Part IV.--Items of General Interest

Employee Plans; Examination Guidelines

Announcement 98-1

The Internal Revenue Service has developed proposed examination guidelines for employee plans examiners to use when examining issues relating to employer deductions under § 404 of the Internal Revenue Code and the minimum funding standards under § 412. The guidelines provide technical background and guidance as to issues that should be considered during an examination. The guidelines are not intended to be all inclusive, and may be modified based on specific issues encountered by the examiners during an examination.

As with earlier examination guidelines, the Service is seeking public comments on the proposed guidelines before they are finalized for the Internal Revenue Manual.

Copies of these guidelines have been made available to the tax reporting services. The guidelines are also available from the Service. Requests for a copy of the examination guidelines may be submitted in writing to the following address:

Internal Revenue Service
Assistant Commissioner (Employee Plans and Exempt Organizations)
Attention: CP:E:EP:FC Room 2236
Washington, DC 20224

Written comments on the guidelines may be submitted to the above address on or before April 13, 1998 to the above address.

EXAMINATION GUIDELINES FOR IRC 404

These guidelines provide guidance on examining the deductibility of contributions by sponsoring employers of a qualified retirement plans subject to the limits of section 404 of the Internal Revenue Code (IRC).

These guidelines are not intended to be all inclusive; consequently, the techniques identified may be modified based on the actual examination issues encountered. The purpose of these guidelines is to help the examining specialist decide what areas to concentrate on and what issues to raise with respect to particular plans. Given the purpose of these guidelines, they can not be, nor are they intended to be, a precedential or comprehensive statement of the Service’s legal position on the issues covered herein. They are not to be relied upon or cited as authority to taxpayers. Accordingly, the guidelines are being issued for the sole purpose of assisting the examining specialist in performing an examination of certain issues for which it was believed guidelines would be helpful. It is not expected that each issue discussed in these guidelines will be relevant in every examination.

EXAMINATION GUIDELINES

DEDUCTIBILITY OF QUALIFIED RETIREMENT PLAN CONTRIBUTIONS UNDER IRC 404

1. IRC 404: Deductions - General Rules and Applicability

1.1 Overview

NOTE: This chapter does not address changes applicable to IRC 404 under the Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, or the Taxpayer Relief Act of 1997, P.L. 105-34.

(1) Contributions to qualified plans are deductible by the sponsoring employer (subject to the limits of IRC 404) and the plan beneficiaries are not taxed until benefits are received.

(2) The amount deductible under IRC 404 must first be deductible under Chapter 1 of the Internal Revenue Code (generally, under IRC 162 as an ordinary and necessary business expense). The deduction must be based on compensation paid or accrued for services actually rendered; payment for future services is not to be included.

a. Under a special rule for self-employed individuals, contributions to the plan on behalf of an employee are considered to satisfy the conditions of IRC 162 or IRC 212 to the extent that they do not exceed the individual’s earned income (determined without regard to the deductions allowed by this section) derived from the trade or business with respect to which such plan is established, and to the extent that such contributions are not allocable to the purchase of life, accident, health, or other insurance (i.e., if the plan deduction does not exceed the individual’s earned income from the business sponsoring the plan determined before the plan deduction). See IRC 404(a)(8).

(3) The plan must be written, communicated to employees, and in effect by year end. See Engineered Timber Sales, Inc. v. Comm., 74 TC 808 (1980).

(4) IRC 404 also controls non-qualified plans of deferred compensation or benefits; the employer receives a deduction at the same time participants include the value of benefits as taxable income.

a. However, if separate accounts are not maintained, there is no employer deduction, even when employees are taxed on the benefits. See IRC 404(a)(5).

1.2 General Rules For Defined Benefit Plans

(1) In the case of a defined benefit plan, an actuarial valuation is performed by an actuary to determine benefits, liabilities, minimum funding requirements, and the maximum tax deducible contribution, among other

things.

a. The maximum deduction is based in part on the benefits provided by the plan, and the assumptions employed by the actuary as to interest, mortality, turnover, etc.

1.2.1 General Deductible Limit Under IRC 404

(1) In general, the maximum deduction under IRC 404 is given by one of the three rules found under IRC 404(a)(1)(A)(i), (ii), and (iii).

1.2.1.1 IRC 404(a)(1)(A)(i): Minimum Funding Requirement

(1) Under IRC 404(a)(1)(A)(i), a deduction is provided for the minimum required under IRC 412 to avoid a funding deficiency. Under this rule, the employer can deduct what is required to fund the plan for IRC 412 minimum funding standards.

(2) A special rule provides if amounts required under IRC 412 were paid for the preceding year but were not deducted <u>solely</u> because they were not timely paid for IRC 404, they are "includible contributions" and are deductible under the IRC 404(a)(1)(A)(i) rule for the current year. Note, however, that total deductions under IRC 404(a)(1)(A)(i) are subject to the applicable full

funding limit.

(3) **Example 1:**

- Plan Year End = Fiscal Year End = Calendar Year; Tax Return due & filed 3/15 of following year.

- Req’d Under IRC 412 for 1996: $10,000
  Req’d Under IRC 412 for 1997: $11,000

- Paid 3/15 following year & deducted previous year: 1996 - $8,000; 1997 - $11,000

- Paid 9/15 following yr: 1996 - $2,000; 1997 - $0

- "Includible Contributions": 1996 - $0; 1997 - $2,000

- Total Deduction: 1996 - $8,000; 1997 - $13,000

- Total Paid: 1996 - $10,000; 1997 - $11,000

For the 1996 year, the employer timely paid $10,000 within 8½ months for IRC 412 purposes ($8,000 on 3/15/97, and $2,000 on 9/15/97). However, only $8,000 was deductible for 1996 because $2,000 was not timely paid for IRC 404 purposes (it was paid subsequent to the tax return filing on 3/15/97). Assuming that the full funding limitation does not otherwise limit the deduction, this $2,000 is deductible as an "includible contribution" in 1997, even though when added to the $11,000 contribution for 1997 it causes the deduction to exceed the otherwise computed IRC 404(a)(1)(A)(i) limit.

1.2.1.2 IRC 404(a)(1)(A)(ii): Level Spread Method

(1) Under IRC 404(a)(1)(A)(ii), a deduction is provided for the level funding amount. Under this rule, the employer can deduct the cost of funding all benefits, as a level dollar amount or a level percent of pay, over the future service of each employee.

a. This rule applies to certain actuarial cost methods that allocate or spread the cost of unfunded benefits over future service.

b. If the cost with respect to any three (3) participants exceeds 50% of the total cost, the cost for such participants must be spread over at least 5 taxable years.

1.2.1.3 IRC 404(a)(1)(A)(iii): Normal Cost Plus 10 Year Amortization

(1) Under IRC 404(a)(1)(A)(iii), a deduction is provided for the normal cost plus 10 year unfunded liability amortization. Under this rule, an employer can deduct the normal cost computed by the actuarial funding method,

plus a level 10 year amortization of unfunded liabilities.

a. This rule is applicable to certain actuarial cost methods that separately identify liability attributable to past events.

(2) An equation can be written as:

404(a)(1)(A)(iii) Limit = (NC + sum of limit adjustments + interest), where

- "NC" is the normal cost for the plan year;

- "limit adjustment" is the lesser of the 10 year amortization amounts or the outstanding balance of the liability bases; and

- "interest" is interest to the earlier of the end of the plan year or fiscal year. See 1.2.4.1, for rules on establishing amortization bases.

1.2.2 Consistent Treatment: IRC 404 to IRC 412

(1) Under Reg. 1.404(a)-14(d)(1), the computation of the deductible limit for a plan year is based on the benefit structure used for purposes of IRC 412 for the plan year.

(2) In general, the assumptions, methods, and factors used in computing costs for IRC 412 minimum funding standards must also be used for computing IRC 404 deductible limits.

(3) There are exceptions to this, however:

a. As discussed below, the assets used for IRC 404 maximum deduction purposes may differ from the assets used in IRC 412 minimum funding computations.

b. As discussed above, IRC 404(a)(1)(A)(ii) requires spreading the cost for certain participants over a minimum of five (5) years in some situations. There is no similar requirement under the IRC 412 rules.

c. When the Alternative Minimum Funding Standard is used under IRC 412, the amount deductible under IRC 404(a)(1)(A)(i) as the amount needed to avoid a funding deficiency will be different than the amount required under the alternative standard to avoid a deficiency on the Schedule B. Alternative Minimum

Funding Standards are encountered infrequently in practice. See Reg. 1.404(a)-14(e)(2).

1.2.3 Linking Tax Year to Plan Year

(1) The employer's deduction is taken for a tax year, but is determined with reference to a plan year.

a. When the two years are the same, the concurrent plan year controls the tax year deduction.

b. Reg. 1.404(a)-14(c) provides that, if the two years do not coincide, the deductible limit is determined from either the plan year that begins in the tax year, the plan year that ends in the tax year, or a pro-rata share of each year.

c. The linkage that is chosen by the employer cannot be changed unless approved as a change in accounting method under IRC 446(e).

1.2.4 Amortization Bases

(1) If the deductible limit is determined under IRC 404(a)(1)(A)(iii), the maximum deduction consists of the normal cost of the plan, plus the limit adjustments for the 10-year amortization bases, plus interest to the earlier of the plan year end or the fiscal year end. The

limit adjustments require the maintenance of bases.

1.2.4.1 Establishing Amortization Bases

(1) Reg. 1.404(a)-14(g) provides for the establishment of 10-year amortization bases for purposes of determining the deductible limit under IRC 404(a)(1)(A)(iii).

(2) In general, for an immediate gain funding method, a 10-year base must be established each time a separate amortization base is established for purposes of IRC 412 for one of the following:

a. experience gains or losses;
b. change in actuarial assumptions;
c. change in funding method; or
d. past service based upon establishment or amendment of the plan.

(3) A spread gain method must not establish a base for a gain or loss but rather must spread that amount in future normal costs. See Reg. 1.404(a)-14(g).

a. If a plan using such a method is required under IRC 412(b)(2)(B)(v) or IRC 412(b)(3)(B)(iii) to create an amortization base, it must establish a 10-year base for a change in actuarial assumptions. If the creation of an amortization base is required under the rules of IRC 412(b)(2)(B)(ii) or (iii) or IRC 412(b)(3)(B)(i), then a 10-year base must be established when a plan is established or amended.

b. If a change in funding method results in an increase or decrease in an unfunded liability required to be amortized under IRC 412, then a 10-year base must be established equal to the increase or decrease in unfunded liability resulting from the change in funding method.

(4) A 10-year base is not established for a waived funding deficiency or for the base that is established when switching back to the regular funding standard account from the alternate funding standard account.

(5) Also, no IRC 404 base is established for the IRC 412 base established for current liability full funding.

1.2.4.2 Limit Adjustment

(1) The limit adjustment for any 10-year amortization base is the lesser of the level amount necessary to amortize the base over 10 years using the valuation rate, or the outstanding amount of the base.

1.2.4.3 Amortization Base Maintenance

(1) Reg. 1.404(a)-14(h) provides for the maintenance of 10-year amortization bases. Reg. 1.404(a)-14(h)(3) specifically sets out the procedure for determining the unamortized amount of a base.

(2) It is necessary to maintain the unamortized portion of the base in order to know when a base has been fully amortized.

(3) After a base has been fully amortized, the employer can no longer include the 10-year amortization of such base in determining the deductible limit.

(4) Therefore, if no base has been in existence for more than 10 years, no adjustments will result from any failure to correctly maintain unamortized amounts.

(5) If bases are in existence, a fresh start base may be established in accordance with Reg. 1.404(a)-14(i)(5).

1.2.4.4 Balance Equation

(1) Under a reasonable funding method, the sum of all the outstanding IRC 404 bases should equal the unfunded liability of the plan taking into account the assets adjusted as described below. If this is not the case, ask the actuary to explain any discrepancy.

1.2.4.5 Combining and Offsetting Bases

(1) Reg. 1.404(a)-14(i) provides for the combining and/or offsetting of existing 10-year bases into a single 10-year base. This procedure differs from that used for combining and offsetting amortization bases for purposes of IRC 412.

1.2.4.6 Fresh Start Alternative

(1) Reg. 1.404(a)-14(i)(5) allows a fresh start alternative whereby all existing bases are replaced with one new 10-year base equal to the unfunded liability of the plan. (Note that the unfunded liability must consider the assets, adjusted as described below).

1.2.5 Asset Adjustments

(1) Under Reg 1.404(a)-14(d)(2), certain adjustments must be made to both the actuarial value of the plan's assets and the market value of the plan's assets. These adjustments are made for purposes of determining the deductible limit under IRC 404(a)(1)(A).

a. The adjustments are used when computing the IRC 404 normal cost with aggregate type funding methods (e.g., the individual aggregate funding method), computing unfunded liabilities, and computing the full funding limitation described in Reg. 1.404(a)-14(k).

b. There must be <u>subtracted from the assets</u> the amount of any plan contribution for a plan year in which the plan was qualified that has not been previously deducted (even if that amount may have been credited to the funding standard account). In the case of a plan using a spread gain funding method which maintains an unfunded liability (e.g., the frozen initial liability method, but not the aggregate method), such amount must be included in the unfunded liability of the plan. See Reg. 1.404(a)-14(d)(2)(i).

c. There must be <u>included in the assets</u> the amount of any plan contribution for a plan year that has been deducted with respect to a prior plan year (even if that amount is considered under IRC 412 to be contributed in a plan year subsequent to that prior plan year). In the case of a plan using a spread gain funding method which does not maintain an unfunded liability, such amount must be excluded from the unfunded liability of the plan. See Reg. 1.404(a)-14(d)(2)(ii).

