 12-31-02 is the only day during the tax year end 3-31-02 (4-1-02 to 3-31-02) that a participant would have "benefited". If he was not employed on that day, he would not receive an allocation thus he would not be benefiting at any time during the tax year.

Furthermore, with respect to the Participant that entered the plan on 7-1-02 his entire $50,000 is considered for IRC 404(a)(3) purposes. (T.R. 1.404(a)-9(b)(1))
Who is Benefiting under the Plan?

Since the IRC 404 regulations do not define who is “benefiting”, the IRC 410 regulations governing coverage and how to determine which participant is considered benefiting should be used to make this determination. In general, in order to be considered benefiting an employee must share in the employer contribution. This would include Participants that received only a top heavy minimum allocation under 416 and those that only received a forfeiture allocation (if it was allocated in the same manner as contributions).

With a 401(k) plan, participants only have to be eligible to defer to be considered benefiting. Therefore participants who are eligible to make salary deferrals during the tax year (whether or not deferrals are actually made) are considered to be benefiting and their compensation is included in determining the limits under IRC 404(a)(3). See T.R. 1.410(b)-3(a)(2).

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IRC Section 404(a)(3), Continued

T.R. 1.404(a)-9(a)  Although section 404(a)(3) addresses deductible limits, T.R. 1.404(a)-9(a) expands on section 404(a)(3) and provides:

"If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see section 1.404(a)-1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under the first, second, or third sentence of section 404(a)(3)(A), the contributions must be paid (or deemed to have been paid under section 404(a)(6)) in the taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a)."

In addition to the percentage limitation under IRC 404(a)(3), T.R. 1.404(a)-9 provides two additional requirements that must be satisfied in order for the contribution to be deductible:

• The requirements under 1.404(a)-1 must be met, and;
• The contributions must be paid in a taxable year of the employer, which ends with or within a taxable year of the trust for which it is exempt under section 501(a).

Caution With Respect to the Term “With or Within a Taxable Year of the Trust”

Often times this language is interpreted to mean that in order for a contribution to be deductible for a particular tax year, the contribution must be allocated to the plan year in which the tax year ends. However, this is not the case. The language does not address the timing of the allocation, it simply says that in order for the contribution to be deductible it must be paid during a trust year that is exempt from tax (in other words, the plan must be qualified). Thus, the tax year that the contribution was paid in does not have to end in or with the plan year for which the contribution was allocated.
IRC Section 415

The allowable deduction under IRC 404 is reduced by any annual additions in excess of the section 415 limits. Section 404(j)(1)(B) provides that, "in the case of a defined contribution plan, the amount of any contributions otherwise taken into account shall be reduced by any annual additions in excess of the limitation under section 415 for such year."

However, T.R 1.415-6(b)(6) provides,

“If, as a result of the allocation of forfeitures, a reasonable error in estimating a participant’s annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of section 402(g)(3)) that may be made with respect to any individual under the limits of section 415, or under other limited facts and circumstances that the Commissioner finds justify the availability of the rules set forth in this paragraph (b)(6), the annual additions under the terms of a plan for a particular participant would cause the limitations of section 415 applicable to that participant for the limitation year to be exceeded, the excess amounts shall not be deemed annual additions in that limitation year if they are treated in accordance with any one of the following:"

What follows in this regulation is the four methods that may be used to correct allocations in excess of the IRC 415 limits. These four methods are not the only methods that an employer may use to correct IRC 415 violations but they are the only methods that will deem an excess not to have occurred. Therefore, if the employer uses a correction method other than what is listed in T. R 1.515-6(b)(6)(i)-(iv), the IRC 404 limit must be reduced since an IRC 415 excess occurred.

Another important point to note is that in order for an employer to use one of the four correction methods noted in the regulation, excess IRC 415 allocations must have been a result of a reasonable error. Thus, an employer cannot intentionally make contributions in excess of the IRC 415 limits in order to accelerate the contribution deduction or shelter the money from creditors since the cause of the excess was not due to a reasonable error.

