

Disclaimer

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Short Plan Year Issues



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What a Topic!

* Short plan year

- ADP testing issues under 401(k) plans, 11.418
- Amendment of vesting computation period, 4.51
- Audit requirement for plan: exception for short plan year, 13A.160
- Compensation dollar limit: application to short plan year, 3B.14, 11.86, 11.420
- Coverage testing periods: effect of a short plan year, 8.18
- Deduction limits: effect of short year, 7.695
- Eligibility computation period: short plan year may not serve as eligibility period, 2.10
- Excludable employees for eligibility purposes: determination for short plan year, 8.10
- Final distribution of assets creates short reporting period, 13A.172
- Form 5500 due date for short plan year, 13A.170
- Highly compensated employee definition: how it is affected by short plan year, 1A.291
- Initial plan year as a short period, 1B.28, 4.49, 5.23, 11.418
- ◆ Company not in existence before effective date of plan, 1B.28, 5.24, 11.421
- Integration level under permitted disparity formula: proration for short plan year, 10.5
- Key employee determination: effect of short plan year, 1A.345
- PBGC premiums for short plan year, 13A.263
- Section 401(k) plan with short plan year, 11.418
- Short limitation year: proration of \$415 dollar limit for defined contribution plan for, 5.23
- Termination of plan results in deemed short limitation year, 5.25
- Top heavy ratio determination, 1B.358
- Vesting computation period: short plan year may not serve as vesting period, 4.51

- From the Index of the *ERISA Outline Book* [under the Plan Administration section]



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Definitions

- A **fiscal year** is an entity's financial year. A **calendar year** is a fiscal year.
 - Most practitioners use the term *fiscal year* to denote a non-calendar year.
- A **short plan year** is less than 12 months long and most often occurs
 - Initial plan year
 - Due to a change in plan year (often to sync up to plan sponsor's fiscal year)
 - Final plan year

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Initial Plan Year

- Generally, doesn't appear to be any advantage to adopting short plan year
 - Plan definitions are key
- Can plan effective date be prior to formation of plan sponsor?
 - Appears the answer is yes
 - Corporation formed June 1, 2015 with initial tax year running from June 1-December 31, 2015. Plan effective date could be January 1, 2015.

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Short Plan Year

1.76 "Short Plan Year" means, if specified in the Adoption Agreement or as the result of an amendment, a Plan Year of less than a twelve (12) month period. If there is a Short Plan Year, the following rules shall apply in the administration of this Plan. In determining whether an Employee has completed a Year of Service (or Period of Service if the elapsed time method is used) for benefit accrual purposes in the Short Plan Year, the number of the Hours of Service (or months of service if the elapsed time method is used) required shall be proportionately reduced based on the number of days (or months) in the Short Plan Year. The determination of whether an Employee has completed a Year of Service (or Period of Service) for vesting and eligibility purposes shall be made in accordance with Department of Labor Regulation §2530.203-2(c). In addition, if this Plan is integrated with Social Security, then the integration level shall be proportionately reduced based on the number of months in the Short Plan Year.

- Resulting from plan amendment
- Generally does not require IRS approval, but see Revenue Procedure 87-27.
- If approval needed, file Form 5308.
 - Must be filed on or before the last day of the end of the short period. User fee applies.

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Who Must File

Except as described below, any employee retirement plan to which the minimum funding standards of section 412 apply (such as a defined benefit plan, money purchase pension plan, or target benefit plan) must file Form 5308 to request approval to change its plan year.

Any employees' trust forming a part of a qualified plan (whether or not the trust is part of a plan subject to section 412) must file Form 5308 to request approval to change its trust year.

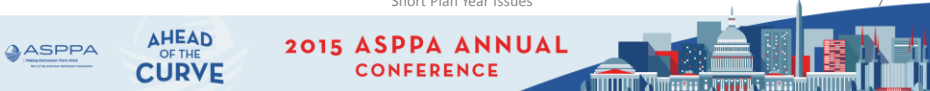
Exceptions. The following plans do not have to file Form 5308 to request approval to change their plan year:

- Profit-sharing plans.
- Stock bonus plans.
- Insurance contract plans described in section 412(e)(2).
- Governmental plans described in section 414(d).
- Church plans described in section 414(e) that have not made the election under section 410(d).
- Plans that have not, at any time after 9/2/74, provided for employer contributions.
- Certain plans established and maintained by fraternal benefit societies, orders, or associations (see section 412(e)(2)).
- Certain plans established and maintained by voluntary employee's beneficiary associations (see section 412(e)(2)).

