Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(a)–2: Impossibility of diversion under qualified plan or trust.

A revenue procedure describes limited relief from disqualification for certain defined contribution retirement plans currently maintained by Professional Employer Organizations. See Rev. Proc. 2003-86, page 1211.

26 CFR 601.201: Rulings and determination letters. (Also, Part I, §401, §1.401(a)–2.)

Rev. Proc. 2003–86

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 2002–21, 2002–1 C.B. 911, relating to relief provided to certain defined contribution plans maintained by professional employer organizations (PEOs) that benefit Worksite Employees who perform services for a client organization (CO). These plans are referred to below as PEO Retirement Plans. The questions and answers contained in this revenue procedure provide guidance on certain transitional issues that were raised by practitioners after the publication of Rev. Proc. 2002–21.

SECTION 2. BACKGROUND

.01 If a PEO satisfies the requirements under Rev. Proc. 2002–21, the Service will not disqualify the PEO Retirement Plan solely on the grounds that the plan has violated the exclusive benefit rule of § 401(a)(2) of the Internal Revenue Code by benefiting Worksite Employees who perform services for a CO. Under section 5 of Rev. Proc. 2002–21, a plan sponsor of a PEO Retirement Plan has two options for taking remedial action in order to obtain the relief provided in section 4 of that revenue procedure. Under the first option, the PEO can terminate the PEO Retirement Plan in accordance with section 5.02 of the revenue procedure. Under the second option, the PEO can convert its single-employer PEO Retirement Plan into a Multiple Employer Retirement Plan in accordance with the requirements under section 5.03 of the revenue procedure. The PEO must have made a decision regarding these options by the PEO Decision Date, which is defined in Rev. Proc. 2002–21 as the date that is 120 days after the first day of the plan year beginning on or after January 1, 2003 (for a calendar year plan, May 2, 2003). Section 7 of Rev. Proc. 2002–21 provides transitional and procedural rules for PEO Retirement Plans and Multiple Employer Retirement Plans.

.02 The definitions in Rev. Proc. 2002–21 also apply for purposes of this revenue procedure.

SECTION 3. SCOPE

The guidance provided by the questions and answers in this revenue procedure may be relied upon by PEO Retirement Plans that are eligible for relief under section 4 of Rev. Proc. 2002–21 and Multiple Employer Retirement Plans.

SECTION 4. QUESTIONS AND ANSWERS

.01 The following questions and answers provide guidance on common inquiries that the Service has received relating to certain transitional issues for a PEO Retirement Plan and a Multiple Employer Retirement Plan.

.02 A PEO electing to use the transitional rules in the questions and answers in this revenue procedure must adopt conforming plan amendments for the Multiple Employer Retirement Plan no later than the last day of the remedial amendment period relating to the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16 (115 Stat. 38) (EGTRRA). The EGTRRA remedial amendment period is the period under § 401(b) during which plan sponsors may adopt retroactive remedial amendments with regard to EGTRRA. As provided in Notice 2001–42, 2001–2 C.B. 70, the EGTRRA remedial amendment period will end no earlier than the last day of the first plan year beginning on or after January 1, 2005.

.03 Unless otherwise specified, the guidance in this revenue procedure applies to the first plan year beginning after the Compliance Date.

.04 Generally, for purposes of § 401(a), it is permissible for a Multiple Employer Retirement Plan to treat Worksite Employees who perform services for a CO as if they were employees of the PEO for all plan years up to and including the plan year in which the Compliance Date occurs.

.05 Alternatively, for purposes of § 401(a), it would be permissible for a Multiple Employer Retirement Plan to treat Worksite Employees who perform services for a CO as employees of the CO for all plan years.

.06 Plan documents should reflect whether a Multiple Employer Retirement Plan has chosen under this revenue procedure to treat all the Worksite Employees who perform services for a CO as employees of the PEO for plan years up to and including the plan year in which the Compliance Date occurs or to treat all the Worksite Employees as employees of the CO for all plan years, and such treatment should be consistent for all § 401(a) purposes, except as specifically provided for in this revenue procedure.

Q–1: **Successor Plans.** Can a Spinoff Retirement Plan make distributions upon termination of the plan in accordance with section 5.04(2) of Rev. Proc. 2002–21 to Worksite Employees who perform services for a CO, if (following termination of the PEO Retirement Plan or conversion of the PEO Retirement Plan to a Multiple Employer Retirement Plan) the CO maintains a defined contribution plan for its employees (whether or not the plan covers Worksite Employees) or if the PEO maintains another plan that covers the PEO's own employees?

A–1: (a) Section 1.401(k)–1(d)(3) of the Income Tax Regulations provides that a distribution may not be made upon termination of a § 401(k) plan if the employer establishes or maintains a successor plan. A successor plan is defined as any other defined contribution plan maintained by the same employer if the plan exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. The plan is not a successor plan if at all times during the 24-month period beginning 12 months before the termination, fewer than two percent of the employees who were eligible under the terminated plan as of the date of plan termination are eligible under the plan.