1.3 Additional Rules and Exceptions

(1) While the general limitations on deductions are provided under IRC 404(a)(1)(A)(i),(ii), and (iii), exceptions to the general rules may result in a greater or lesser amount being deductible.

1.3.1 Benefits to be Valued

(1) In valuing the plan, the actuary may be constrained in the amount of benefits to value.

(2) Changes in plan benefits that become effective in a future year are to be ignored. See Reg. 1.412(c)(3)-1(d)(1) and Rev. Rul. 77-2.

(3) Also, under Reg. 1.415-5, automatic increases in the IRC 415 dollar limitation do not apply until January 1 of the calendar year in which they become effective.

a. TEFRA reinforced this position by adding IRC 404(j). This section states the computation of the deductible limit shall not include any benefits in excess of the IRC 415 limit for such year.

b. Also see United States Tax Court Case 80 T.C. No. 4, Feichtinger v. Commissioner, which upheld this position for years prior to TEFRA.

c. Should a plan contain no provision for increasing the dollar limitation, the benefits are always limited to the dollar limit specified in the plan. See Rev. Ruls. 81-195 and 81-215 for illustration of the application of these rules.

(4) Therefore, the funding method may not take into account either of the increases discussed in (2) and (3) above when computing the deductible limits under IRC 404(a)(1)(A).

1.3.2 Compensation Limitations

(1) The compensation limitation of IRC 401(a)(17) applies in determining the deductible limit.

a. For years after 1993, compensation in excess of $150,000 cannot be taken into account. The $150,000 limit is subject to future increases.

b. For years before 1997, the family aggregation rules of IRC 414(q)(6) apply. Thus, the combined compensation of spouses and their children under age 19 cannot exceed $150,000 (as adjusted). For years after 1996, this family aggregation rule no longer applies.

1.3.3 Full Funding Limitation And IRC 404

(1) The amount computed under the general IRC 404 rules above is limited by the full funding limitation.

a. IRC 404(a)(1)(A) provides that the maximum amount deductible for a taxable year shall be an amount equal to the full funding limitation for such year determined under IRC 412. See also Reg. 1.404(a)-14(k).

b. In determining the applicable full funding limitation for IRC 404 purposes, assets must be adjusted as required for other IRC 404 purposes. See Reg. 1.404(a)-14(k). See also IRC 412 chapter on "Full Funding Limitation" (section 1.4.6), for further rules and discussion.

c. Where the prevailing FFL is the accrued liability FFL, and the total deductible contribution (including carryovers) for a plan year equals or exceeds such accrued liability FFL (and the amount of the accrued liability FFL is contributed), then all 10 year amortization bases maintained by the plan will be considered fully amortized and the deductible limit for subsequent plan years will not be adjusted to reflect the amortization of these bases.

d. Where the prevailing FFL is the 150% current liability FFL and the total deductible contribution (including carryovers) equals or exceeds such FFL, the IRC 404 bases continue to be amortized with the deductible contribution.

1.3.4 Other Limitations

(1) An amount greater than the above limits may be deductible under the exceptions of IRC 404(a)(1)(D) or IRC 404(g).

1.3.4.1 Special Limit For Large Plans

(1) IRC 404(a)(1)(D) provides a special rule for certain non-multiemployer defined benefit plans.

(2) The plan must have 101 or more participants (including former participants or beneficiaries with assets still held by the plan) for the plan year.

a. The 101 or more participants rule counts all employees of the employer in all defined benefit plans maintained by the employer.

(3) For such plans, the maximum amount deductible under IRC 404(a)(1) shall not be less than the unfunded current liability determined under IRC 412(l) for the plan year.

a. The unfunded current liability includes adjustment to the end of the plan year for benefits accruing during the year plus interest to the end of the year at current liability interest rate.

1.3.4.2 Terminating Plans: IRC 404(g)

(1) IRC 404(g) provides special rules concerning the deduction of employer liability payments paid under section 4041(b), section 4062, section 4063, section 4064, or part 1 of Subtitle E of Title IV of ERISA.

(2) No deduction is allowable under IRC 404(g) to provide for benefits in excess of guaranteed benefits. Thus, an employer cannot immediately deduct the difference between the present value of accrued benefits and the assets even if the plan is terminating.

(3) Amounts contributed in the year of termination, but not fully deductible, are subject to deduction rules under IRC 404(a) in subsequent years.

(4) Amounts deductible under IRC 404(g) are subject to the full funding limit.

(5) (1) through (4) above are applicable to qualified plans only. See Reg. 1.404(g)-1(c)(2).

1.3.4.3 Collectively Bargained Plans: IRC 404(a)(1)(B) and (C)

(1) A special rule applies for collectively bargained plans. If an amendment decreases benefits, and the full funding limit for the year is zero, a deduction is allowed equal to the <u>lesser</u> of a or b below:

a. the full funding limit plus the unamortized base resulting from the decrease in benefit liability due to the amendment; or

b. the normal cost minus a 10 year amortization of the benefit liability decrease.

(2) Further, a collectively bargained plan maintained by a regulated utility doing business in at least 40 states may treat a decrease in liability due to increases in Social Security benefits as a plan amendment for purposes of this rule.

1.3.5 Interest

(1) Under IRC 404(a)(1)(A)(ii) and (iii), the deductible limit may include interest on the actuarially computed costs. Such interest is computed from the date the costs

are determined to the <u>earlier</u> of (i) the end of the plan year; or (ii) the end of the fiscal/tax year. See Reg. 1.404(a)-14(f)(3).

Example 2: For a plan with a calendar year plan year, a level cost under IRC 404(a)(1)(A)(ii) is computed as $10,000 as of January 1, 1996. The fiscal year that relates to the plan year ends June 30, 1996. The interest rate used is 8%. The maximum deductible limit under IRC 404(a)(1)(A)(ii) is $10,400; which is the $10,000 level cost plus one-half year’s interest to June 30, since this ends earlier than the plan year.

1.3.6 Expenses & Fees

(1) Administrative fees and expenses paid directly by the employer are deductible to the employer under IRC 162 or IRC 212.

(2) Such expenses are not considered plan contributions and, hence, are not subject to the limits of IRC 404. See Rev. Rul. 84-146.

(3) However, investment fees, brokers' commissions and the like paid by the plan sponsor are treated as plan contributions subject to the limits of IRC 404. See Rev. Rul. 86-142.

1.3.7 Uniform Capitalization Rules

(1) Employers subject to the uniform capitalization rules may not be able to deduct the full IRC 404 limit from the general rule above.

(2) A portion of the 404 limit may be required to be assigned to production or inventory costs, which are capitalized and not immediately deductible. See Announcement 88-55.

1.3.8 Time of Payment

(1) For purposes of IRC 404(a)(1), (2), and (3), contributions paid up until the due date of the taxpayer's tax return (including extensions) may be deemed to be paid on the last day of the preceding tax year.

1.3.9 In-Kind Contributions

(1) While contributions to qualified plans in a form other than cash are technically allowed, such

contributions bear special scrutiny. When examining a plan, consider the following tips. See also Prohibited Transactions Examination Guidelines (IRM 7(10)54, Chapter 700).

a. Check the Form 5500 for indications of non-cash contributions.

b. Verify the fair market value of any property contributed.

c. Confirm that the deduction claimed with respect to the property does not exceed IRC 404 limits.

d. Determine if the property was contributed to satisfy a funding obligation. If so, this is a prohibited transaction. See also Comm. v. Keystone Consolidated Industries, 568 U.S. 152 (1993).

e. See if any liens were attached to the property contributed. If so, this is a prohibited transaction. See also Rev. Rul. 80-140. An employer’s contribution of a promissory note is not adequate payment for IRC 404, and is a prohibited transaction.

1.3.10 Money Purchase Plans

(1) The deductible limit is usually determined under IRC 404(a)(1)(A)(i) as the amount needed to satisfy the minimum funding standard, unless a larger amount is required because of a prior funding waiver.

(2) The maximum deduction is determined based on IRC 415 limits.

1.3.11 Profit Sharing Plans

(1) The deductible limit is determined under IRC 404(a)(3) as 15% of the compensation paid during the taxable year to the participants.

1.3.12 Combined Limits Under IRC 404(a)(7)

(1) If amounts are deductible under IRC 404(a)(1) through (4) in connection with one or more defined contribution plans and one or more defined benefit plans, (e.g., a defined contribution plan and a profit sharing plan, or a profit sharing plan and a defined benefit plan), the total amount deductible in a taxable year under such plans must not exceed the greater of:

a. 25% of the compensation paid (or accrued) during the taxable year to the beneficiaries under such plans, or

b. The amount of contributions made to or under the defined benefit plans to the extent such contributions do not exceed the amount of employer contributions necessary to satisfy the IRC 412 minimum funding standard with respect to such defined benefit plans for the plan year which ends with or within the taxable year (or for any prior plan year).

(2) In the case of any defined benefit plan (other than a multiemployer plan) with over 100 participants for the plan year, the amount necessary to satisfy the minimum funding standard with respect to such plan year for purposes of (1) above shall not be less than the unfunded current liability of the plan under IRC 412(l).

(3) The two or more plan limits apply using the minimum funding standards for the plan year ending with or within the tax year. This could be different than the applicable deductible limit if the employer usually determined the deductible limit based on the plan year commencing in the tax year.

(4) If the IRC 404(a)(7) limit restricts an employer from making deductible contributions to a defined contribution plan, the plan will not be considered as failing to provide definitely determinable benefits. Of course, the plan must have language limiting the employer contributions.

1.3.13 Allocation of Deduction For Multiemployer Collectively Bargained Plans Described in IRC 413(b)

(1) IRC 413(b)(7) provides that each applicable limitation provided by IRC 404(a) is determined as if all participants in a collectively bargained plan are employed by a single employer. See the proposed chapter on Multiemployer Plans for further rules and discussion.

(2) The amounts contributed to the plan by a participating employer, for the portion of the taxable year which is included in the plan year, are considered not to exceed a limitation of IRC 404(a) if the anticipated employer contributions for such plan year do not exceed such limitation.

a. For this purpose, anticipated employer contributions are determined in a manner consistent with the manner in which actual contributions are determined.

(3) If such anticipated contributions exceed the IRC

404(a) limitation, the portion of each such employer’s contributions which is not deductible under IRC 404 shall be determined in accordance with regulations prescribed by the Secretary

(4) Trustees of multiemployer plans under which the contributions may exceed the IRC 404 limits often correct the problem by adopting amendments increasing benefits. If the amendment is to have retroactive effect, however, it must satisfy the requirements of IRC 412(c)(8).

1.3.14 Multiple Employer Plans Described in IRC 413(c)

(1) If the plan was established as a multiple employer plan after December 31, 1988, limitations under IRC 404(a) are determined as if each employer were maintaining a separate plan. For purposes of computing these limitations, assets and liabilities are allocated in accordance with IRC 413(c)(7).

(2) If the plan was established on or before December 31, 1988, and if a timely election was not made (within the first plan year beginning after the enactment of the Technical and Miscellaneous Revenue Act of 1988) to use the rules under (1) above, deductions are determined under 1.3.13, Allocation of Deduction for Multiemployer Collectively Bargained Plans Described in IRC 413(b).

1.4 Excise Tax on Nondeductible Contributions

(1) IRC 4972 imposes an excise tax on employers (other than governmental and certain tax-exempt employers) equal to 10% of the nondeductible contributions made to a qualified employer plan.

a. A qualified employer plan generally means any plan meeting the requirements of IRC 401(a) that includes a trust exempt from tax under IRC 501(a), any annuity plan described in IRC 403(a), any simplified employee pension within the meaning of IRC 408(k), and any simple retirement account (within the meaning of IRC 408(p).

b. For a tax-exempt employer to be exempt from the tax imposed by IRC 4972, the employer must have at all times been exempt from tax under subtitle A of the Internal Revenue Code and not have received any tax benefit from the plan.

(2) When paying the tax imposed under IRC 4972, the appropriate form to file is Form 5330.

(3) IRC 4972(c)(6)(B), added by RPA ’94, provides a limited exception to this excise tax. Under IRC 4972(c)(6)(B), the excise tax does not apply to contributions to defined contribution plans that are

nondeductible solely because of the IRC 404(a)(7) combined limit on deductions for contributions.

a. The IRC 4972(c)(6)(B) exception to the excise tax applies only to the extent that nondeductible contributions do not exceed six percent of compensation paid or accrued to beneficiaries under the defined contribution plans, and only if IRC 404(a)(1)(D) applies to any defined benefit plans maintained by the employer.

b. Because IRC 4972(c)(6)(B) was made effective retroactively for taxable years ending on or after December 31, 1992, certain employers that paid excise taxes imposed under IRC 4972 for taxable years ending on or after December 31, 1992 may have been entitled to excise tax refunds under this exception.

(4) IRC 4972(c)(4) also provides a special rule for self-employed individuals that, for purposes of IRC 4972, treats certain excess amounts as amounts allowable as deductions under IRC 404.

a. The excess amount that is treated as an allowable deduction is the excess of the amount required to be contributed to a plan under IRC 412 on behalf of a self-employed individual (as defined in IRC

401(c)(1)), over the earned income (as defined in IRC 404(a)(8)) of such individual derived from the trade or business with respect to which such plan is established.