Automatic approval. Instead of filing Form 5308, a plan or trust is granted automatic approval to change its plan/trust year if all the following requirements are met:

- All actions necessary to implement the change of plan year, including plan amendment and a resolution of the Board of Directors (if applicable), have been taken on or before the short period.
- No plan year is longer than 12 months.
- The change will not delay the time when the plan would otherwise have been required to conform to the requirements of any statute, regulation, or published position of the IRS.
- The trust, if any, retains its exempt status for the short period required to effect the change as well as for the taxable year immediately preceding the short period.
- The trust, if any, has no unrelated business taxable income under section 511 for the short period.
- No change of plan year has been made for any of the 4 preceding plan years.
- Defined benefit plan deductions are taken as described in section 5 of Rev. Proc. 87-27, 1987-1 C.B. 769.


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Plan Termination

- Doesn't necessarily create short plan year
- Does create a short limitation year for a defined contribution plan for IRC §415 purposes if the termination occurs before the end of the limitation year.
 - Example: Employer adopts amendment terminating calendar year profit sharing plan as of July 31
 - Dollar limit pro-rated for number of months (X 7/12)
 - Compensation for §415 purposes = 100% of compensation paid during short period [as limited by IRC §401(a)(17)]

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Form 5500 Reporting

- Filing due 7 months after the end of the short plan year
 - For new plan or short year created by amendment, participant count on first day of plan year determines the need for a report of independent accountant
 - May defer attaching audit for the first of two consecutive years if short plan year is 7 months or less
 - Terminating plan has short reporting year only in year all assets are distributed.

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Deferral of Accountant's Report

- Ongoing plan covering > 100 participants with June 30 year end is amended to shift to a calendar year creating a short plan year in 2015
 - Report of independent accountant
 - Must be attached to Form 5500 filed for plan year ending 06/30/2015
 - May be deferred for plan year ending 12/31/2015
 - For year ending 12/31/2016 must present information for years ending 06/30/2015, 12/31/2015, and 12/31/2016.

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Counting Years of Service

- Eligibility
- Vesting
- Benefit accrual purposes

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Adoption Agreement Choices*

- SERVICE CREDITING METHOD
- **NOTE:** If no elections are made in this Section, then the Hours of Service Method will be used and the provisions set forth in the definition of Year of Service in Plan Section 1.85 will apply.
- ELAPSED TIME METHOD shall be used for the following purposes (select all that apply):
 - a. N/A. Plan only uses the Hours of Service Method.
 - b. all purposes.
 - c. eligibility to participate.
 - d. vesting.
 - e. sharing in allocations or contributions.

* non-standardized provisions

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Measuring Service for Eligibility

- Count an employee's hours of service during an *eligibility computation period* and must start beginning with the date of employment
 - Use actual hours worked
 - Equivalency methods
 - Elapsed time alternative

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Eligibility Computation Period

- A period of 12 consecutive months
- Initial period – begins on employment commencement date (the first day the employee is credited with an hour of service)

Eligibility Computation Period - The Eligibility Computation Period is the 12-consecutive-month period beginning on an Employee's Employment Commencement Date and each 12-consecutive-month period beginning on an anniversary of his Employment Commencement Date.
- Example – hired December 13, 2015; period runs from December 13, 2015 to December 12, 2016.