The following examples will illustrate the IRC 415 concepts discussed above.
Example 1
The plan and the employer both have a calendar year end. The year under audit is 2001. The IRC 401(a)(17) compensation limit for 2001 was $170,000. The plan document provides that excess IRC 415 allocations will be corrected in accordance with T.R. 1.415-6(b)(6)(i). The employer made contributions during the 2001 plan year totaling $49,750. The employer deducted $49,750 on his 2001 tax year. The employer provided you with the following schedule.

<table>
<thead>
<tr>
<th>PARTICIPANT</th>
<th>COMPENSATION</th>
<th>ANNUAL ADDITIONS</th>
<th>415 LIMIT</th>
<th>EXCESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$200,000</td>
<td>$16,250</td>
<td>$30,000</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>$150,000</td>
<td>$15,500</td>
<td>$30,000</td>
<td>0</td>
</tr>
<tr>
<td>C</td>
<td>$65,000</td>
<td>$18,000</td>
<td>$16,250</td>
<td>$1,750</td>
</tr>
<tr>
<td>Total</td>
<td>$415,000</td>
<td>$49,750</td>
<td></td>
<td>$1,750</td>
</tr>
</tbody>
</table>

Analysis
You ask the employer to provide documentation showing that the excess IRC 415 allocation was corrected. According to the employer, they forgot to make the required correction. What steps do you take?

- First, you determine that the IRC 404(a)(3) limit is $57,750 (15% * 385,000($170 +150 + 65)).
- Then you determine the allowable deduction under IRC 404 is limited to the amount actually paid, $49,750.
- Finally, you apply IRC 404(j) and reduce the $49,750 by $1,750 (the IRC 415 excess).

Conclusion:
The amount the employer may claim on his return is $48,000. The $1,750 IRC 415 excess was not corrected and therefore cannot be deducted on Form 1120 for 2001.

Continued on next page
Example 2  Now assume that the IRC 415 excess was a result of a reasonable error and the employer made correction in accordance with the plan document. Would the outcome of your audit change?

Yes, the full amount originally deducted by the employer is correct. This is because correction was made in accordance with T.R 1.415-6(b)(6) and the excess was attributable to a reasonable error.

Example 3  Again, the plan and the tax year are the same. The year under audit is 2001. The plan document calls for IRC 415 excesses to be corrected in accordance with T.R 1.415-6(b)(6)(ii). Employer contributions for the 2001 plan year total $72,000, all of which was allocated as reflected on the employer’s IRC 415 test, which is reproduced below. The deduction claimed by the employer on his 2001 tax return was $72,000.

During the examination you discover that the employer failed to correct the excess IRC 415 allocations.
Analysis of participants

<table>
<thead>
<tr>
<th>PARTICIPANT</th>
<th>COMPENSATION</th>
<th>ANNUAL ADDITIONS</th>
<th>415 LIMIT</th>
<th>EXCESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$200,000</td>
<td>$21,000</td>
<td>$30,000</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>$150,000</td>
<td>$21,000</td>
<td>$30,000</td>
<td>0</td>
</tr>
<tr>
<td>C</td>
<td>$65,000</td>
<td>$18,000</td>
<td>$16,250</td>
<td>$1,750</td>
</tr>
<tr>
<td>D</td>
<td>$ 75,000</td>
<td>$12,000</td>
<td>$18,750</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$490,000</td>
<td>$72,000</td>
<td></td>
<td>$1,750</td>
</tr>
</tbody>
</table>

Analysis

You take the following steps:

- First, you determine the IRC 404(a)(3) limit is $69,000 (15% * $460,000 (170 + 150 + 65 + 75)).

- Next, you determine the adjustment required to the employer’s tax return is $3,000 ($72,000 – 69,000). $1,750 of the $3,000 is non-deductible on two counts. It is an IRC 415 excess and it is an IRC 404(a)(3) excess.

Example 4

The facts are the same as Example 3 but the employer corrected the excess allocation in accordance with T.R. 1.415-6(b)(6). Does this change your audit results?

Yes and No.

The amount of the adjustment ($3,000) would not change since the IRC 404(a)(3) limit is exceeded by $3,000.