(b) Neither a defined contribution plan maintained by the CO for its employees (whether or not the plan covers Worksite Employees) nor a plan maintained by the PEO covering the PEO's own employees will be treated as a successor plan to the Spinoff Retirement Plan for purposes of § 1.401(k)–1(d)(3). Accordingly, the Spinoff Retirement Plan is permitted to make a distribution to Worksite Employees regardless of whether the CO or the PEO maintains a plan described in the preceding sentence.

Q–2: **Top-heavy rules.** After a PEO Retirement Plan converts to a Multiple Employer Retirement Plan, how do the top-heavy rules apply with respect to participants' benefits that accrued in the PEO Retirement Plan by the Compliance Date?

A–2: (a) Q&A G–2 of § 1.416–1 provides that a multiple employer plan is subject to the requirements of § 416, but only with respect to each individual employer. Q&A T–2 of § 1.416–1 provides that, for top-heavy purposes, a multiple employer plan to which an employer makes contributions on behalf of its employees is treated as a plan of that employer to the extent that benefits under the plan are provided to its employees because of service with the employer.

(b) Section 7.01(3) of Rev. Proc. 2002–21 provides that, for purposes of determining whether a Multiple Employer Retirement Plan is top-heavy (as defined in § 416(g)(1)(A)(ii)) in its first plan year, the determination date with respect to the first plan year will be the last day of such plan year.

(c) In general, a CO that is a sponsor of a Multiple Employer Retirement Plan may treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan on or before the Compliance Date as attributable to contributions made by the CO when determining whether the plan is top heavy for plan years beginning after the Compliance Date. If a CO chooses this option, in subsequent years the CO must continue to treat the benefits of Worksite Employees who provide services to the CO that accrued in the PEO Retirement Plan on or before the Compliance Date as attributable to contributions made by the CO when determining whether the plan is top-heavy.

(d) However, it is also permissible for a CO that is a sponsor of the Multiple Employer Retirement Plan to treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan prior to the plan conversion as attributable to contributions made by the PEO and not the CO. Thus, when testing the Multiple Employer Retirement Plan for top-heaviness, a CO may treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan on or before the Compliance Date prior to the plan conversion as being zero. Nevertheless, the Multiple Employer Retirement Plan must include in these Worksite Employees' benefits the amounts that accrued in the PEO Retirement Plan prior to the plan conversion and compute the gains and losses attributable to these benefits in subsequent plan years.

(e) For purposes of this Q&A–2, the following applies:

(1) The consistency rule of section 4.06 of this revenue procedure is deemed

satisfied if each CO is consistent in treating the accrued benefits of all Worksite Employees who perform services for that CO in accordance with either (c) or (d) of this question and answer.

(2) In determining whether a plan is top-heavy, the aggregation rules under § 414(b), (c), and (m) apply with respect to a CO. See Q&A T–1 of § 1.416–1.

(3) Regardless of whether the plan uses the option set forth in (c) or (d) of this Q&A–2, the determination date with respect to the first plan year of the Multiple Employer Retirement Plan will be the last day of such plan year.

Q–3: **ADP and ACP Testing.** How do the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests under § 401(k)(3) and (m)(2) apply to a Multiple Employer Retirement Plan in its first plan year?

A–3: (a) *General rule*. A Multiple Employer Retirement Plan must be treated as a new plan for purposes of ADP and ACP testing rules rather than as a successor plan to the PEO Retirement Plan. Thus, for the first plan year beginning after the Compliance Date, a Multiple Employer Retirement Plan can elect to use the prior year testing method for the ADP and/or ACP test without regard to the ADP and ACP testing methods used by the PEO Retirement Plan.

(b) *ADP testing*. A Multiple Employer Retirement Plan that uses the prior year testing method for the ADP test is permitted to provide that the ADP for the nonhighly compensated employees for the first plan year beginning after the Compliance Date is 3% or is determined based on the actual deferral percentages of the nonhighly compensated employees for that year.

(c) *ACP testing*. A Multiple Employer Retirement Plan that uses the prior year testing method for the ACP test is permitted to provide that the ACP for the nonhighly compensated employees for the first plan year beginning after the Compliance Date is 3% or is determined based on the actual contribution percentages of the nonhighly compensated employees for that year.

Q–4: **Minimum Distribution Requirements.** For purposes of applying the required minimum distribution rules under § 401(a)(9) with respect to Worksite Employees who have attained age 70½ but have not yet retired, who will be treated as a 5-percent owner of a CO in the first plan year of the Multiple Employer Retirement Plan, what is the first calendar year for which a minimum distribution is required, and how is the required distribution calculated for that calendar year?