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Subsequent Periods

- After initial period, the plan has options for defining the *eligibility computation period*
 - Shift to plan year – the second eligibility computation period begins with the first day of the plan year that begins after the employment commencement date
 - Anniversary year method – uses the anniversary of the employment commencement date as benchmark
 - May be difficult to administer
 - Important for two year eligibility plans

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Adoption Agreement Choices*

- HOURS OF SERVICE METHOD shall be used for the following purposes (select all that apply):
 - f. N/A. Plan only uses the Elapsed Time Method.
 - g. eligibility to participate in the Plan. The eligibility computation period after the initial eligibility computation period shall...
 - 1. shift to the Plan Year after the initial computation period.
 - 2. be based on the date an Employee first performs an Hour of Service (initial computation period) and subsequent computation periods shall be based on each anniversary date thereof.
 - h. vesting. The vesting computation period shall be...
 - 1. the Plan Year.
 - 2. the date an Employee first performs an Hour of Service and each anniversary thereof.
 - i. sharing in allocations or contributions (the computation period shall be the Plan Year).

* non-standardized provisions

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Eligibility Computation Period Examples

- Julie employed September 15, 2015.
 - Shift to plan year, then eligibility computation periods run
 - September 15, 2015 to September 14, 2016 and
 - January 1, 2016 – December 31, 2016.
 - Anniversary year eligibility computation periods run
 - September 15, 2015 to September 14, 2016 and
 - September 15, 2016 to September 14, 2017

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What Happens in Short Year?

- If eligibility computation period shifts to plan year, the eligibility computation may not be less than 12 months so may not be the short plan year.
- Example: Plan with June 30 year end is amended to calendar year end in 2015. Plan year computation periods are:
 - July 1, 2015 to June 30, 2016
 - January 1, 2016 to December 31, 2016

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Prorated Hours for Short Plan Years

- Plan can prorate the hours requirement for a year of service during the short plan year
- But must also offer credit a year of service to employees who complete at least 1,000 hours of service during the 12-month period beginning with the first day of the plan year that was in progress when the plan was amended.

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Prorated Example

- Plan with June 30 year end is amended to calendar year end in 2015 and credits a year of service for the short year if employee completes at least 500 hours of service during the July 1-December 31, 2015 short year.
 - Employee works 400 hours in short year, but works > 1,000 hours from July 1, 2015 – June 30, 2016
 - Employee is credited with a year of service

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Year of Eligibility Service

- Is credited at the end of the eligibility period in which it is earned, even if the hours requirement is met earlier in the year.
- Important for monitoring entry date if eligibility conditioned on year of service.
 - In prior example, since year of service not credited until June 30, 2016, entry date is well after short plan year ends.

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1,000 Hours Condition for Allocation

- In a plan with a last day/1000 hours requirement for profit sharing allocation, is the hours requirement prorated for short plan year?
- Discretionary provision not required by statute or regulation, so plan document provision is binding
 - If intention is to prorate or otherwise limit hours required, must do so by amendment

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Vesting

- Method must be specified in the document
- Elapsed time method
 - No vesting computation period; instead *periods of service* are computed
 - Easier for a part-time employee to become vested
 - No fiscal year or short plan year issues
- Counting-hours method – must track hours of service in a *vesting computation period*

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Vesting Computation Period

- Must be a period of 12 consecutive months
- Most plans designate the **plan year** for administrative ease
- Can be amended, but cannot be less than 12 months so an overlap of periods may occur
- Example: Plan with May 31 year end is amended to calendar year end in 2015. Vesting computation periods based on plan year are:
 - June 1, 2015 to May 31, 2016
 - January 1, 2016 to December 31, 2016

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Prorated Hours for Short Plan Years

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Prorated Example

- Plan with May 31 year end is amended to calendar year end in 2015 and credits a year of service for the short year if employee completes at least 500 hours of service during the June 1-December, 2015 short year.
 - Employee works 400 hours in short year, but works > 1,000 hours from June 1, 2015 – May 31, 2016
 - Employee is credited with a year of service

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Other Special Circumstances for Vesting Computation Periods

- Initial short plan year of less than 12 months is treated the same as an amendment of the computation period
 - If the plan counts pre-plan service, then 12-month period is based on first plan year end (assuming the plan year is the computation period)
 - If the new plan ignores pre-plan service, then periods overlap, or you can use only pre-plan service that rounds out the 12-month period
- Using employment year avoids short plan year issues but data collection may be more complex

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Plan Counts Pre-Plan Service*

- If the plan counts pre-plan service, then 12-month period is based on first plan year end (assuming the plan year is the computation period)
- Example: Initial plan year 08/01/2015-12/31/2015
 - Vesting computation period is 01/01/2015 – 12/31/2015 even though plan effective date was August 1, 2105
 - Also count 12-month “plan years” prior to January 1, 2015.