EXAMINATION GUIDELINES FOR IRC 412

These guidelines provide guidance on examining qualified retirement plans subject to the minimum funding standards under section 412 of the Internal Revenue Code (IRC).

These guidelines are not intended to be all inclusive; consequently, the techniques identified may be modified based on the actual examination issues encountered. The purpose of these guidelines is to help the examining specialist decide what areas to concentrate on and what issues to raise with respect to particular plans. Given the purpose of these guidelines, they can not be, nor are they intended to be, a precedential or comprehensive statement of the Service’s legal position on the issues covered herein. They are not to be relied upon or cited as authority to taxpayers. Accordingly, the guidelines are being issued for the sole purpose of assisting the examining specialist in performing an examination of certain issues for which it was believed guidelines would be helpful. It is not expected that each issue discussed in these guidelines will be relevant in every examination.

EXAMINATION GUIDELINES

MINIMUM FUNDING STANDARDS UNDER IRC 412

1 IRC 412: Minimum Funding Standards

1.1 Introduction

1.2 Accumulated Funding Deficiency

1.3 Applicability of IRC 412

1.3.1 Questions to Consider

1.3.2 Terminating Plans

1.4 Computation of Amounts Required Under IRC 412 - Defined Benefit Rules

1.4.1 Actuarial Valuation

1.4.1.1 Valuation Date

1.4.2 Funding Method - Benefit Valuation

1.4.2.1 General Requirements: Funding Methods

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1.4.2.3 Valuing Costs Attributable to Changes in Benefit Structure Effective After the Valuation Date

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1.4.2.4 Immediate Gain Funding Methods

1.4.2.4.1 Special Considerations Under the Unit Credit Service Pro-Rate Funding Method

1. IRC 412: Minimum Funding Standards

1.1 Introduction

NOTE: This chapter does not address changes applicable to IRC 412 under the Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, or the Taxpayer Relief Act of 1997, P.L. 105-34.

(1) IRC 412 provides minimum funding standards applicable to plans subject to IRC 412. Similar rules are provided in sections 301 through 308 of the Employee Retirement Income Security Act of 1974 (ERISA). A plan to which this section applies shall have satisfied the minimum funding standard for the plan year if the plan does not have an accumulated funding deficiency.

(2) The minimum funding standard under IRC 412, with a few exceptions listed under IRC 412(h), generally applies to all defined benefit and money purchase (including target benefit) plans.

(3) While IRC 412 gives the general funding requirements, special rules may also apply under other sections:

- IRC 418 and 418A for multiemployer plans in reorganization;
- IRC 413(c) for certain multiple employer plans; and

- IRC 413(b) for collectively bargained plans.

1.2 Accumulated Funding Deficiency

(1) The term "accumulated funding deficiency" means for any plan the excess of the total charges to the funding standard account for all plan years over the total credits to such account for such years or, if less, the excess of the total charges to the alternative minimum funding standard account for such plan years over the total credits to such account for such years. See section 1.8 if the plan does have an accumulated funding deficiency, to determine the applicable excise tax.

1.3 Applicability of IRC 412

(1) Not all plans are subject to the minimum funding standards. The following questions will help determine whether a plan is subject to the standard.

1.3.1 Questions to Consider

(1) Is the plan a qualified plan or has the plan ever been a qualified plan? If the plan is not qualified and has never been qualified it is not subject to IRC 412. It may, however, be subject to the requirements of section 302 of ERISA.

(2) Is the plan a defined benefit plan, money purchase, or target benefit plan? These plans are subject to the minimum funding standards. Note that cash balance plans are defined benefit plans and, thus, also subject to the standards. Profit sharing plans are not subject to the standards.

(3) Does the plan meet the exceptions of IRC 412(h)? If yes, then the plan is not subject to the minimum funding standards. IRC 412(h) generally exempts the following plans.

a. Profit sharing or stock bonus plan
b. Insurance contract plan described in IRC 412(i)
c. Governmental plan (within the meaning of IRC 414(d))
d. Certain church plans
e. Any plan which has not, at any time after September 2, 1974, provided for employer contributions
f. Plans established and maintained by a society, order, or association described in IRC 501(c)(8) or (9), if no part of the contributions are made by employers of participants in such plan.

(4) Is the plan "in effect" for the year? If the plan is new, the minimum funding standards apply for the first year the plan is in effect.

a. Regulation 1.410(a)-(2)(c) provides that for purposes of that section a plan is considered to be in existence on a particular day if (i) the plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed under the plan as of such day, and (ii) the plan was not terminated on or before that day.

1.3.2 Terminating Plans

(1) Minimum funding rules apply until the end of the plan year in which a plan is terminated. Rev. Rul. 79-237, 1979-2 C.B. 190, provides rules for determining the charges and credits to the funding standard account in the plan year in which the plan is terminated.

NOTE: The current funding method for the plan continues to apply in the year of termination unless the method is changed using Rev. Proc. 95-51, or a ruling is requested under Rev. Proc. 78-37.

(2) If the plan termination occurs during the year, the date of termination does not make the plan year any shorter.

(3) Certain charges and credits, however, are prorated based on the days up to the termination date divided by 365 days. This includes:

a. Normal Cost for the plan year
b. Certain amortization charges and credits.

(4) Other charges and credits are not prorated, e.g.:

a. Employer contributions
b. Any special credit for a waived funding deficiency for the year
c. Amount credited due to switch back from alternate minimum funding standard account
d. Full funding limitation credit
e. Interest (interest is credited or charged at the usual rate to the end of the plan year)
f. Prior year funding deficiency or credit balance.

(5) Contributions for the plan year made after the plan year but not later than 8½ months after the end of the plan year can still be considered as contributions for the plan year and are deemed made on the last day of the plan year.

(6) The 10% excise tax (IRC 4971(a)) applies to any funding deficiency for that plan year. No additional 10% excise taxes will apply for any subsequent year.

(7) The 100% penalty tax (IRC 4971(b)) applies if the

funding deficiency as of the end of the plan year is not corrected, (unless waived, see Rev. Proc. 81-44).

(8) A Schedule B is required for all defined benefit plans of any size for all plan years including the year of termination. After the plan year in which the plan is terminated ends, minimum funding ceases and Schedule B's are no longer required.

Examination Tip: If a Schedule B is filed for a subsequent year it is possible that the plan did not terminate. Make sure that there actually was a termination and that the assets were distributed as soon as administratively feasible but within a year of the termination date. See also Rev. Rul. 89-87, 1989-2 C.B. 81, for situations where a plan is not considered terminated.

(9) If a complete distribution of assets occurs during the year of termination, the 5500 and Schedule B are due 7½ months after the distribution. However, this does not shorten the 8½ month period after the end of the full plan year to have contributions credited to the funding standard account for that year.

(10) For defined contribution plans, the minimum funding standard charges will reflect the entire amount of any contributions due on or before the date of termination, but no contributions due after that date. For this purpose, a contribution is due as of the earlier of:

a. the date specified in the plan, or
b. the date as of which the contribution is required to be allocated.

1.4 Computation of Amounts Required Under IRC 412 - Defined Benefit Rules

(1) There are a number of factors to consider when calculating the amount required under IRC 412 in a defined benefit plan. The following factors are described below. See also, Asset Valuation Guidelines, Examinations Handbook, IRM 7(10)54:326.4.

a. Actuarial Valuation
b. Funding Method
c. Actuarial Assumptions
d. Valuation of Assets
e. Current Liability
f. Full Funding Limitation

1.4.1 Actuarial Valuation

(1) IRC 412(c)(9) requires that an annual valuation, in which a plan’s liability and experience gains and losses are

determined, be done at least once every year.

(2) IRC 6059 requires the periodic filing (currently annually), by the plan administrator for each defined benefit plan to which IRC 412 applies, of an actuarial report, prepared and signed by an enrolled actuary. The contents of the actuarial report must include a description of the funding method and actuarial assumptions used to determine costs under the plan, and the contribution necessary to reduce the accumulated funding deficiency to zero.

(3) Reg. 301.6059-1(a) provides that, for defined benefit plans subject to the minimum funding standards of IRC 412, the plan administrator must file the actuarial report, certified by an enrolled actuary, on the Schedule B attachment to Form 5500. This is the actuarial report required under IRC 6059.

(4) An actuarial valuation is a snapshot of the assets and liabilities of the plan on the valuation date. The actuary values the projected plan benefits and then, after consideration of the plan’s current assets and funding method, expresses the result as an annual cost.

1.4.1.1 Valuation Date

(1) The valuation date must be a date during the plan year. A change in the valuation date is considered to be a change in funding method. Automatic approval might be applicable. See Rev. Proc. 95-51 and section 1.4.2.6, on required approval.

(2) If a plan has been amended (or terminated) during the year, a change in valuation date is sometimes made to reflect the amendment.

1.4.2 Funding Method--Benefit Valuation

(1) A funding method is used to compute the normal cost of a plan for a plan year and, if applicable, any amortizable bases.

1.4.2.1 General Requirements: Funding Methods

(1) A funding method must be reasonable. To be reasonable, the present value of future benefits must equal the following--

- the sum of the present value of normal costs over the future working lifetime of participants,

- plus the sum of the unamortized portions of any amortizable bases,

- plus the plan assets,

- less any credit balance,

- plus any debit balance under IRC 412(b).

- In other words, the basic funding formula in Reg. 1.412(c)(3)-1(b)(1) must be satisfied.

(2) The funding method of a plan includes not only the overall funding method used by the plan but also each specific method of computation used in applying the overall method.

a. Actuarial assumptions are not part of the method.
b. A change in the method of valuing assets is a change in funding method.

1.4.2.2 Inclusion of All Liabilities/Plan Population

(1) All liabilities of the plan, whether vested or not, must be taken into account.

(2) The plan population must include three classes of individuals:

a. Participants currently employed in the service of the employer:

b. Former participants who either terminated service with the employer or retired and are entitled to benefits: and

c. All other individuals currently entitled to benefits.

(3) Plan population exceptions include:

a. Participants not satisfying minimum age and service requirements of IRC 410(a); and

b. Former participants who might become entitled to benefits under the rule of parity.

(4) Reg. 1.412(c)(3)-1(d)(2) provides that while a reasonable funding method must not anticipate the affiliation with the plan of future participants not employed in the service of the employer on the plan valuation date, the affiliation of current employees who have not satisfied the participation requirements of the plan may be anticipated under a reasonable funding method.

NOTE: Terminated vested participants may be excluded from the valuation if their entire benefit has been provided by an insurance contract and such contract is excluded from the assets.

1.4.2.3 Valuing Costs Attributable to Changes in Benefit Structure

Effective After the Valuation Date.

(1) The following guidelines should be used to determine the charges and credits to the funding standard account to reflect changes in benefits that become effective after the valuation date and/or after the first day of the plan year.

(2) Reg. 1.412(c)(3)-1(d)(1) states that, except as provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year. There are several exceptions that have been permitted.

a. Under IRC 412(c)(8), certain amendments made before 2½ months after the end of the plan year (2 years in the case of a multiemployer plan) may be taken into account for funding purposes if made effective as of the first day of the plan year. Benefit increases or decreases may be reflected. If the accrued benefit of any participant as of the earlier of the adoption or effective date is reduced, approval by the Employee Plans Division is required. See Rev. Proc. 94-42, 1994-1 C. B. 717.

b. Rev. Rul. 81-215 permits the anticipation of an increase in the IRC 415 limitation if the increase occurs within the plan year. Rev. Rul. 81-195 illustrates the rules for taking into account a single increase in the 415 dollar limit for a calendar year.

(3) In the case of a change in the benefit structure that becomes effective during a plan year subsequent to a given plan year for which the charges and credits to the funding standard account are being computed, such change in benefit shall not be considered in determining the charges or credits to the funding standard account for such given plan year. See Rev. Rul. 77-2, 1977-1 C.B. 120.

(4) Where a change in benefit structure becomes effective as of a date during a plan year (but after the first day in that plan year), the charges and credits to the funding standard account:

a. should not reflect the change in that benefit structure for the portion of that plan year before the effective date of that change; and

b. should reflect the change in that benefit structure for the portion of the plan year after the effective date of the change. See section 2.02 of Rev. Rul. 77-2, 1977-1 C.B. 120.

(5) Alternatively, a change in benefit structure that is

not adopted on or before the valuation date for the plan year for which it becomes effective may be (but is not required to be) ignored in determining the charges and the credits to the funding standard account for that plan year. Whether such a change is taken into account is part of the cost method adopted and cannot be changed once the annual information return (Form 5500 series) is filed unless an automatic change is made under Rev. Proc. 95-51, 1995-2 C.B. 430, or a ruling is requested under Rev. Proc. 78-37, 1978-2 C.B. 540. See section 3 of Rev. Rul. 77-2, 1977-1 C.B. 120.

1.4.2.3.1 Collectively Bargained Plans

(1) The funding method of a collectively bargained plan (other than a multiemployer plan) must anticipate benefit increases scheduled to take effect during the term of the collective bargaining agreement applicable to the plan, in determining projected benefits. Thus, collectively bargained plans are required to recognize any negotiated benefit increases scheduled to take effect in a future plan year for purposes of the normal funding rules (but not for the rules for underfunded plans.) This is effective for plan years after December 31, 1994. See IRC 412(c)(12), added by RPA ′94.

