

TCRS 2004-02: A SUMMARY OF PEO REVENUE PROCEDURE 2003-86

As part of the Transamerica Center for Retirement Studies' on-going efforts to educate the small business community on retirement plan-related regulatory and legislative developments, we are providing this overview of the IRS' recent Revenue Procedure ("Rev. Proc.") 2003-86 that provides additional guidance for Professional Employer Organizations ("PEOs") and the administration of their plans.

This new Rev. Proc. addresses many of the issues that were raised by the industry after the release of Revenue Procedure 2002-21. These issues include:

- Successor plan rules
- Post 2003 top-heavy determination and testing – PEO plan converted to a multiple employer plan
- Highly compensated employee ("HCE") determination for 2004
- ADP and ACP testing for 2004 plan year
- Minimum distribution rules and 5% ownership status

Under Rev. Proc. 2003-86, a PEO single employer plan that followed the rules under Rev. Proc. 2002-21, and therefore was entitled to the relief under that Rev. Proc. will also be able to take advantage of the transitional relief provided in this Rev. Proc. This relief is transitional because it generally affects only the 2004 plan year. Note, however, that some elections relating to certain transitional rules carry over to future years. Section 3 of the Rev. Proc. clearly states that the guidance under this Rev. Proc. may be relied upon by multiple employer retirement plans (in general). This transitional relief affects such areas as successor plan rules, top-heavy determination, HCE determination, ADP and ACP testing, minimum distribution rules and 5-percent ownership determination.

For purposes of this summary, we will assume the PEO's plan year to be the calendar year. Here are the highlights of Rev. Proc. 2003-86:

Successor Plan Rules¹

- Neither the PEO's defined contribution plan for its internal employees nor the client company's ("CC's") defined contribution plan will be treated as a successor plan.
- Consequently, the PEO single employer plan (or spin-off and termination plan) can make distributions upon plan termination even though the PEO or CC has another defined contribution plan.

Post 2003 Top-Heavy Determination and Testing –PEO Plan Converted to a Multiple Employer Plan ("MEP")²

- The account balances as of December 31, 2004, must be used in determining if a CC's plan is top-heavy for 2004. In other words, the CC's plan is being treated as a brand new plan for 2004.
- The CC can elect to treat the benefits of worksite employees that accrued under the PEO single employer plan prior to 1/1/04 as having been provided by the CC. This election once made, must be consistently applied for all future years.³
- Alternatively, the CC can choose to treat the benefits of worksite employees that accrued under the PEO single employer plan prior to 1/1/04 as having been provided by the PEO. Thus, in testing the CC plan, the pre-2004 account balance would be zero (0). This election, once made, must be consistently applied for all future years. For top-heavy determination, the pre-2004 account balances of worksite employees accrued under the PEO's single employer plan must continue to include gains and losses in years after 2003.

HCE Determination for 2004²

- Worksite employees are treated as employees of the CC and all compensation, whether paid by the CC or PEO, in the look-back year (e.g., 2003 is the look-back year for the 2004 testing year) is treated as paid by the CC if the worksite employees rendered services to the CC that year.
- Additional guidance is required on whether compensation is pro-rated when a worksite employee works for more than one CC in a given year. This can have significant impact since certain benefits depend on how compensation is determined.⁴

ADP and ACP Testing for 2004 Plan Year²

- This Rev. Proc. provides that the CC plan must be treated as a new plan in 2004. Therefore, the CC can choose the 3% first year rule. Alternatively, the Rev. Proc. allows the CC to choose current year.
- However, where the testing method is pre-selected at the MEP level, the CC must look to the terms of the plan document in determining the appropriate testing method.⁴

Additional guidance is required in the following scenarios⁴:

- What is the appropriate testing method for a CC who transfers from one MEP to another MEP where the pre-selected testing method at the MEP level is different?
- What is the appropriate testing method for the first MEP year for a CC with a single employer plan that is converted to a MEP that has a pre-selected testing method that is different from the single employer plan?

Minimum Distribution Rules and 5-Percent Ownership Status²

For worksite employees who have attained age 70½ but have not yet retired and who will be treated as 5-percent owners of a CC during 2004, the MEP may use one of the following options in determining 5-percent owner status:

- First, the MEP may choose to test whether worksite employees would be treated as 5-percent owners on 1/1/04. If a worksite employee is a 5-percent owner of the CC on 1/1/04, he is treated as a 5-percent owner for the plan year ending in the calendar year in which he attained age 70½.
- Alternatively, the MEP may choose to test whether worksite employees who are over age 70½ in 2004 were 5-percent owners of the CC in the year they actually attained age 70½.
- Regardless of the option elected above, the MEP will not be required to make minimum distributions for years before 2004 for worksite employees who are still employed and who attained age 70½ before 1/1/04. In addition, no excise tax under Code section 4974 will apply to these worksite employees.
- A minimum distribution is required for 2004 and subsequent years for:
 - each worksite employee who is determined to be a 5-percent owner of a CC under either of the options above and who attained age 70½ before 1/1/04, and
 - each worksite employee who is a 5-percent owner of the CC and attained age 70½ during 2004.
- The required beginning date for the 2004 required minimum distribution is 4/1/05.
- Subsequent minimum required distributions follow existing rules.
- The rules in Q&A-4 of regulation section 1.401(a)(9)-5 and the Uniform Lifetime Table in Q&A-2 of regulation section 1.401(a)(9)-9 apply in calculating the minimum required distribution amounts.

Required Plan Amendments

- Amendments required by this Rev. Proc. (for example, those implementing elections by the CC or the PEO) must be adopted at the same time as the EGTRRA amendments due at the end of 2005 (plus extensions, if any).

Overall, this Rev. Proc. provides the much-needed break for PEOs. The transitional relief provides PEOs with the flexibility they need as they face the challenges of converting from single to multiple employer plans. Service providers should welcome the relief as well.

¹ Presents sales opportunities.

² Transitional rules provide testing and administrative relief.

³ If the PEO plan did not cover HCEs prior to 1/1/04, a CC making this election may avoid becoming top-heavy for some years after conversion.

⁴ There is no guidance on these issues. We are going to confirm IRS intent as soon as possible.