*assumes plan year vesting computation period

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Plan Does Not Count Pre-Plan Service*

- If the new plan ignores pre-plan service, then periods overlap, or you can use only pre-plan service that rounds out the 12-month period
- Two approaches:
 - Use 12-month period beginning August 1, 2015 running through July 31, 2015
 - Act as though 2015 calendar year service counts, but prior periods do not [IRC §411(a)(4)(C) does not preclude the plan from counting less than all service before the plan's effective date.]

*assumes plan year vesting computation period

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§401(a)(17) Limits

- Dollar limit for compensation that is used for allocations and testing
- If compensation is defined with reference to a 12-month period ending with or within the plan year, no pro-ration of limit is needed.
- If plan year compensation is used, then highlighted rule applies.

The annual Compensation limit under Code Section 401(a)(17) shall be adjusted by the Secretary to reflect increases in the cost of living, as provided in Code Section 401(a)(17)(B); provided, however, that the dollar increase in effect on January 1 of any calendar year is effective for determination periods beginning in such calendar year. If a Plan determines Compensation over a determination period that contains fewer than 12 calendar months (a "short determination period"), then the Compensation limit for such "short determination period" is equal to the Compensation limit for the calendar year in which the "short determination period" begins multiplied by the ratio obtained by dividing the number of full months in the "short determination period" by 12; provided, however, that such proration shall not apply if there is a "short determination period" because (i) the Employer elected in Subsection 1.05(b) of the Adoption Agreement to determine contributions based only on Compensation paid during the portion of the Plan Year during which an individual was an Active Participant or (ii) an Employee is covered under the Plan less than a Full Plan Year.

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§401(a)(17) Issues

- Based on the dollar limit in effect at the beginning of plan year (whether short, fiscal, or calendar year).
- No pro-ration of limit if compensation before entry date is not counted (assuming plan year is 12 months)
- Compensation limit is prorated for short period ADP/ACP testing if plan year compensation is used

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§401(a)(17) Limit Example #1

- Employer adopts calendar year profit sharing plan effective November 1, 2015.
 - If compensation is defined with reference to the calendar year ending with or within the plan year, then all 2015 compensation is counted and §401(a)(17) limit is not adjusted
 - If compensation is defined as plan year compensation, §401(a)(17) threshold is reduced accordingly
 - Affects allocations and nondiscrimination testing

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§401(a)(17) Limit Example #2

- What if the short plan year end is not December 31?
 - Choose **compensation** definition that uses compensation earned during the 12 month period ending on the last day of the plan year
 - Define **limitation year** as 12 month period ending on the last day of the plan year
 - Removes necessity to pro-rate limits, but may complicate data collection

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Know Your Document

- Most fiscal or short plan year issues are resolved
 - or made complicated – by virtue of choices made or hard-coded in the plan document
- Important to evaluate impact of defining service with reference to
 - Plan year vs. calendar year ending within the plan year
 - Hours worked vs. elapsed time
 - Other

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Limitation Years / §415

- Annual additions/accruals may be further limited based on limitation year
- If tied to calendar year,
 - May be plan year
 - Calendar year ending within plan year
 - But is always 12 months so no proration necessary
- If tied to plan year, any short year will require proration of §415 limit.

Limitation Year (check one):

- (1) Calendar Year
 (2) Plan Year
 (3) Other: _____

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Limitation Year Example

- Plan and limitation year currently March 31
- Amend plan to calendar year effective January 1, 2015 for both plan year and limitation year
 - Short plan year and limitation period run from April 1, 2014 to December 31, 2014
 - Dollar limit for such period is $(\$52,000 \times 9/12) = \$39,000$
 - Compensation is limited to pay from 04/01/2014 – 12/31/2014, so must consider impact of §401(a)(17)

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§401(a) Permitted Disparity

- For safe harbor permitted disparity allocations, the taxable wage base (“TWB”) in effect at the beginning of the plan year is used
 - Plan year July 1, 2014 to June 30, 2015
 - TWB is amount in effect for 2014, or \$117,000
- If the plan year is < 12 months and plan year compensation is limited to that short period, the integration level must be prorated.