(2) For plan years beginning before January 1, 1995, for collective bargaining agreements in effect before January 1, 1995, a collectively bargained plan′s funding method could, but was not required to, anticipate scheduled benefit

increases. The way in which scheduled benefit increases were anticipated was part of the plan’s funding method and could not be changed without Service approval.

1.4.2.4 Immediate Gain Funding Methods

(1) A funding method is an immediate gain type method if, under the method the accrued liability:

a. may be determined solely from the computations with respect to the liabilities;

b. is an integral part of the funding method; and

c. is the excess of the present value, as of any valuation date, of the projected future benefit costs for all plan participants and beneficiaries over the present value of future contributions for the normal cost of all current plan participants.

(2) Examples of the immediate gain type of funding method include:

a. unit credit method,
b. entry age normal method, and
c. individual level premium method.

(3) An immediate gain method calculates gains and losses directly. An actuarial gain or loss results in a change in

unfunded actuarial liability.

a. Under an immediate gain type funding method, the total gain or loss is reported on the Schedule B (or can be calculated as the difference between the expected unfunded liability and the actual unfunded liability).

b. The actuarial report may also show a gain and loss analysis by source indicating which gains and losses arose from each assumption.

1.4.2.4.1 Special Considerations under the Unit Credit Service Pro-rate Funding Method

(1) In order to be acceptable the method must determine the projected benefit by projecting the salary, using the assumed salary scale, and projecting any other components, under respective assumptions, that would be used in the calculation of the benefit on the expected separation date, to the age(s) when the benefits are assumed to commence.

(2) For active participants, the projected benefit at each expected separation is allocated to the years of credited service as follows.

a. The portion of the projected benefit allocated to the current year is determined as the projected benefit taking into account only credited service through the end of the current plan year, minus the projected benefit that would be determined for the participant taking into account only credited service through the beginning of the current plan year. The benefit determined as of the end of the current plan year may not be less than the participant’s estimated accrued benefit as of the end of the current plan year.

b. The portion of the projected benefit allocated to prior plan years is the projected benefit taking into account only credited service through the beginning of the current plan year. The portion of the projected benefit allocated to prior plan years may not be less than the participant’s actual accrued benefit as of the beginning of the current plan year.

c. If a participant is expected to satisfy an eligibility requirement for a particular benefit that is being valued (e.g., subsidized early retirement benefit) as of an expected separation date, the amounts above must be determined as if the employee has satisfied the eligibility requirement.

d. When valuing ancillary benefits that are not directly related to the accrued retirement benefit, the portion of the projected benefit allocated to the current plan year is the projected benefit at the expected separation date divided by the number of years of service the participant will have at such date. The portion of such projected benefit allocated to prior years of service is the projected benefit multiplied by a fraction, the numerator of which is the number of years of service at the beginning of the plan year, and the denominator of which is the number of years of service the participant will have at the expected separation date.

(3) For a participant other than an active participant, or for a beneficiary, the projected benefit is the accrued retirement benefit, or other plan benefit, under the terms of the plan and the projected benefit is allocated to prior plan years.

1.4.2.5 Spread Gain Funding Methods

(1) A funding method is a spread gain type method if it is not an immediate gain type method.

(2) Examples of the spread gain type of funding method include the:

a. Aggregate method;

b. Frozen initial liability method; and

c. Attained age normal method.

(3) In order for the basic funding formula in Reg. 1.412(c)(3)-1(b)(1) to be satisfied for a plan that uses a spread gain method and has a zero unfunded liability (e.g., the aggregate method), the assets used to determine the normal cost for minimum funding purposes must be adjusted. The assets must be decreased by any credit balance (or increased by any accumulated funding deficiency) in the funding standard account as of the valuation date.

(4) If a plan uses a spread gain funding method, gains and losses are not directly calculated but are spread over current and future years in the determination of the normal cost. Thus, an experience gain will cause a decrease in the normal cost accrual rate and an experience loss will cause an increase.

(5) If it appears that gains or losses are substantial and from sources likely to recur, the specialist may request a breakdown of the gains and losses from the plan actuary (if not provided in the actuarial report) or contact the district actuary for assistance.

(6) Gains and losses under a spread gain method can only be approximated.

NOTE: A change in a normal cost rate under a spread gain method may be due to various non-recurring events, including non-actuarial events such as plan changes, substantial increases or decreases in covered population or changes in assumptions. If the actuarial report does not show the change in normal cost rate due to these events, obtain the information from the plan actuary or contact the district actuary.

(7) Spread gain methods generally express normal cost in either a format that calculates an accrual rate or a format that calculates a constant dollar amount.

Example 1: A format that calculates an accrual rate might look like this:

$$\text{Normal Cost Accrual Rate} = \frac{\text{Present Value of Projected Benefits} - \text{Actuarial Asset Value} - \text{Unfunded Liability}}{\text{Present Value of Future Compensation}}$$

The fraction is the normal cost accrual rate. This rate multiplied by current pay equals the dollar amount of normal cost for that individual.

NOTE: The normal cost rate would be a constant percentage of compensation if all the plan’s assumptions are realized (and assuming no changes in plan provisions or assumptions).

Example 2: A spread gain method that calculates a normal cost as a constant dollar amount might look like this:

$$\text{Normal Cost Per Participant} = \frac{\text{Present Value of Projected Benefits} - \text{Actuarial Asset Value} - \text{Unfunded Liability}}{\text{Present Value of \$1 Annuity to Retirement Age}}$$

The normal cost per participant is multiplied by the number of participants who are below retirement age to get the normal cost for the plan.

If all the plan’s assumptions are realized, the level normal cost per participant under a spread gain method which calculates the normal cost as a constant dollar amount per employee would be unchanged.

1.4.2.5.1 Individual Aggregate Funding Method: Special Considerations

(1) If the funding method is a spread gain method that allocates the assets between participants for purposes of computing the normal cost for each participant, such an allocation must be reasonable to satisfy Reg. 1.412(c)(3)-1(c)(5). If this requirement is not satisfied, the funding method will not produce level normal costs as required by Reg. 1.412(c)(3)-1(b).

(2) Some acceptable allocation formulas are to allocate assets in proportion to the:

a. Prior year’s allocated assets plus the prior year’s normal cost, both increased with interest to the valuation date; or

b. Current year’s accrued liability under the traditional individual level premium method.

(3) For the first year of this method as a transition from a different method, it is acceptable to allocate assets in proportion to the present value of projected or accrued benefits.

(4) Some unacceptable allocation formulas, because they will not produce level normal costs, are to allocate assets in proportion to:

- present value of projected benefits;
- present value of accrued benefits;
- projected benefits; or,
- accrued benefits.

Under these unacceptable methods, when a new participant enters the plan or when additional benefits accrue, assets are reallocated from other participants resulting in a non-level normal cost.

1.4.2.6 Change In Funding Method

(1) In the past, the Service has issued guidance which specified conditions under which approval for certain changes in funding method would be automatically permitted, saving the plan sponsor the burden of requesting a ruling from the Service. Currently, the only guidance in effect is provided under Rev. Proc. 95-51, 1995-2 C.B., 430.

(2) Rev. Proc. 95-51 permits an automatic approval for a change in cost method to one of nine different cost methods, a change in the valuation date to the first day of the plan year, and a change to one of three asset valuation methods. Each of the cost methods and asset valuation methods is described in detail in the revenue procedure.

(3) If automatic approval does not apply for a plan, approval must be requested from the Employee Plans Division (Actuarial Branches) in Headquarters (formerly referred to as National Office). For automatic approval to be available, certain conditions must be satisfied. These conditions are specified in sections 5 and 6 of Rev. Proc. 95-51.

a. Rev. Proc. 95-51 states that a change will not be eligible for automatic approval if the cost method is being changed and it has been changed in any of the preceding 4 plan years, if the valuation date is being changed and has been changed in any of the preceding 4 plan years, or if the asset valuation method is being changed and has been changed in any of the preceding 4 plan years.

b. Similarly, a change in method which is made in connection with a plan spinoff or a plan merger, with respect to a cash balance plan, or for a plan with a negative unfunded liability (i.e., in surplus) is not automatically approved.

(4) The revenue procedure grants automatic approval for certain required changes. For example, automatic approval is granted for:

a. a collectively bargained plan to change its method to anticipate future benefit increases that are part of a collectively bargained agreement; and

b. certain funding method changes which are required when the current method becomes unreasonable (i.e., when negative normal costs are calculated under the aggregate method). Such changes may be made regardless of whether a change has been made during the preceding 4 plan years.

(5) Any amortization base which is established on account of a change in funding method which is automatically approved under Rev. Proc. 95-51 has an amortization period of 10 plan years.

a. In addition, changes for which an individual ruling letter is issued, which were requested after the date that Rev. Proc. 95-51 was issued, will also be subject to the 10 year amortization rule.

b. Amortization bases due to changes in funding methods which were either automatically approved under prior guidance or approved by Headquarters could have different amortization periods. Prior guidance would specify the applicable period of amortization. Likewise, a ruling letter from Headquarters would specify the period of amortization for an approved change in method.

1.4.3 Actuarial Assumptions

(1) IRC 412(c)(3) requires that costs, liabilities, rates of interest, and other factors under a plan be determined using reasonable assumptions.

1.4.3.1 Reasonable Assumption Requirements

(1) Each actuarial assumption and method must be reasonable (taking into account actual plan experience and reasonable expectations) or the assumptions in aggregate must result in a total contribution which is equivalent to that which would be determined if each such assumption and method were reasonable.

a. In the case of a multiemployer plan, this criterion is satisfied if assumptions are reasonable in the aggregate taking into account the experience of the plan and reasonable expectation of future experience.

(2) The actuarial assumptions must, in combination, be the actuary’s best estimate of anticipated experience under the plan.

1.4.3.2 Adjustment of Plan Costs

(1) If the assumptions have been found to be unreasonable, the minimum funding standards and deductible limits must be

redetermined on the basis of reasonable assumptions. There are several possible redetermination methods.

a. The preferable method is for the plan actuary to perform a new actuarial valuation using revised assumptions that he/she can demonstrate to be reasonable.

Examination Tip: If the actuary for the plan is unwilling or unable to perform a new actuarial valuation using revised assumptions, consult the district actuary.

1.4.3.3 Additional Comments

(1) If plan costs are attributable primarily to participants with benefits at the IRC 415 dollar limit or compensation at the IRC 401(a)(17) limit, a salary scale has little effect.

(2) If it is necessary to review the salary scale, the Schedule B will either indicate a constant rate of salary increase or show ratios of salary at retirement to salary at age 25, 40 and 55. The following table will convert these ratios to an average annual rate of salary increase. The numbers can also be derived through the use of a hand calculator.

Age	Rate of Avg. Salary Increase	Ratio at various retirement ages 55	60	62	65
25	2%	181%	200%	208%	221%
25	5	432	552	608	704
25	8	1006	1479	1725	2172
40	2	135	149	155	164
40	5	208	265	293	339
40	8	317	466	544	685
55	2	-	110	115	122
55	5	-	128	141	163
55	8	-	147	171	216

(3) Interest rates used to determine the current liability are within a range mandated by law and are not subject to reasonable assumption requirements.

Examination Tip: Refer all cases involving unreasonable actuarial assumptions to the district actuary for guidance.

1.4.4 Valuation of Assets

(1) In defined benefit plans the value of the assets is an important part of the overall valuation method. IRC

412(c)(2) permits the use of the actuarial value of assets instead of the market value.

(2) The actuarial value of plan assets may be determined on the basis of any reasonable method of valuation which takes into account fair market value and which is permitted under the regulations. Reg. 1.412(c)(2)-1(b) provides the following six requirements.

a. The actuarial asset valuation method must be applied on a consistent basis.

b. The method of determining the actuarial value (but not fair market value) of the assets must be specified in the plan’s actuarial report (required under IRC 6059).

c. The same day or days (such as the first or the last day of a plan year) must be used for all purposes to value the plan’s assets for each plan year, or portion of plan year, for which a valuation is made.

d. The valuation method must take into account fair market value by making use of the (i) fair market value, or (ii) average value of the plan’s assets as of the applicable asset valuation date. (Average value is described in Reg. 1.412(c)(2)-1(b)(7).

e. A method will not be considered reasonable if it is designed to produce a result which will be consistently above or below the fair market value or the average value of plan assets.

f. The actuarial value must fall between a minimum of 80% of market value and 120% of market value. All asset valuation methods, except those used by multiemployer plans, are subject to the 80 - 120 corridor.

(3) Multiemployer plans are also permitted to use a corridor for the actuarial value of not more than 115% of average value and not less than 85% of average value.

a. Section 9303(c) of the Pension Protection Act of 1987 (which was part of the Omnibus Reconciliation Act of 1987, (OBRA ′87)) provided that, effective with plan years beginning after December 31, 1987, the regulations under IRC 412(c)(2) which permit a plan to use the 85 - 115 corridor around average value shall not apply to plans other than multiemployer plans.

NOTE: The changes made by OBRA ′87 have not yet been reflected in the regulations.

(4) Because a change in the method of valuing assets is a change in funding method, such change must either fall under a current revenue procedure providing automatic approval or a letter ruling must be obtained from the Employee Plans

Division, (Actuarial Branches) in Headquarters approving the new method for valuing the assets. A method may satisfy the consistency requirement even though computations are based only on the period elapsed since the adoption of the method or on asset values occurring during that period.