However, no portion of the amount would be classified as an IRC 415 excess, since correction was made in accordance with T.R. 1.415-(6)(b)(6) and therefore an IRC 415 excess is deemed not to have occurred.
## Audit Guidelines

**Audit Steps**

The table below includes audit steps to determine if the source documents support the contribution deducted by the employer:

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Obtain the allocation schedule or contribution allocation report from the employer and compare to Form 5500. Determine reasons for any differences.</td>
</tr>
</tbody>
</table>
| 2    | Obtain the employer’s federal tax return for the plan year under audit. When the plan year and the tax year are not the same you may need to solicit the employer’s tax returns for the two years that overlap the plan year.  
- Determine the amount of the pension deduction claimed and compare to Form 5500 and allocation schedule, resolving any discrepancies. Employer contributions are not always deducted on line 24 of Form 1120 or on the corresponding lines of Forms 1120S, 1065, or Form 1040 Schedule C, etc. Accounting standards often require an employer to include a portion of its plan contributions in cost of goods sold or to capitalize a portion of this cost. Reconciling contributions to the amounts deducted on the employer’s return becomes more difficult when an employer: (1) maintains more than one deferred compensation plan (whether qualified or nonqualified), (2) picks up the administrative costs of the plan or plans, (3) includes elective deferrals as part of its salary & wages deduction, (4) claims its section 404 deduction strictly on a cash basis, or (5) files a consolidated return.  
- Interviewing the person who prepared the tax return and obtaining a copy of their workpapers is helpful in reconciling the deduction for plan contributions. |
| 3    | Determine the due date for filing the employer’s tax return (including any extensions obtained by the employer). This may be done by IDRS research and/or by obtaining a copy of employer’s extension to file. |
| 4    | Determine the due date(s) for contributions (for purposes of deductibility and, if applicable, minimum funding). |

Continued on next page
### Audit Guidelines, Continued

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
</tr>
</thead>
</table>
| 5    | Verify that contributions were paid to the trust timely.  

- Obtain a contribution schedule from the employer/POA reflecting the dates and amounts of all contributions made for the plan year.  
- The total per the schedule should agree with Form 5500, the allocation schedule and the employer’s tax return.  
- Obtain proof of payment (cancelled checks, wire transfer confirmations, bank and brokerage statements).  
- Compare dates and amounts to what was noted in the contribution schedule. |
| 6    | Determine the contribution limits.  

- If the plan covers self-employed individuals, you will need to calculate earned income before proceeding with step 7.  
- For stock bonus and profit sharing plans go to step 7.  
- For a money purchase plan go to step 8. |
| 7    | IRC section 404(a)(3) provides the deductible limit.  

- The limit is either 15% or 25% of total eligible compensation (remember to limit each participant’s compensation to the IRC 401(a)(17) limit). The percentage depends on whether Pre-EGTRRA or EGTRRA law applies. |
| 8    | For a money purchase plan, IRC section 404(a)(1)(i) provides the deductible limit. This would be the amount necessary to satisfy the minimum funding standards provided by IRC section 412(a). Thus, the plan document for a money purchase plan governs the amount deducted as well as the amount that must be contributed. But in no case may it exceed 25% of compensation for all defined contribution plans.  

Furthermore, in a money purchase plan, the definition of compensation for deduction purposes is compensation used in the contribution formula. |
| 9    | In accordance with IRC section 404(j), the deductible limit as computed in Steps 1-8 above, must be reduced by any annual additions in excess of the IRC 415 limit. |
| 10   | If discrepancies exist, follow the guidelines in the IRC 404 Discrepancies section below. |
CHAPTER 9  VERIFYING 404 DEDUCTIONS FOR DC PLANS

IRC 404 Discrepancies

When discrepancies are found, use the following table for guidance:

<table>
<thead>
<tr>
<th>If contributions paid to the trust are:</th>
<th>Then</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Less than the amount deducted</td>
<td>➢ Adjust the employer’s tax return to eliminate excess deductions</td>
</tr>
<tr>
<td>• Less than the amount required under IRC 412</td>
<td>➢ Assess IRC 4971 excise tax.</td>
</tr>
<tr>
<td>• More than deductible limit</td>
<td>➢ Assess IRC 4972 excise tax and adjust the employer’s tax return.</td>
</tr>
<tr>
<td>• More than the amount allocated</td>
<td>➢ You may have a qualification issue.</td>
</tr>
</tbody>
</table>

IRC 4971
IRC section 4971 provides for a 10% (5% for multiemployer plans) excise tax applicable to plans subject to section 412. The tax is assessed on the amount of the accumulated funding deficiency determined as of the end of the plan year. Excise tax is payable by the employer responsible for contributions and Form 5330 is filed based on the employer’s tax year.

IRC 4972
IRC section 4972 provides for a 10% excise tax on all nondeductible contributions that remain in the trust on the last day of the plan year. IRC section 4972(c)(2) provides that any amounts in the trust that were not deductible in a prior year must be applied toward the current year’s deduction limits before any current year contributions are used.

Exempt Organizations are not subject to the excise tax under section 4972.

Continued on next page
Suspense Accounts

Even though this information regarding suspense accounts has been included previously in this chapter, it is important to note again when considering making a discrepancy adjustment. All employer contributions made during a plan year must be allocated to the extent IRC 415 is not violated. This is true regardless of whether the contribution is deductible. Except in limited circumstances such as a mistake of fact regarding a participant’s compensation, the employer may not refund the nondeductible portion. To do so may be considered an exclusive benefit violation. Furthermore, nondeductible amounts may not be placed in a suspense account since suspense accounts in a DC plan are only allowed for the following reasons:

(See Revenue Ruling 80-155)

- To hold unallocated stock in a leveraged ESOP.
- To hold contributions or forfeitures that cannot be allocated due to IRC section 415 limits.

Therefore, an employer cannot maintain a suspense account for either IRC section 404 or IRC section 412 purposes. If a suspense account is maintained for either of these reasons, the terms of the plan have not been followed. Depending on various factors, such as the dollar amount involved, the number of years involved, and the reason why the error occurred (to shield excess monies from creditors vs. a mistake of fact), disqualification or the Closing Agreement Program (CAP) may be warranted.
Self-employed Individuals

Introduction
IRC sections 404(a)(8) and 401(c) provide the rules and definitions for plans that cover self-employed individuals. Self-employed individuals may be partners in a partnership or a sole proprietor.

These sections of the Code provide that “earned income” must be used in place of “compensation” when computing the deductible limit under section 404(a)(3). Basically, earned income is income after all ordinary and necessary business expenses less one-half of the individual’s self-employment tax and the plan contribution.

For purposes of section 404, S-Corporations are treated just like a C-Corporations. The owners of S-Corporations are not treated as partners, which is often the case for many other non-plan code sections. The IRS has ruled that S-Corporations and their shareholders must establish and operate qualified plans at the corporate level, even though all profit and loss passes through to the shareholders.

This issue was raised in PLR 8716060, where a sole shareholder of an S corporation sought to establish a self-employed retirement plan with respect to pass through corporate income. The IRS ruled that such a plan was not allowable, as Revenue Ruling 59-221 had ruled that S-Corporation income was not income from self-employment, and therefore was not earned income as defined by section 401(c)(2).

The courts have held that S-Corporation pass through income does not qualify as net earnings from self-employment for Keogh plan deduction purposes because while section 401(c) extends the benefit of deductibility to sole proprietors and partners, it does not extend the benefits to S-Corporation shareholders.

Algebraic Equation
Use a simple algebraic equation to calculate the maximum deduction allowed. For a sole proprietor with no employees the Pre-EGTRRA limit would be calculated as follows: $C = 15\% (E_l - C)$, where

- $C$ = Maximum deductible plan contribution, and
- $E_l$ = Earned Income after all expenses and one-half social security but not the plan contribution.