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§401(a) Example

- Plan adopted 07/01/2015
- Plan year = calendar year, but effective on adoption date of 07/01/2015
- Plan defines compensation as that earned during the plan year, so
 - §401(a)(17) limit must be pro-rated $[\$265,000 * 6/12 = \$132,500]$
 - Integration level must be pro-rated $[\$118,500 * 6/12 = \$59,250]$
- Annual contribution = 10% of total pay, plus 5.7% of pay in excess of TWB

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§401(a) Example [continued]

- Participant earns \$25,000 monthly, or \$150,000 for short plan year, but only \$132,500 may be used for allocation purposes
- Excess compensation = $\$132,500 - 59,250 = \$73,250$
- Contribution = \$17,425.25
 - $10\% \times \$132,500 = \$13,250$ plus
 - $5.7\% \times \$73,250 = \$4,175.25$

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HCE Determination

- An HCE is defined as a 5% owner any time during the current or preceding plan year, or person who had compensation in excess of the threshold in the preceding plan year (w/ or w/o top-paid group election)
 - 5% owner test looks at current year and the look-back year
 - Compensation test is based on look-back year data
 - Look-back year is always a 12 month period
 - 12 months preceding the plan year, OR
 - Calendar year ending within the plan year.

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HCE – New Plan with Short Year

- Calendar year plan with effective date of May 1, 2015
 - Determination year is May 1 to December 31, 2015.
 - Look-back year is May 1, 2014 to April 30, 2015.
- May have no effect if sponsoring entity did not exist prior to the effective date of the plan.

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Amendment Creates Short Plan Year

Example: Plan with August 31 year end amended to be calendar year plan beginning January 1, 2015.

Short Year HCEs

- **Determination** year is
09/01/2014-12/31/2014
- **Look-back** year is
09/01/2013-08/31/2014
 - 5% owner test looks at **both** periods
 - Compensation test uses only look-back year.

2015 Calendar Year HCEs

- **Determination** year is
01/01/2015-12/31/2015
- **Look-back** year is
01/01/2014-12/31/2014
 - 5% owner test looks at **both** periods
 - Compensation test uses only look-back year.



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Key Employee Determination

- Key employees include 5% owners, but also
 - 1% owners with compensation > \$150,000
 - Officers with compensation > \$170,000 [for 2014/2015]
 - Compensation based on plan year
 - No guidance for short plan year, so is it reasonable to either annualize actual pay or pro-rate limits?
 - Example: 1% owner earns \$90,000 during 4 month short plan year
 - Annualized = $\$90,000 \times (12/4) = \$270,000$
 - Pro-rate limit = $\$170,000 \times (4/12) = \$50,000$
- Either way, this individual is a key employee.

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Top-heavy Rules

- Short plan year does not change calculation – top-heaviness is merely a snapshot of the plan measured as of year end
- When identifying persons in one / five year look-backs for distributions, short plan year is counted as a [full] year
- 3% of short plan year §415 compensation is minimum
 - Calculation when plan termination date is prior to the end of the plan year is a little different

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IRS Q&A*

- Calendar year defined contribution plan is top-heavy; plan terminates as of September 15.
 - For that plan year, September 15 is treated as if it were the last day of the plan year, so that non-key employees who are employed on that date are entitled to top-heavy minimum.
 - 3% minimum
 - = 3% X (Compensation from 01/01 - 09/15)

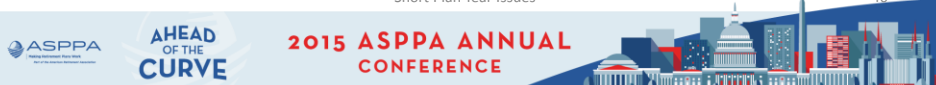
*See ASPPA Annual Conference 2015 IRS Q&A, page 1
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§401(k) Plans