1.4.5 Current Liability

(1) Calculating a plan’s current liability became part of the actuary’s job with the enactment of OBRA ’87. OBRA ’87 mandated that current liability be calculated using an interest rate in the "permissible range", but did not specify a mortality table. Current liability calculated according to the rules under OBRA ’87 is referred to as the "OBRA ’87 current liability".

(2) Further restrictions on the interest rate and mortality table used to calculate current liability were enacted by RPA ’94. Current liability calculated according to the rules under RPA ’94 is referred to as "RPA ’94 current liability".

1.4.5.1 General Definition of Current Liability

(1) "Current liability" is defined in IRC 412(l)(7) as all liabilities to employees and their beneficiaries under the plan.

(2) In general terms, current liability is the sum of the present values of liabilities attributable to credited service earned through the end of the prior plan year for each participant, calculated using actuarial assumptions permitted under the Code for these purposes.

1.4.5.2 OBRA ’87 Current Liability

(1) Under OBRA ’87, current liability must be calculated using an interest rate in a permissible range around a weighted average interest rate. See Notice 88-73, 1988-2 C.B. 383, for a description of the methodology used to compute the weighted average interest rate and the permissible range.

(2) The Service issues a monthly notice in the Internal Revenue Bulletin which provides the weighted average interest rate, the permissible range, and the average yield on 30-year Treasury Constant Maturities for the month.

(3) While no specific mortality table is required to be used for calculating OBRA ’87 current liability, the same mortality table generally used for purposes of IRC 412 is used for this calculation.

1.4.5.3 RPA ’94 Current Liability

(1) Under RPA ’94, the upper limit for the highest interest rate in the permissible range of interest rates used to calculate current liability was reduced by one percentage point per year for plan years beginning after 1994, until reaching 105% (of the weighted average interest rate) for 1999 and subsequent years. See Q&A-9(1) of Rev. Rul. 96-21, 1996-1 C.B. 64, for specific circumstances under which the OBRA ’87 interest rate may be different from the RPA ’94 interest rate.

(2) RPA ’94 also required that the mortality table used for determining current liability must be the table prescribed by the Secretary. Such a mortality table (1983 G.A.M.) for calculating current liability for non-disabled lives for plan years beginning after 1994 was provided in Rev. Rul. 95-28, 1995-1 C.B. 74. For years after 1999, such mortality table may be updated by the Service. See IRC 412(l)(7)(C).

(3) For the special rules and mortality table that may be used to compute current liability for disabled lives, see IRC 412(l)(7)(C) and Rev. Rul. 96-7, 1996-1 C.B. 59.

1.4.5.4 General Comments

(1) The other actuarial assumptions used in calculating OBRA ’87 and RPA ’94 current liability must each be the same assumption as that used for calculating other costs for the funding standard account.

(2) The actuary must take into account rates of early retirement and the plan’s early retirement provisions.

(3) Turnover assumptions may be included to reflect the probability that currently employed nonvested or partially vested participants will terminate employment prior to becoming fully vested.

(4) Both current liabilities are computed taking into account only credited service through the end of the prior plan year.

(5) No salary scale projections should be used in these computations. See Notice 90-11, 1990-1 C.B. 319.

(6) In determining a plan’s current liability, any unpredictable contingent event benefit is not taken into account until the event on which the benefit is contingent occurs. See IRC 412(l)(7)(B).

(7) Under IRC 412(c)(5), changes in assumptions used to determine current liability that result in decreases in current liability may require approval by the Secretary (discussed below).

(8) Where calculations under IRC 415 are required to determine participants’ accrued benefits, the mortality

table and interest rate used to adjust benefits and limitations must satisfy IRC 415(b)(2)(E) as amended by RPA ’94 and the SBJPA.

(9) Both OBRA ’87 and RPA ’94 current liabilities and the interest rates used for their calculation are reported on the Schedule B of Form 5500.

1.4.5.5 Current Liability Increase

(1) The current liability for a plan year is calculated taking into account credited service as of the end of the prior plan year but computed as of the valuation date.

(2) Where an end of year current liability figure is required, the current liability at the valuation date is adjusted to the end of the year.

(3) See Q&A-7 of Rev. Rul. 96-21 for the methodology used to adjust current liability for purposes of applying the transitional rule under IRC 412(l)(11).

(4) Although the individual may be accruing an additional benefit during the year, the end of year current liability described above does not include the liability for any additional piece of benefit accruing during the year.

a. The expected increase in current liability due to benefits accruing during the plan year is separately calculated and reported on Schedule B of Form 5500.

b. In determining the expected increase in current liability through the end of the year where the actuarial assumptions include a salary scale assumption, the salary increase may be used to compute the expected increase in accrued benefits through the end of the plan year (but may not be used to project increases in accrued benefits for later years).

(5) Under RPA ’94, the expected increase in current liability due to benefits accruing during the year is taken into account in calculating the deficit reduction contribution and the limitation on the additional funding requirement. See IRC 412(l).

1.4.5.6 Important Current Liability Calculations

(1) Two important calculations under IRC 412(l) are those to calculate "unfunded current liability" and the "funded current liability percentage". Because these are calculations under IRC 412(l), for years after 1994 the assumption requirements of IRC 412(l)(7)(C) must generally be satisfied (i.e., RPA ’94 current liability is used unless otherwise specified).

(2) Unfunded current liability with respect to a plan year is defined in IRC 412(l)(8)(A) as the excess (if any) of the current liability under the plan, over the value of the plan’s assets as determined under IRC 412(c)(2).

(3) The funded current liability percentage with respect to a plan year is defined in IRC 412(l)(8)(B) as the percentage which the value of the plan’s assets, as determined under IRC 412(c)(2), is of the current liability under the plan.

a. Some uses of the funded current liability percentage (e.g., the funded current liability percentage used in calculating the amount that the IRC 412(l) additional funding charge must not exceed) require that such percentage is calculated taking into account the expected increase in current liability due to benefits accruing during the plan year.

b. IRC 412(l)(8)(E) states that for purposes of IRC 412(l) the assets are decreased by any credit balance. For some calculations, it may be specified otherwise. For example, in determining the applicability of IRC 412(l) to a plan under IRC 412(l)(9) and in determining the limitation of IRC 412(c)(7)(E), the assets used to determine a plan’s funded current liability percentage are not decreased by the credit balance.

1.4.5.7 Where Current Liability Is Used

(1) A plan’s current liability and funded current liability percentage for a plan year must be calculated to determine certain limitations applicable to the plan and whether the plan is subject to the requirements of certain Code sections for the plan year.

a. The prevailing full funding limitation

b. Additional funding charge under IRC 412(l)

c. Quarterly contribution requirement under IRC 412(m)

d. Liens under IRC 412(n)

1.4.5.8 Approval to Change Current Liability Assumptions Required Under Certain Circumstances

(1) In certain instances, approval from the Service is required to change the actuarial assumptions used to determine the current liability of a plan. Approval to change assumptions may be required for plans other than multiemployer plans that are subject to Title IV of ERISA that have certain minimum decreases in the current liability.

(2) No approval is required to change assumptions in order to comply with the assumption restrictions under IRC

412(l)(7)(C), (i.e., the interest rate and mortality assumptions described above).

(3) If any of the <u>other</u> assumptions used to determine the current liability are changed (e.g., retirement rates under the plan), approval from the Service must be obtained for certain plans that do not meet any one of three conditions described below. If the plan is able to satisfy any one of these three conditions, the plan sponsor is <u>not</u> required to obtain approval from the Service for these changes.

a. The first condition is that the aggregate unfunded vested benefits as of the close of the plan year preceding the year in which assumptions were changed for the plan, for the plan and all other plans maintained by contributing sponsors and members of such sponsor’s controlled group which are covered by Title IV of ERISA, are less than or equal to $50 million.

b. The second condition is that the change in assumptions resulted in a decrease in the current liability of less than or equal to $5 million.

c. The third condition is that the decrease in the current liability is less than five percent of the current liability before such change, even though the decrease was greater than $5 million and less than or equal to $50 million.

d. If any one of these three conditions is met, approval for the change in assumptions is not required from the Service.

1.4.6 Full Funding Limitation

(1) Before the plan actuary can complete calculations for the required minimum funding charge, the full funding limitation applicable to the plan for the plan year must be determined. This will affect the amount of employer contribution which can be made and the amount of contributions which will be deductible.

1.4.6.1 Currently Applicable Full Funding Limitations

(1) Under IRC 412(c)(7), as amended by RPA ’94, the full funding limitation is equal to the lesser of the full funding limitations determined in 1.4.6.1.1 or 1.4.6.1.2, but is not less than the limitation in 1.4.6.1.3.

(2) The full funding limitations are reported on Schedule B of Form 5500.

1.4.6.1.1 The Accrued Liability or ERISA Full Funding Limitation

(1) The sum of the accrued liability and normal cost (both brought to the end of the year with interest) minus the value of plan assets (also brought to the end of the year with interest).

(2) This full funding limitation is referred to as either the "accrued liability full funding limitation" or the "ERISA full funding limitation".

(3) For this purpose:

- The accrued liability is determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan;

- The interest rate is the valuation rate; the accrued liability is generally on an ongoing basis; and

- The value of assets is the lesser of the fair market value or the actuarial value determined under IRC 412(c)(2); and assets are decreased by the credit balance.

1.4.6.1.2 The OBRA ’87 or 150% Current Liability Full Funding Limitation

(1) 150% of current liability (including the expected increase in current liability due to benefits accruing during the plan year), brought to the end of the year with interest using the current liability interest rate, minus the asset value brought to the end of the year with interest at the valuation rate.

(2) This full funding limitation is referred to as either the "OBRA 87 full funding limitation" or the "150% current liability full funding limitation".

(3) For this purpose:

- The value of assets is the lesser of the fair market value or the actuarial value of assets determined under IRC 412(c)(2), and assets are decreased by any credit balance.

- Current liability has the meaning given to it under IRC 412(l)(7) without regard to IRC 412(l)(7)(C) and (D).

1.4.6.1.3 The RPA ’94 Override

(1) IRC 412(c)(7)(E) provides that the full funding limitation determined under IRC 412(c)(7)(A) shall not be less than 90% of the current liability (including the expected increase in current liability due to benefits accruing during the plan year) brought to the end of the year with interest using the current liability interest rate, minus the actuarial value of assets as determined under IRC 412(c)(2) brought to the end of the year with interest at the valuation rate.

(2) This limitation is referred to as the "RPA ’94 override".

(3) For these purposes: the RPA '94 interest and mortality assumptions of IRC 412(l)(7)(C) are used, and assets are not reduced by the credit balance.

1.5 Funding Standard Account

(1) Plans subject to IRC 412 are required to maintain a funding standard account or, if elected, an alternative minimum funding standard account. The funding standard account is the administrative tool used to insure proper implementation of the funding standards.

(2) The funding standard account is included in Schedule B of Form 5500 and is completed by the plan's enrolled actuary. The funding standard account is made up of a number of charges and credits.

1.5.1 Charges to the Funding Standard Account

(1) Prior year funding deficiency, if any

(2) Employer's normal cost for plan year

(3) Amortization charges (initial past service liability if applicable, waivers, experience losses, amendments, changes in assumptions, changes in funding method, charges due to alternative minimum funding standard)

(4) Interest

(5) Interest due to late quarterly contributions (or unpaid liquidity shortfall), if applicable

(6) Additional funding charge (see section 1.5.6.3), if applicable

1.5.2 Credits to the Funding Standard Account

(1) Prior year credit balance, if any

(2) Employer’s contribution for plan year

(3) Amortization credits (experience gains, amendments, changes in assumptions, changes in funding method, credits due to switch from alternative minimum funding standard)

(4) Full funding limitation credits (see section 1.5.6.1)

(5) Waived funding deficiency if applicable

(6) Interest

1.5.3 Examining the Funding Standard Account

(1) The following issues should be considered during an examination of the funding standard account found on Schedule B of Form 5500.

(2) Verify both the amount and the origin of each item charged or credited to the funding standard account.

(3) Amortization schedules should also be scrutinized to ascertain whether items which are subject to amortization have been correctly amortized in accordance with IRC 412(b) or (g) or other guidance issued by the Service (e.g., Rev. Proc. 95-51 provides for amortizing changes in the funding method).

(4) Since the funding standard account is a cumulative account, the end of year credit balance from one plan year becomes the beginning of year credit balance for the following plan year.

a. If the balances are not the same, the actuary may have revised the balance to correct for errors discovered with respect to prior years or for changes such as mergers or spinoffs occurring during the year. If this is the case, the detailed worksheets should be secured and reviewed before the revised credit balance is accepted.

b. Funding deficiencies may have been corrected by timely contributions made after the preparation of the Schedule B.

(5) Items in the amortization schedules are also based on prior year amounts brought forward.

(6) Request assistance from the district actuary as needed in this review.

1.5.4 Normal Cost

(1) The normal cost is determined based on the funding method being used and may be expressed as:

a. a level dollar amount, or a level percentage of pay, that is computed from year to year on either an individual basis or an aggregate basis, or

b. an amount equal to the present value of benefits accruing for a particular plan year

(2) For spread gain methods, the normal cost reflects experience gains and losses.

