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Consequences of Plan Disqualification

In order to take advantage of the tax benefits of a qualified retirement plan, plans must comply with certain regulations. When a plan is not operated in accordance with current law, it runs the risk of disqualification. In this event, the plan's trust is stripped of its' tax-exempt status and is viewed as taxable income for plan participants.

Plan disqualification affects the employer, plan participants and the plan trust.

Effect on the Participants

As a general rule, an employee who is a participant of a disqualified plan must include all employer contributions made on his or her behalf, to the extent he or she is vested in the contributions, in income for all calendar years in which the plan is disqualified.

Additionally, disqualified plan participants do not have the option to make an eligible rollover distribution to a qualified plan or IRA.

Exceptions to the General Rule:

- If "failure to meet either the additional participation or minimum coverage requirements" is among multiple reasons for plan disqualification, highly compensated employees (HCEs) must include their entire vested balance, not previously taxed, in income.
- If "failure to meet either the additional participation or minimum coverage requirements" is the sole reason for plan disqualification, highly compensated employees (HCEs) must include their entire vested balance, not previously taxed, in income. Non-highly compensated employees (NHCEs) do not include any employer contributions in their income until the money is withdrawn and received.

Effect on the Employer

If the employer contributes to an employee's account once the plan is disqualified, the contribution cannot be deducted by the employer until the contribution is includible in the employee's gross income. If the plan does not separate the nonexempt trust into employee accounts, as in a defined benefit plan, contributions are not permitted.

All contributions made into a nonexempt trust by an employer on behalf of an employee are subject to Social Security, Medicare and Federal Unemployment taxes. Taxation is dependent on the employee's vested interest in the contribution. If fully vested when made, taxation occurs at the time of the contribution. Otherwise, both the contribution and earnings will be taxed when fully vested.

Effect on the Plan Trust

A plan trust is seen as a separate legal entity. Once the plan becomes disqualified, the non-tax exempt trust must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, and pay income tax on earnings.

Restoring Plan Qualification

If your plan has been disqualified, the most important step is to determine the error that resulted in disqualification and correct it immediately. The IRS has extensive resources for learning about common errors in plans and taking steps to fix them. If you are aware of the error and ready to correct, the IRS Self Correction Program and Voluntary Correction Program are available. However, if your plan is currently under audit examination, errors must be corrected using the Audit Closing Agreement Program.

Source:
Tax Consequences of Plan Disqualification. Internal Revenue Service. Updated 22 May 2014.
http://www.irs.gov/Retirement-Plans/Tax-Consequences-of-Plan-Disqualification