A–4: (a) *General Rule*. Section 401(a)(9)(A) provides that a trust will not be a qualified trust unless the plan provides that the entire interest of each employee will be distributed to the employee not later than the required beginning date or, in accordance with the regulations, will be distributed beginning not later than the required beginning date over the life of the employee or the lives of the employee and a designated beneficiary. The required beginning date is defined in § 401(a)(9)(C) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. However, § 401(a)(9)(C)(ii) provides that, in the case of an employee who is a 5-percent owner (as defined in § 416(i)(1)(B)(i)), the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70½.

(b) *Options for Determining 5-Percent Ownership Status*. Beginning in 2004, a Multiple Employer Retirement Plan may use either of the following two options in determining whether Worksite Employees who have attained age 70½ (but have not yet retired) before the first day of the first plan year of the Multiple Employer Retirement Plan are 5-percent owners of a CO for whom they perform services. Under the first option, a Multiple Employer Retirement Plan may opt to test whether Worksite Employees are 5-percent owners of a CO on the first day of the first plan year of the Multiple Employer Retirement Plan. If a Worksite Employee is a 5-percent owner on that day, the Worksite Employee will be treated as a 5-percent owner of the CO in the plan year ending in the calendar year in which the employee attained age 70½. Under the second option, a Multiple Employer Retirement Plan may opt to test whether Worksite Employees who are over the age of 70½ in 2004 were 5-percent owners of a CO in the year that the Worksite Employees actually attained age 70½. For this testing purpose, the Worksite Employees will be treated as employees of the CO, not the PEO.

(c) *Minimum Distribution Requirements for Worksite Employees who are 5-Percent Owners*. Under either option, a Multiple Employer Retirement Plan will not be required to make minimum distributions under § 401(a)(9) for calendar years before 2004 to Worksite Employees who have attained age 70½ before the first day of the first plan year of the Multiple Employer Retirement Plan and who have not retired (and the employees will not be subject to the excise tax under § 4974 for failure to receive required minimum distributions for those years) even if they are 5-percent owners of a CO for whom they perform services. However, a minimum distribution is required for 2004 and subsequent years for each Worksite Employee who is a 5-percent owner of a CO (determined under paragraph (b) of this Q&A–4) and who attained age 70½ before January 1, 2004, as well as each Worksite Employee who is a 5-percent owner of a CO and who attains age 70½ in 2004. The required beginning date for the 2004 required minimum distribution for those Worksite Employees (those who attained age 70½ in 2004 and in any earlier year) is April 1, 2005. Thus, the required minimum distribution for 2004 for those employees is not required to be made until April 1, 2005, but subsequent required minimum distributions must be made by the end of the calendar year for which they are made, including the required minimum distribution for 2005. For calculating the minimum required distributions for Worksite Employees for each calendar year, see Q&A–4 of § 1.401(a)(9)–5 and the Uniform Lifetime Table in Q&A–2 of § 1.401(a)(9)–9.

Q–5: **Determination of Highly Compensated Employee (HCE Status).** If an individual was a Worksite Employee in the year preceding the first plan year of the Multiple Employer Retirement Plan, is compensation received by that individual during that year taken into account in determining if the individual is a highly compensated employee, as defined in § 414(q)(1), in the first plan year of the Multiple Employer Retirement Plan?

A–5: (a) *General Rule*. HCE status is generally determined on the basis of the

plan year of the plan for which a determination is being made (the determination year) and the preceding 12-month period (the look-back year). Section 414(q)(1) defines a highly compensated employee as any employee who was a 5-percent owner at any time during the determination year or the look-back year and any employee who, for the look-back year, had compensation from the employer in excess of $80,000 (adjusted for inflation) and, if the employer elects, was in the top-paid group of employees for the look-back year.

(b) *Worksite Employees Treated as CO Employees*. For purposes of Rev. Proc. 2002–21, the HCE status of an individual who was a Worksite Employee in the year preceding the first plan year of the Multiple Employer Retirement Plan (the MERP look-back year) and who performed services for a CO in that year is determined by treating the Worksite Employee as an employee of the CO for the MERP look-back year. Any compensation received by the Worksite Employee from the PEO or the CO in the MERP look-back year for services performed for the CO must be treated as received from the CO. Accordingly, all compensation received by a Worksite Employee from the PEO or the CO for services performed for the CO in the MERP look-back year must be considered in determining whether the Worksite Employee is an HCE of the CO for the first plan year of the Multiple Employer Retirement Plan.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–21 is amplified.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Donzel H. Littlejohn of the Employee Plans, Tax Exempt and Government Entities Division and Pamela R. Kinard of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue procedure, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday by calling 1–877–829–5500 (a toll-free number). Mr. Littlejohn can be reached at (202) 283–9888 and Ms. Kinard can be reached at (202) 622–6060 (not toll-free numbers).