(3) Under all funding methods, normal cost may be affected by amendments to the plan, changes in demographics (e.g.,

turnover, new participants, increases in compensation) and changes in assumptions.

Examination Tip: The attachments to the Schedule B may include summary data, summary of benefit provisions and summary of assumptions and funding method. It should include information regarding changes. Additional explanations may be found in actuarial valuation reports. Review this information and check the normal cost for reasonability.

1.5.5 Amortization of Unfunded Accrued Liability

(1) Review amortization schedules to determine whether items have been correctly amortized in accordance with IRC 412(b) or (g).

(2) The Schedule B of Form 5500 includes the total of unfunded accrued liability charges and the total of unfunded accrued liability credits shown separately.

(3) The attachment to the Schedule B should include a maintenance schedule with each base shown separately. This schedule usually includes:

a. Date established

b. Amount of original base

c. Type of base (e.g. amendments, experience, etc.)

d. Outstanding balance (unfunded amount)

e. Period remaining

f. Amortization charge or credit amount

1.5.5.1 Items to Verify

(1) Whether the type of base is appropriate for the funding method (and other facts).

a. The types of unfunded accrued liability bases established vary with the funding method being used. The aggregate and individual aggregate funding methods do not normally have any unfunded accrued liability bases. (An exception might be if a waiver was being amortized.)

b. No spread gain method (i.e. aggregate, individual aggregate or frozen initial liability funding method) should have experience gains and losses being amortized.

c. If the plan is using an immediate gain funding method (i.e. entry age normal, unit credit, projected unit credit), an experience gain or loss is usually established each year.

d. If the plan is amended, a past service liability is usually established unless the plan is using an aggregate funding method.

(2) Whether the amortization period being used is correct.

a. The amortization period varies based on the date the liability was established and the purpose it was established for.

b. Multiemployer plans are subject to different period requirements than other plans.

c. For non-multiemployer plans, amortization periods for initial unfunded liability and unfunded liability due to amendments are:

Initial base for plans in effect 01/01/74	40 years
Initial base for plans established after 01/01/74	30 years
Plan amendments	30 years

d. For non-multiemployer plans, experience gains and losses amortization periods for:

Plan years beginning prior to 1988*	15 years
Plan years beginning 1988* and later	5 years

(* Notice 88-52 contains transition rules for 1988)

e. Amortization periods for changes in actuarial assumptions for:

Plan years beginning prior to 1988	30 years
Plan years beginning 1988 and later	10 years

f. Amortization charges may be combined into one amount and amortized over a period equal to the remaining amortization period for all items combined. Similarly, amortization credits may be combined. Amortization charges and credits may be offset and amortized over a period equal to the remaining amortization period of the greater of the charges or credits. Proposed Reg. 1.412(b)-1(d)(3) provides an acceptable methodology for computing the remaining amortization period.

(3) Whether the amortization amount is correct.

a. Check the amortization charge or credit by using a financial calculator and spreading the unfunded portion of the liability over the remaining amortization period at the valuation pre-retirement interest rate.

(4) Whether the outstanding balance (unfunded amount) has been brought forward correctly.

a. The unfunded amount should be equal to the prior year's unfunded amount reduced by the amortization charge or credit and increased by interest using the prior year's valuation pre-retirement interest rate.

(5) Whether the "equation of balance" is satisfied.

a. The net outstanding balance of amortization charges and credits minus the prior year's credit balance (each adjusted with interest, if necessary) should equal the unfunded accrued liability of the plan. You should ask for an explanation if the plan does not meet this "equation of balance" test.

1.5.5.2 Special Rules For Multiemployer Plans

(1) Multiemployer plans are subject to various special rules. The quarterly contribution and deficit reduction contribution requirements do not apply to multiemployer plans. Multiemployer plans in reorganization are subject to special rules. See section 1.5.7.

1.5.5.2.1 Other Differences for Multiemployer Plans

(1) Amortization periods for multiemployer plans: multiemployer plans are subject to different amortization period requirements than other plans.

a. For multiemployer plans, initial or plan amendment bases established prior to such date (including certain amendments adopted prior to such date but effective in a subsequent year), for a plan which was a multiemployer plan before the date of enactment of the Multiemployer Pension Plan Amendments Act (MEPPAA) of 1980, the amortization period is 40 years.

b. Initial base or plan amendment base established after MEPPAA is amortized over 30 years.

c. Experience gains and losses, if established prior to MEPPAA are amortized over 20 years, and if established after MEPPAA are amortized over 15 years.

d. Changes in actuarial assumptions are amortized over 30 years.

(2) Withdrawal liability for multiemployer plans

a. IRC 412(b)(7)(A) provides that amounts received by a multiemployer plan in payment of all or a part of an employer’s withdrawal liability are considered an amount contributed by the employer to or under the plan.

b. Additional charges and credits to the funding standard account may be applicable to prevent withdrawal liability payments from being unduly reflected as advance funding for plan liabilities.

(3) Treatment of amendments for multiemployer plans: See section 1.4.2.3.1 for rules for anticipated increases in collectively bargained plans.

1.5.5.2.2 Shortfall Rules for Collectively Bargained Plans (Including Multiemployer Plans)

(1) Collectively bargained plans, whether single-employer or multiemployer, may elect to use the shortfall method.

(2) The shortfall method is intended to "correct" for year-to-year fluctuations in the hours of service (or units of production) on which actual contributions are based if contributions are made at a rate specified under the terms of a legally binding agreement applicable to the plan. See section 1.5.9.1 for shortfall rules for collectively bargained plans.

1.5.5.3 Extension of Period Under IRC 412(e)

(1) IRC 412(e) and Reorganization Plan No. 4 give the Secretary of Treasury the authority to extend the amortization period for any unfunded liability.

(2) Amendments increasing liabilities could cause the extension to no longer apply.

(3) A special interest rate is used for such extension, i.e. the greater of the plan rate or 150% of the federal mid-term rate for the first month of such plan year. In the

case of a multiemployer plan, the rate under IRC 6621(b) is used.

Examination Tip: If an extension was granted, review relevant documents.

1.5.6 Special Charges and Credits

(1) Special charges and credits to the funding standard account include:

- Full funding credit
- Waiver charges and credits
- Additional funding charges
- Additional interest charges
- Alternative minimum standard and switchbacks

1.5.6.1 Full Funding Credit

(1) To avoid overfunding IRC 412(c)(7) provides the full funding limitation, which was discussed earlier in section 1.4.6, as the lesser of the accrued liability full funding limitation or the current liability full funding limitation (but not less than the RPA ’94 override).

(2) The accrued liability full funding limitation equals the excess of the accrued liability (including normal cost)

at the close of a plan year over the lesser of the fair market value of the plan’s assets or the actuarial value under IRC 412(c)(2). See section 1.4.6.1.1.

(3) The current liability full funding limitation equals the excess of 150% of current liability (including the expected increase in current liability due to benefits accruing during the plan year) over the lesser of the fair market value of the plan’s assets or the actuarial value under IRC 412(c)(2). See section 1.4.6.1.2.

(4) There is also a minimum 90% current liability full-funding limit which uses a more restrictive definition of current liability. See section 1.4.6.1.3.

1.5.6.1.1 Computing the Full Funding Credit

(1) If the accumulated funding deficiency (calculated without regard to any credit balance for the plan year or any contributions made for that plan year) exceeds the applicable full funding limitation (calculated as of the valuation date and projected, if necessary, to the end of the plan year), then the amount of the excess is credited to the funding standard account for that plan year.

a. If the accrued liability full funding limitation applies, the excess is credited in the funding standard account and the amounts described in IRC 412(c)(6)(B) will be considered fully amortized as of the end of the plan year.

b. If only the current liability full funding limitation applies, then the excess is credited to the current funding standard account, a ten year charge base is established equal to this amount as of the beginning of the next plan year, and bases are not considered fully amortized.

c. If both the current liability full funding limitation and the accrued liability full funding limitation are less than the accumulated funding deficiency calculated as described above, then two special full funding credits will be given in the funding standard account with the current liability full funding special credit becoming a ten year charge base at the beginning of the next plan year, and the accrued liability special credit resulting in the specified bases treated as fully amortized as of the end of the plan year.

1.5.6.2 Waiver Charges and Credits

(1) IRC 412(d) gives the Secretary of Treasury the authority to waive the funding deficiency in hardship cases.

This authority has been delegated to the Director, Employee Plans Division. See Rev. Proc. 94-41.

1.5.6.2.1 Waiver of the Minimum Funding Requirement

(1) A plan may develop a funding deficiency as of the end of a plan year because the company sponsoring the plan cannot afford to contribute the amount required to prevent a funding deficiency for that year. If this is the case, the company may request a waiver in the amount required to bring the balance of the funding standard account to zero as of the end of the plan year.

a. When a waiver is requested timely and granted, the minimum funding standard account for the plan year for which the waiver is granted is credited with the amount waived.

b. Such amount must also be amortized by charges to the account beginning with the year following the year for which the waiver is granted.

Examination Tip: If there are any charges or credits to the funding standard account that indicate that a waiver has been granted for the current or past years, verify that a waiver was granted.

1.5.6.2.2 Plan Amendments While Waiver Being Amortized

(1) IRC 412(f) provides that, with certain exceptions, a waiver will cease to apply if the plan is amended while the waiver is being amortized and plan liabilities increase as a result of the amendment.

(2) This could happen if the plan amendment increases benefits through a change in benefit accrual or a change in the rate at which plan benefits become nonforfeitable.

(3) If a plan is so amended during a plan year, the full remaining balance of the waiver becomes a charge in the funding standard account.

(4) IRC 412(f)(2) provides for certain exceptions to this rule for amendments where the plan sponsor has requested and received a ruling that the changes are reasonable and the increased liability is de minimis in amount. See Rev. Rul. 79-407 and Rev. Proc. 79-62. If such a ruling letter was received and is being adhered to, the amendment will not adversely affect the amortization of the waiver.

1.5.6.2.3 Waiver Conditions

(1) Waivers that are granted frequently contain conditions necessary for the waiver to be valid. Conditions are

usually designed to protect the benefit security of the participants. Examples include conditions which require:

a. Security approved by the Pension Benefit Guaranty Corporation (PBGC);

b. Repayment of waived amounts over a shorter period than otherwise specified in the Code;

c. Specific required cash payments at certain specific dates; or

d. Special allocation procedures on plan termination.

(2) Inspect the document granting the waiver to determine whether all the conditions contained in the document have been satisfied. Generally, the waiver will remain in force as long as the conditions are met. If the terms of the waiver have not been followed, the waiver becomes retroactively null and void. That means the amounts owed for all plan years will be recomputed as if the waiver never existed.

1.5.6.2.4 Special Interest Rate for Amortization

(1) The interest rate and period used to determine the waiver amortization amount depend on the date the waiver was requested and the plan year it was first required to be amortized, respectively.

(2) The following rules determine the interest rate according to when the waiver is requested.

a. For a waiver requested on or before 4/6/86, the interest rate is the valuation interest rate.

b. For a waiver requested after 4/6/86 and on or before 12/17/87, the interest rate is the federal short-term rate under IRC 6621(b).

c. For a waiver (non-multiemployer) requested after 12/17/87, the interest rate is 150% of the federal mid-term rate under IRC 1274.

(3) The following rules determine the period used for the amortization of the waiver.

a. If the waiver is first amortized in a plan year beginning before 1/1/88, then the period is 15 years.

b. If the waiver is first amortized in a plan year beginning after 12/31/87, then the period is 5 years.

(4) However, multiemployer plans still use the federal short-term interest rate under 6621(b) with a 15 year amortization period.

Examination Tip: Verify that, if the plan has a waiver in effect, the conditions have been met and the amortization charge has been correctly calculated.

1.5.6.3 Additional Funding Requirements

(1) Additional funding requirements under IRC 412(l) may apply for certain plans (other than multiemployer plans) that have an unfunded current liability.

(2) The additional funding charge for a plan year is equal to:

a. The excess of the deficit reduction contribution (DRC) over the sum of the charges for such plan year under IRC 412(b)(2) reduced by the sum of the credits for such plan year under IRC 412(b)(3)(B), plus

b. The unpredictable contingent event amount (if any) for such plan year.

(3) The deficit reduction contribution is the sum of:

a. The unfunded old liability amount (e.g., unfunded old liability amount plus additional unfunded old liability amount),
b. The unfunded new liability amount,
c. The expected increase in current liability due to benefits accruing during the plan year, and
d. The aggregate of the unfunded mortality increase amounts.

Examination Tip: Verify that, if the additional funding charge is applicable, the additional charge amount has been correctly calculated.

1.5.6.3.1 Applicability of the Additional Funding Requirement

(1) This additional funding requirement may apply for certain plans which:

a. are not multiemployer plans;
b. have more than 100 participants (in all defined benefit plans of the employer or controlled group) on any day of the preceding plan year; and
c. have an unfunded current liability.

(2) If the plan has more than 100 participants but less than 150 participants, the additional funding requirement is multiplied by 2% times the highest number of participants in excess of 100 on any day of the preceding plan year.

1.5.6.3.1.1 Gateway Test

(1) A plan’s "Gateway percent" is equal to the actuarial value of assets (unreduced by any credit balance) divided by the current liability computed with the highest allowable interest rate. If a plan’s "Gateway percent" is at least 90%, these additional funding requirements do not apply.