- Elective deferral and catch-up contribution provisions always relate to taxpayer's year, which is generally the calendar year
- Short plan year is a separate testing period
 - ADP/ACP using current year testing method is performed in normal manner
 - Prior year testing method uses prior year data of NHCEs whether or not it's a 12 month period
 - All other nondiscrimination testing performed for the short plan year in same manner as full plan year

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Establishing a Safe Harbor 401(k) Plan

- 12-month rule
 - Must be adopted *before* the first day of the plan year
 - Must be in effect for a *full* 12-month plan year
- Example: On 9/1/2015 an employer wants to add safe harbor features to a traditional calendar-year 401(k) plan. The earliest the plan can be amended is 1/1/2016



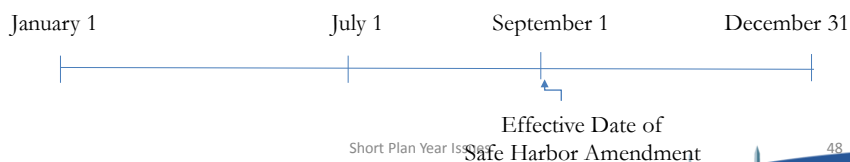
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Exceptions to 12-Month Rule

- New 401(k) plan – if initial plan year is *at least* 3 months
- Existing profit sharing plan – *at least* 3 months
- New business – may be less than 3 months
- Example: Employer wants to add safe harbor feature to a profit sharing plan on September 1. Can adopt “mid-year” by September 1



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Terminating a Safe Harbor §401(k) Plan

- Due to merger, acquisition or business hardship
 - Plan *retains* safe harbor status if short plan year created
 - Exempt from ADP testing
 - Possibly exempt from ACP testing
 - Top-heavy exemption preserved (if qualify)
 - Safe harbor contribution through termination date

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Terminating a Safe Harbor §401(k) Plan

- Due to any other reason
 - Plan *loses* safe harbor status if short plan year created
 - Subject to ADP/ACP testing
 - Subject to top-heavy rules
 - Safe harbor contribution through termination date



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Deductions

- A contribution is deductible under §404(a)(6) so long as it is made during the tax year* to which it applies.
- For defined contribution plans, 25% of all compensation paid or accrued to participants during the employer's taxable year.
- Plan year may differ from employer's tax year.
 - May require additional data collection

*up to the due date of the tax return.

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Example: Plan Year \neq Tax Year

- Tax year ends September 30; calendar plan year
 - For tax year ending 09/30/2015, total compensation of eligible participants = \$600,000
 - 25% deduction limit = \$150,000
 - Company makes \$150,000 contribution on 09/01/2015
 - To which plan year does the contribution belong?

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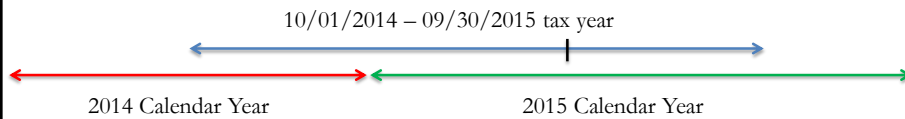


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Example: Plan Year \neq Tax Year [continued]



- Since 09/01/2015 is within the period allowed under §415 to be considered an annual addition, the contribution could be allocated either to the 2014 OR the 2015 plan year.
- Basis for allocation is compensation as defined in the plan; does not have to relate to company's tax year.

Short Plan Year Issues

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Compensation and Deduction Limit

- Look to whether participant is *benefitting* during the year for purposes of §410(b)
 - Last day/1000 hour requirement for allocation can limit compensation base
 - Top-heavy minimum can increase base if active but not meeting 1000 hour requirement
 - Eligibility to make §401(k) contribution causes pay to be included
- Timing: watch tax return due date vs. minimum funding due date

Short Plan Year Issues

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Short Tax and Plan Years

- Suppose tax and plan years are coincidentally revised and create identical short years
- §404(a)(3) deduction limit is applied to aggregate participant compensation paid for the short period.

Short Plan Year Issues

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Thank you for attending.

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