Continued on next page
CHAPTER 9  VERIFYING 404 DEDUCTIONS FOR DC PLANS

Self-employed Individuals, Continued

Example 1 - Sole Proprietor With no Employees

Using the equation above, assume that earned income for the sole proprietor is $150,000. Solving for \( C \), the maximum deductible contribution that may be made is calculated as follows:

\[
C = 15\% (150,000 - C) \\
C = 22,500 - .15C \\
1.15C = 22,500 \\
C = \frac{22,500}{1.15} \\
C = 19,565
\]

– Since the sole proprietor has no employees, the entire contribution is allocated to the sole proprietor.

We can see that the $19,565 is correct by computing the maximum deduction allowed under IRC section 404(a)(3) by using earned income of $130,435 (150,000 - 19,565) and multiplying it by the 15% limit. Thus, the limit is $19,565 ($130,435 * .15).

Example 2 - Sole Proprietor With 2 Employees

Using the same algebraic equation, now assume that the sole proprietor has two employees with compensation totaling $50,000. Therefore, use earned income of $200,000 (150,000 + 50,000) to calculate the maximum deductible contribution as follows:

\[
C = .15 (200,000 - C) \\
C = 30,000 - .15C \\
1.15C = 30,000 \\
C = \frac{30,000}{1.15} \\
C = 26,087
\]

– The $26,087 contribution would be allocated to the three employees (the sole proprietor and his two employees) according to the plan’s allocation formula.

We can see that the $26,087 is correct by computing the maximum deduction allowed under IRC section 404(a)(3) by using earned income of $173,913 (200,000 - 26,087) and multiplying it by the 15% limit. Thus, the limit is $26,087 ($173,913 * .15).

Continued on next page
## Audit Tips - Over and Under Funding

<table>
<thead>
<tr>
<th>Guidelines</th>
<th>When reviewing the supporting documentation for contributions made, consider the following questions: (A “NO” response indicates a potential problem)</th>
</tr>
</thead>
</table>

- Was payment made in cash by the employer?
- Was payment made to the trust/plan?
- With respect to a check:
  - Does the amount in the lower right hand corner (the bank’s magnetic ink which shows the amount paid) agree with the other supporting documentation, such as the dollar amount of the check and contribution schedule?
  - Was the time frame reasonable between the date the check was written and the date it cleared the bank? The date the check cleared the bank is printed on the back of the check by the bank.
Audit Tips For Non-Cash Contributions

Introduction

The table below lists the steps to take when reviewing non-cash contributions:

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Verify that the plan document permits non-cash contributions. If not, a prohibited transaction occurred.</td>
</tr>
<tr>
<td>2</td>
<td>Determine the fair market value (FMV) of the property at the time it was transferred.</td>
</tr>
<tr>
<td></td>
<td>• Review independent appraisal, recent sales receipts, book value comparisons with similar companies and/or make a referral to an IRS valuation engineer.</td>
</tr>
<tr>
<td></td>
<td>• Revenue Ruling 59-60, 1959-1, CB 237, provides guidance for valuing securities.</td>
</tr>
<tr>
<td>3</td>
<td>Determine the employer’s cost basis in the property transferred.</td>
</tr>
<tr>
<td>4</td>
<td>Determine if the employer incurred a taxable gain or a nondeductible loss from the transfer. Because the transaction is between related parties, the loss is not allowed. If several stocks have been transferred at the same time, make sure that a loss was not netted with a gain.</td>
</tr>
<tr>
<td></td>
<td>• If a gain was generated, verify that it was properly reported on the taxable return.</td>
</tr>
<tr>
<td></td>
<td>• If a loss was generated, verify that it was not deducted on the taxable return.</td>
</tr>
<tr>
<td></td>
<td>No gain or loss is recognized if the company contributes its own stock.</td>
</tr>
</tbody>
</table>
Summary

You have learned in this chapter how to:

- Determine if contributions were made timely for purposes of section 404(a)(6) (deductibility);
- Determine the effect of section 404(a)(6) to section 401(k) and (m) plans;
- Determine the deduction limits under IRC section 404(a)(3) using pre-EGTRRA and EGTRRA law;
- Calculate earned income for self-employment purposes;
- Determine the effect nondeductible contributions have on the employer’s tax return and on related Forms 5330.