(2) An exception is also made for certain plans with a "Gateway percent" of at least 80%, if such percentages for two consecutive plan years out of the last three plan years were at least 90%.

(3) Additional transition rules may apply for plan years beginning in 1995 and 1996.

1.5.6.3.2 Definitions/Rules Used in Calculating the DRC

(1) Unfunded old liability. The unfunded old liability is the unfunded current liability as of the beginning of the first plan year beginning after December 31, 1987, (determined without regard to amendments increasing liabilities adopted after October 16, 1987).

(2) Unfunded old liability amount. The unfunded old liability amount is the amount required to amortize the unfunded old liability over 18 years.

a. It may also include unfunded existing benefit increase liabilities under existing collective bargaining agreements, amortized over 18 years beginning with the plan year in which the benefit increase occurs. If the plan’s assets become greater than the plan’s current liability, then the old liability amount is considered fully funded.

b. The unfunded old liability amount is increased by the amount necessary to amortize the additional unfunded old liability (defined below) over 12 years beginning with the first plan year after December 31, 1994.

c. Employers may irrevocably elect an optional rule for the additional unfunded old liability, in which the entire increase in current liability attributable to plan years before 1995 is amortized over 12 years.

(3) <u>Additional unfunded old liability</u>. The additional unfunded old liability is the amount by which the "RPA ’94 current liability" exceeds the "OBRA ’87 current liability", where:

a. The RPA ’94 current liability is the current liability as of the beginning of the 1995 plan year, valued using the assumptions required by IRC 412(l)(7)(C) as in effect for plan years beginning after 1995, and

b. The OBRA ’87 current liability is the current liability as of the beginning of the 1995 plan year, valued using the prior interest rate and the mortality assumptions that were used to determine current liability for plan years beginning in 1993.

(4) <u>Unpredictable contingent event amount</u>.

a. An unpredictable contingent event benefit is a benefit that is not contingent on age, service, compensation, death, disability or an event that is "reasonably and reliably predictable." The most common example is shutdown benefits. "Window early benefits" are not considered to be unpredictable contingent event benefits.

b. If such an event occurs, an additional amount is added to the net deficit reduction contribution amount to determine the additional funding requirement.

c. The unpredictable contingent event amount is equal to the greater of:

* (100% - FCL%) times the amount of unpredictable contingent event benefits paid during the plan year (where FCL% is the funded current liability percent) and further multiplied by the applicable percentage under IRC 412(l)(5)(B). *(For plan years beginning in 2001 and thereafter, such applicable percentage is 100%)*

* The unpredictable contingent event benefit liabilities amortized over 7 years or

* The additional unfunded new liability amount that would have been determined if the unpredictable contingent event benefit liabilities were included in unfunded new liability

d. The unpredictable contingent amount is not more than the outstanding amount of the liability being amortized.

(5) <u>Unfunded new liability</u>. The unfunded new liability is the unfunded current liability determined without regard to the:

a. unamortized portion of the unfunded old liability,

b. unamortized portion of the additional unfunded old liability,

c. unamortized portion of each unfunded mortality increase,

d. unamortized portion of the unfunded existing benefit increase liability, and

e. liability with respect to any unpredictable contingent event benefits (without regard to whether the event has occurred).

(6) Unfunded new liability *amount*. The unfunded new liability amount is the applicable percentage of the unfunded new liability. The applicable percentage is:

30% - [0.40 times (% (if any) by which FCL% exceeds 60%)]

where FCL% is the funded current liability percent.

Thus, if the funded current liability percent is 60% or less, then 30% of the unfunded new liability is included in the deficit reduction contribution calculation.

NOTE: Prior to 1995, the applicable percentage was: 30% - [0.25 times (% (if any) by which FCL% exceeds 35%)]

(7) Unfunded mortality increase amount.

a. The unfunded mortality *increase* is the excess of current liability for the first year for which a plan uses any new mortality table issued under RPA ’94, over current liability for such plan year which would have been determined if the mortality table in effect for the preceding plan year had been used.

b. The unfunded mortality increase *amount* is the amount necessary to amortize an unfunded mortality increase over 10 years from the date established.

(8) Phase-in and transition rules. The phase-in rule of IRC 412(l)(11) provides an alternative method of computing the additional required funding charge, which may be elected by the employer in any year up to the year 2001. Rev. Rul. 96-21 provides guidance for employers who want to elect to phase-in the increase in the additional funding requirement.

(9) Base maintenance rules. Rev. Rul. 96-20 provides guidance on the requirements for the establishment and maintenance of certain amortization bases under IRC 412(l). If the plan's assets become greater than the plan's current liability, then the old liability amount is considered fully funded.

(10) Asset value adjustments. For purposes of determining the unfunded current liability, the plan's assets are reduced by any credit balance in the funding standard account.

(11) Disbursements. For purposes of determining the liquidity shortfall, disbursements from the plan include all disbursements from the trust including purchase of annuities, payments of single sums and other benefits, and administrative expenses.

1.5.6.4 Interest on Missed Quarterlies

(1) IRC 412(m) provides that quarterly installments of the contributions may be required for defined benefit plans (other than multiemployer plans). See section 1.7.1 Quarterly Contribution Requirement.

(2) If the minimum payments are not timely, an additional interest charge is payable using the greater of the plan interest rate or 175% of the federal mid-term rate.

(3) This additional interest charge is, generally, carried forward each year for purposes of the balance equation.

***Examination Tip*:** Verify that, if the quarterly contribution requirement has not been met, the additional interest charge has been correctly calculated.

1.5.6.5 Alternative Minimum Standard and Switchbacks

(1) An alternative minimum standard is available under IRC 412(g) to certain plans. This allows, in some instances, a lesser contribution without imposing an excise tax. If a plan elects to use this standard, a detailed worksheet must be attached to the Schedule B of Form 5500.

(2) Only a plan using the entry age normal funding method may use the alternative minimum funding standard account.

Any other method would fail to meet the "in all years" requirement under IRC 412(g)(1).

(3) A plan that uses the frozen initial liability method may not use the alternative funding standard account even if the method used to determine the initial unfunded accrued liability was entry age normal. Frozen Initial Liability with Entry Age Normal is not Entry Age Normal.

1.5.6.5.1 Maintenance of Funding Standard Account and Switchback

(1) A plan to which IRC 412 applies must maintain a minimum funding standard account even during years when the minimum funding standards are determined under an alternative minimum funding standard account.

(2) When the plan switches from the alternative minimum funding standard to the regular minimum funding standard, the excess (if any) of any debit balance in the regular funding standard account over any debit balance in the alternative minimum funding standard account is credited in the regular funding standard account and also becomes an amortization charge base to be amortized over a period of 5 years at the plan valuation rate.

(3) If a plan has an accumulated funding deficiency in excess of the full funding limitation at the close of a plan

year, the funding standard account is credited with the amount of such excess.

1.5.6.5.2 Alternative Minimum Funding Standard Account

(1) The alternative minimum funding standard account is charged with the sum of:

a. The lesser of normal cost under the funding method used under the plan or normal cost determined under the unit credit method;

b. The excess of the present value of accrued benefits under the plan over the fair market value of the assets; and

c. The excess of credits to the alternative minimum funding standard account for all prior plan years over charges to such account for all such years.

(2) The alternative minimum funding standard is credited with the amount considered contributed by the employer to or under the plan for the plan year.

1.5.7 Special Rules for Multiemployer Plans in Reorganization (IRC 418-418A)

(1) A multiemployer plan that is in serious financial difficulty may be returned to financial health through "reorganization" as described in IRC 418, and in IRC 418A through IRC 418E.

(2) If a plan is in reorganization for a particular plan year, its minimum funding requirement may be modified under IRC 418B. A multiemployer plan is in reorganization if the plan’s "reorganization index" is greater than zero.

a. A plan’s reorganization index is the excess of the vested benefits charge over the net charge to the funding standard account.

b. In general, the vested benefits charge is the amount necessary to amortize the plan’s unfunded vested benefits over 10 years for benefits attributable to participants in pay status and over 25 years for benefits attributable to other participants. Certain adjustments may also be applicable.

c. The net charge to the funding standard account is the excess of the regular charges over the credits (including normal cost and amortization amounts).

d. Thus, if the contribution required under the regular funding standard account is less than the contribution required if unfunded vested benefits were paid over 10 years for persons in pay status and 25 years for all other persons, the plan will be in reorganization.

(3) Modified minimum funding standard: if a multiemployer plan is in reorganization, an explanation of the basis for the determination should be included in the attachments to the Schedule B of Form 5500. In addition, a worksheet should be included in the attachments for review showing:

a. The amounts considered contributed by employers;

b. Any amount waived by the IRS;

c. The development of the minimum contribution requirement (taking into account the applicable overburden credit, cash-flow amount, contribution bases and limitation on required increases on the rate of employer contributions); and

d. The resulting accumulated funding deficiency

1.5.8 Special Rules for Certain Multiple Employer Plans (IRC 413(c))

(1) In general, if a plan is a multiple employer plan subject to the rules of IRC 413(c), the minimum funding standard requirements under IRC 412 are calculated as if each employer were maintaining a separate plan. There are two exceptions.

a. Plans established after 1988 that use a method for determining required contributions which provides that any employer contributes not less than the amount which would be required if such employer maintained a separate plan.

b. Plans established prior to 1989 are treated as if all participants were employed by a single employer unless the plan administrator timely elected (not later than the close of the first plan year beginning after the enactment of the Technical and Miscellaneous Revenue

Act of 1988 (TAMRA ’88)) to be treated as if each employer were maintaining a separate plan.

(2) If each employer is subject to the minimum funding requirements under IRC 412 separately, detailed calculations for each employer should be included in the attachments to the Schedule B of Form 5500.

(3) It is possible for the Schedule B for multiple employer plans to show both a funding deficiency and a credit balance in the same year (attributable to different employers). This could not happen for other plans.

1.5.9 Special Rules for Collectively Bargained Plans

(1) Collectively bargained plans, whether single-employer or multiemployer, are subject to special rules under IRC 413(b). In general, the minimum funding standard provided by IRC 412 is determined as if all participants in the plan were employed by a single employer.

1.5.9.1 Shortfall Rules for Collectively Bargained Plans

(1) Collectively bargained plans, whether single-employer or multiemployer, may use the shortfall method if contributions are made at a rate specified under the terms of a legally binding agreement applicable to the plan.

(2) The shortfall method is intended to "correct" for year-to-year fluctuations in the hours of service (or units of production) on which actual contributions are based. The shortfall method is not intended to correct funding shortfalls that may result if the bargained contribution rate is set at too low a level to fund the benefit liabilities adequately.

(3) Under the shortfall method of funding, the normal cost in the funding standard account is the charge per unit of production (or per unit of service) multiplied by the actual number of units of production (or units of service) that occurred during the plan year. Each amortization installment in the funding standard account is similarly calculated.

(4) The difference between the net amount charged or credited under this method and the net amount that otherwise would have been charged or credited under IRC 412 for the same period is termed a "shortfall gain or loss" and is to be amortized during certain subsequent plan years.

Examination Tip: If the plan is using the shortfall method, review Reg. 1.412(c)(1)-2 before starting the audit, and review the data used to compute the estimated unit charge and determine whether it was reasonable. The actual number of units of service or production should also be verified.

1.5.9.2 Amendments to Collectively Bargained Plans

(1) Collectively bargained benefit increases scheduled to become effective in future years under a currently effective collective bargaining agreement are recognized in calculating the regular charges and credits in the funding standard account for years beginning in 1995 and later. However, such increases are not included in the current liability or additional funding charge amounts until effective.

1.6 Money Purchase Rules

(1) Money purchase plans are subject to minimum funding standards since they require fixed, nondiscretionary contribution levels. A target benefit plan is a money purchase plan, and is subject to the minimum funding requirements. For money purchase plans, assets must be valued at fair market value.

1.6.1 "Normal Cost"

(1) The "normal cost" for a money purchase plan is the amount required for the plan year under the plan formula.

1.6.2 Special Considerations if Waiver in Effect

(1) Rev. Rul. 78-223 contains guidance on special requirements for money purchase plans if a waiver is in effect.

a. Adjusted account balances: Affected participants must be restored to the position in which they would have been had the waived amount been contributed (to the extent possible); and acceptable methods include using the actual yield of the trust or using a fixed rate of interest not less than 5%.

b. Waiver payments: The plan must specify how the amounts necessary to amortize the waived funding deficiency (the waiver payments) are to be determined.

c. Experience gains or losses: Experience gains or losses must be amortized under the minimum funding standards, except to the extent that a plan is fully funded, rather than immediately and totally applied.

d. Interim benefits/allocation: The plan must specify what benefit payments are available to participants under an interim benefit method. Possible methods include: immediate allocation method, suspense account method, or unrestricted distribution method.

e. Interest rate of 0% on accumulated funding deficiency: If a money purchase plan has an accumulated funding deficiency, the applicable interest charge is based on an assumed interest rate of 0%.

(2) Normally, the need to create an amortization base does not exist under a money purchase plan. However, such a base would be created, for example, with the issuance of a waiver of the minimum funding standard for a plan, or if a plan amendment is adopted that provides contribution credits for prior years of service.

(3) If a waiver has been granted, a funding standard account must be maintained and a Schedule B of Form 5500 must be filed. However, the Schedule B need not be signed by an enrolled actuary.

1.7 Timeliness of Contributions to Satisfy Minimum Funding Requirements

(1) Contributions must be made by 8½ months after the end of the plan year.

Examination Tip: Verify the amounts and dates of all employer contributions made for the plan year. Such contributions are also credits to the funding standard account. If the contributions credited to the funding standard account do not equal the employer contributions listed, request an explanation.

(2) A contribution is not considered to be timely made unless it is paid to the proper recipient as opposed to some intermediary.

a. In a trusteed plan, this means to the trustee.

b. In a wholly insured plan, this means to the insurance company.

c. Promissory notes do not constitute payment until the money is actually put into the trust. Therefore, payments by promissory note are not considered timely paid.

(3) Contributions should be paid within 2½ months after the close of the plan year. However, IRC 412(c)(10) provides an extension for 6 months for purposes of IRC 412 (but not for IRC 404).

Examination Tip: If the timely contributions are insufficient to meet the minimum funding standard, including any late quarterly contribution interest charge and all other applicable special charges, an accumulated funding deficiency results and the minimum funding penalties should be applied.

1.7.1 Quarterly Contribution Requirement

(1) IRC 412(m) provides that quarterly installments of the contributions may be required for defined benefit plans. Quarterly installments are not required for:

a. Multiemployer plans
b. Plans with no unfunded current liability in the prior plan year
c. Money purchase plans

(2) For affected plans, the required installments are due on the 15th day of the month following the end of a quarter. For calendar year plans, the due dates are April 15, July 15, October 15 and January 15 of the following year.

1.7.1.1 Required Installments Not Timely

(1) If a required installment is not made on time, a late interest charge is calculated and charged to the funding standard account. See section 1.8.4.

1.7.1.2 Computation of Quarterly Amount

(1) Rev. Rul. 95-31, 1995-1 C.B. 76, and Notice 89-52, 1989-1 C.B. 692, provide guidance regarding the calculation of the quarterly requirement. The required installment is 25% of the required annual payment. The required annual payment is the lesser of:

a. 90% of the amount required to be contributed for the current year, determined as of the beginning of the plan year; or

b. 100% of the amount so required for the prior year, determined as of the end of the prior plan year.

(2) The amount required to be contributed is determined without regard to any waiver in effect.

(3) Special rules apply to plans which have any unpredictable contingent event benefit liabilities. Such liabilities are not taken into account in determining the required annual payment. However, the required installments are increased by the greatest of a, b, or c below:

a. The unfunded percentage (i.e. 100%-FCL%) times the amount of such benefits paid during the three month period (see section 1.5.6.3.2);

b. 25% of the unpredictable contingent event benefit liabilities amortized over 7 years; or

c. 25% of the additional unfunded new liability amount that would have been determined if the unpredictable contingent event benefit liabilities were included in unfunded new liability.

NOTE: The unpredictable contingent amount is not more than the outstanding amount of the liability being amortized.

(4) The credit balance may be applied against the quarterly contributions that would otherwise have been required.

(5) If a plan does not meet the liquidity requirement of IRC 412(m)(5), it is treated as failing to pay the required installment. See 1.8.5, Liquidity Shortfall Under IRC 412(m)(5).

1.8 Result of Failure to Satisfy Minimum Funding Requirement

1.8.1 Controlled Groups

(1) If the employer maintaining the plan is a member of a controlled group, then each member of such group is jointly and severally liable for payment of any contributions

required under the minimum funding standard or for any required installments to the plan. See IRC 412(c)(11).

(2) "Controlled group" is any group treated as a single employer under the controlled group, common control, or affiliated service provisions of IRC 414(b),(c),(m), or (o).

1.8.2 Excise Taxes Due to Failure to Satisfy Minimum Funding

(1) Failure to satisfy the minimum funding requirements will result in the imposition of an excise tax on the employer of 10% of the accumulated funding deficiency as of the end of the plan year. See IRC 4971(a).

a. For multiemployer plans and plan years beginning before 1989, the tax imposed is 5% of the accumulated funding deficiency.

b. The accumulated funding deficiency is determined by reference to the Schedule B of Form 5500. Form 5330 is the return for the excise tax (10% or 5%, as applicable).

(2) The tax is due for the employer's tax year which coincides with the plan year, or the tax year in which the plan year ends.

(3) Generally, failure to satisfy the minimum funding requirements will not disqualify the plan.

(4) If the employer maintaining the plan is a member of a controlled group, each member of such group is jointly and severally liable for the tax under IRC 4971(a).

1.8.3 Result of Failure to Correct an Accumulated Funding Deficiency

(1) An accumulated funding deficiency must be corrected by the earlier of:

a. the date of mailing of a notice of deficiency with respect to the first-tier tax under IRC 4971(a), or

b. the date on which the first-tier tax is assessed.

(2) To correct an accumulated funding deficiency for a plan year, a contribution must be made to the plan that reduces the accumulated funding deficiency, as of the end of the plan year, to zero. See Prop. Reg. 54.4971-2(a)(1).

(3) Certain retroactive plan amendments that meet the requirements of IRC 412(c)(8) may reduce an accumulated funding deficiency to zero. See Prop. Reg. 54.4971-2(a)(2).

(4) To the extent the accumulated funding deficiency is not corrected timely, a second-tier tax of 100% is imposed under IRC 4971(b). This tax may be abated if the deficiency is corrected within 90 days after the mailing of a notice of deficiency with respect to the second-tier tax. This period may be extended under IRC 4961 & 4963(e) by the Secretary of the Treasury.

(5) An accumulated funding deficiency cannot be corrected by waiver of a key employee’s benefit.

(6) If a plan maintains both the regular funding standard account and the alternative minimum funding standard account, the taxes are based on the lower of the two amounts.

(7) No deduction is allowed for a tax imposed under IRC 4971(a) or (b). See IRC 275(a)(6).

(8) Under section 3002(b) of ERISA, the Commissioner may waive the imposition of the second-tier tax under IRC 4971(b) in appropriate circumstances. This authority does not extend to the imposition of the first-tier tax under IRC 4971(a). The procedure for requesting such a waiver is established in Rev. Proc. 81-44, 1981-2, C.B. 618. The plan sponsor must demonstrate that imposition of the tax under IRC 4971(b) would be adverse to the interests of plan participants.

(9) Taxes imposed under IRC 4971(a) and (b) do not apply to years after the end of the plan year in which the plan terminates. See Rev. Rul. 79-237, 1979-2 C.B. 190.

(10) If a plan is maintained pursuant to a collectively bargained agreement or by more than one employer, the

liability of each employer for tax imposed under IRC 4971(a) and (b) is allocated on the basis of the employer's respective liabilities for contributions. See IRC 413(b)(6), IRC 413(c)(5), and Prop. Reg. 54.4971-3(b).

(11) An employer that withdraws from a plan remains liable for tax imposed under IRC 4971(a) and (b) with respect to the portion of the accumulated funding deficiency attributable to that employer for plan years before the withdrawal.

1.8.4 Additional Interest Charge Due to Late Quarterly Contributions

(1) Failure to pay the full amount of a required quarterly installment results in an additional interest charge to the funding standard account. Required quarterly installments are due no later than 15 days after the end of each plan quarter.

a. The interest rate charged is the greater of 175% of the federal mid-term rate (as in effect under section 1274 for the first month of the plan year), or the interest rate used to determine the current liability. See IRC 412(m)(l).

b. Interest is charged from the due date of the installment until the date such installment is actually paid.

(2) Overpayment of a quarterly installment may be used to reduce the payments necessary to satisfy subsequent quarterly installments. A credit balance which exists as of the beginning of the plan year may be treated as a payment of a quarterly installment.

(3) The additional interest charge applies to non-multiemployer defined benefit plans for plan years beginning after 12/31/88. Quarterly installments are not required for the first plan year to which IRC 412 applies.

Example 3: The plan year is the 1995 calendar year. A quarterly installment of $10,000 is due April 15, 1995. 175% of the federal mid-term rate in effect on January 1, 1995 is 14.06%. The interest rate under IRC 412(b)(5) is 7%.

The $10,000 installment is paid on June 30, 1995. The additional interest charge is:

$$[\$10,000\ ((1.1406)^{2.5/12}-1)] - [\$10,000\ ((1.07)^{2.5/12}-1)]$$
$$= \$278 - \$142 = \$136.$$

NOTE: Additional examples are given in Notice 89-52, 1989-1 C.B. 692, Q&A-2, 12, and 14.

Examination Tip: For assistance with the calculation of the additional interest charge, agents should contact their local district actuary.

1.8.5 Liquidity Shortfall Under IRC 412(m)(5)

(1) Plans subject to the quarterly contribution requirement of IRC 412(m) which have a liquidity shortfall (as defined in IRC 412(m)(5)(E)) are subject to the liquidity requirement of IRC 412(m)(5). See also Rev. Rul. 95-31, 1995-1 C.B. 76, for details regarding liquidity shortfall requirements.

a. Under this requirement, a plan is treated as failing to pay the full amount of any required installment to the extent that the amount paid (in liquid assets) is less than the liquidity shortfall, and this is the case whether or not the liquidity shortfall exceeds the amount of the required quarterly installment.

b. Thus, for plans subject to IRC 412(m) which have a liquidity shortfall, the quarterly payment requirement is treated as not satisfied for a quarter unless the quarterly payment satisfies both the quarterly contribution requirement and is at least equal to any liquidity shortfall under the plan for that quarter.

(2) However, IRC 412(m)(5)(D) limits the increase resulting in the quarterly payment as a result of IRC 412(m)(5)(A) to the amount which, when added to prior installments for the plan year, is necessary to increase the funded current liability percentage (taking into account the expected increase in current liability due to benefits accruing during the plan year) to 100%.

(3) Where the amount contributed by the due date for a quarter is less than the liquidity shortfall for the quarter, the difference between the liquidity shortfall and the amount paid (but not more than the amount determined under IRC 412(m)(5)(D)) is treated as an underpayment of the quarterly contribution.

(4) The rate of interest charged to the funding standard account under IRC 412(b)(5) with respect to such underpayment amount for the period of the underpayment is equal to the greater of:

a. 175% of the federal mid-term rate (as in effect under IRC 1274 for the 1st month of such plan year); or

b. The rate used to determine RPA ’94 current liability (stated in IRC 412(m)(1)(B) as the rate of interest used under the plan in determining costs, including adjustments under IRC 412(b)(5)(B)).

(5) The liquidity requirement of IRC 412(m)(5) is not a "charge" that is applied to the plan’s funding standard account. Therefore, the liquidity requirement does not increase the minimum funding requirement of the plan. If the employer fails to make a required liquidity payment, such failure by itself does not create an accumulated funding deficiency.

(6) If the liquidity shortfall is not corrected within the allowed time-frame, there are two main consequences.

a. First, there are excise taxes that are imposed under IRC 4971(f). There is a 10% first tier tax that is imposed on the amount of the uncorrected liquidity shortfall for each quarter, and there is a 100% second tier tax that is imposed if the liquidity shortfall for a quarter is not corrected within the next five plan quarters.

b. Secondly, if the liquidity shortfall is not corrected within the time allowed, section 206(e) of ERISA prohibits the plan fiduciaries from making certain payments from the plan. In such a case, the plan fiduciary is prohibited from making single-sum distributions, any payment in excess of the monthly amount paid under a single life annuity, or any purchase of annuity benefits from an insurer.

c. Members of the employer’s controlled group are jointly and severally liable for excise taxes imposed under IRC 4971(f). IRC 4971(f)(4), (added by the SBJPA), authorizes the Secretary to waive the liquidity shortfall excise taxes if the liquidity shortfall is due to "reasonable cause and not willful neglect", and "reasonable steps have been taken to remedy such liquidity shortfall".

1.8.6 Liens

(1) IRC 412(n) applies to defined benefit plans (other than multiemployer plans) for any plan year for which the funded current liability percentage (within the meaning of IRC 412(l)(8)(B)) of such plan is less than 100%. See IRC 412(n)(2).

(2) Where the unpaid balance (including interest) of a missed quarterly installment under IRC 412(m) or any other payment required under IRC 412 (liquidity shortfall, accumulated funding deficiencies), when added to the aggregate unpaid balance of all preceding such installments or other payments for which payment was not made before the due date (including interest), <u>exceeds $1,000,000</u>, IRC 412(n)(1) provides that a lien results in favor of the plan in the amount determined under IRC 412(n)(3).

a. A lien established under IRC 412(n)(1) is upon all property and rights to property, whether real or personal, belonging to such person and any other person who is a member of the same controlled group of which such person is a member.

b. The amount of the lien is equal to the aggregate unpaid balance of required installments and other payments required under IRC 412 (including interest) for plan years beginning after 1987, and for which payment has not been made before the due date. See IRC 412(n)(3).

c. The period of the lien arises on the due date for the required installment or other payment and continues until the last day of the first plan year in which the plan ceases to be described in IRC 412(n)(1)(B). The lien continues to run without regard to whether the plan continues to be described in IRC 412(n)(2) during the period of the lien. See IRC 412(n)(1) and (3).

(3) Persons who commit the failure described in IRC 412(n)(1) (i.e., have aggregate unpaid amounts under IRC 412 exceeding $1,000,000) must notify PBGC of such failure within 10 days of the due date for the required installment or other payment.

(4) Any lien created under IRC 412(n)(1) may be perfected and enforced only by the PBGC or, at the direction of the PBGC, by the contributing sponsor (or any member of the controlled group of the contributing sponsor).