INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director
Brooklyn Key District Office

RECEIVED

APR 26 1993

Taxpayer's Name :

Taxpayer's Address :

Taxpayer's Identification No. :

Years Involved : 1976-1988

Date of Conference : None

ISSUES

1. Whether the provisions in the Annuity Plan (Plan) allowing the Board of Trustees (Trustees) to terminate an employer's status as an Employer because the employer failed to make contributions required under the collective bargaining agreement of a bargaining unit to the Annuity Fund, and consequently to deny participation, vesting, and allocations of contributions to the employees of the terminated employer, violate sections 410 and 411 of the Internal Revenue Code, and the definitely determinable requirement of section 1.401-1(b)(1)(i) of the Income Tax Regulations.

2. Whether the Plan provisions defining an employee's Individual Account, and the amount the employee is to be paid upon a distributable event, in relation to Employer Contributions made, violate section 411 of the Code and the definitely determinable requirement.

3. Whether the Plan provision providing that if no Employer Contributions are made to an employee's Individual Account for any period of 12 consecutive months, the employee shall be eligible to receive his Accumulated Share in the form of a life or joint life annuity, a period certain annuity, or in one lump sum, as the employee and spouse may elect, violates the limitation on distributions for a pension plan under section 1.401-1(b)(1)(i) of the regulations, and the requirement for definitely determinable benefits.

4. Assuming the answer to one or more of the above issues results in the retroactive disqualification of the Plan, whether

the retroactive disqualification of the Plan with respect to each defect should be limited by applying section 7805(b) of the Code.

5. Whether the Plan Trustees' proposal to convert the Plan to a profit-sharing plan prospectively and to base allocations to individual accounts on contributions made, not contributions required to be made under the collective bargaining agreements of employers maintaining the Plan, would violate section 414(i) of the Code and section 1.401-1(b)(1)(ii) of the regulations. Further, whether the Plan's proposal as a profit-sharing plan to substitute investment earnings for employer contributions required but not received, by treating delinquent contributions as a loss to investment yield or as an administrative expense deducted from investment yield, would violate section 1.401-1(b)(1)(ii) of the regulations.

FACTS

The Plan is a multiemployer money purchase pension plan under section 414(f) of the Code with an original effective date of January 1, 1973. The Plan was amended to comply with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA), effective as of January 1, 1976, with respect to which a favorable determination letter was issued on October 3, 1977. The Plan was next amended effective as of January 1, 1985. The Plan Trustees' request for a new determination letter, dated February 16, 1987, for the Plan as amended through January 1, 1987, was submitted. A determination letter has not been issued pending the issuance of this technical advice memorandum. The Plan Trustees now propose to convert the Plan prospectively to a profit-sharing plan. The facts particular to each issue are discussed below.

LAW AND RATIONALE

Issue One

Section 1.05 of the Plan[1] defines the term Employer as any employer who is required by a collective bargaining agreement between itself and one of the unions affiliated with the

make contributions to the Annuity Fund on behalf of its employees, provided, among other conditions, the Trustees have not, by resolution, terminated the employer's status prospectively as an Employer because the employer failed to make contributions to the Fund as provided for in its agreement.

[1]Unless otherwise indicated, all section references to the Plan are to the Plan as amended through January 1, 1987.

Section 5.03 of the Plan states, in relevant part, that an Employer shall no longer participate in the Fund with respect to a bargaining unit if the Trustees determine to terminate that Employer's participation because it fails to make the Contributions for which it is obligated.

Under section 1.06 of the Plan, Covered Employment means employment of an employee for which the Employer is obligated to contribute to the Fund, but specifically excludes employment with an Employer after termination of the employer's status as an Employer for failing to pay contributions which were due.

Consequently, if the Plan Trustees were to terminate an employer's status as an Employer for failure to make contributions - an action not taken to date - the Plan would disregard all service performed subsequent to the termination for participants who are employees of that employer for purposes of participation, vesting, and allocations of contributions.

Section 1.414(f)-1 of the Income Tax Regulations provides special rules for multiemployer plans in existence prior to the passage of the Multiemployer Pension Plan Amendments Act of 1980 (Pub. L. No. 96-364) (MPPA). Specifically, section 1.414(f)-1(b)(2)(i) provides, in pertinent part, that an employer shall be deemed to be a member of the plan in a plan year if the employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for such plan years. Accordingly, for purposes of the special limitation in section 1.414(f)-1, an employer that the trustees of a fund have terminated as an Employer for failure to make required contributions continues to be considered a member of the plan if the employer was still obligated to contribute to the plan under an instrument other than the plan.

In addition, MPPA provided substantial amendments with regard to the rules that apply when an employer withdraws from a multiemployer plan. Specifically, section 104(2) of MPPA added section 4203 of the Employee Retirement Income Security Act of 1974 (ERISA), which defines the term complete withdrawal from a multiemployer plan as occurring when an employer: (1) permanently ceases to have an obligation to contribute under the plan, or (2) permanently ceases all covered operations under the plan. Section 104(2) of MPPA also added section 4212(a) of ERISA, which provides that the term "obligation to contribute" means an obligation to contribute arising under one or more collective bargaining (or related) agreements, or as a result of a duty under applicable labor-management relations law.

Accordingly, for purposes of the special limitation of regulations section 1.414(f)-1 and the withdrawal rules under MPPA, an employer who has been terminated as an Employer under the Plan by the Plan Trustees for failure to make required

contributions continues to be considered a member of the Plan if the employer is obligated to contribute to the Plan under a collectively bargained agreement. Therefore, the determination by Plan Trustees that an employer is terminated does not extinguish the employer's obligation to make past and future contributions under the Plan that are required through the expiration of the collective bargaining agreement, and does not terminate the employer's status as an Employer maintaining the Plan.

Sections 410 and 411 of the Code establish minimum participation and vesting standards. Under these sections, an employee's eligibility to participate and to vest are based on years of service. Section 1.410(a)-1(b)(5) of the regulations provides that rules relating to years of service and breaks in service are found in Part 2530 of the Department of Labor regulations. Section 1.411(a)-6 of the Income Tax Regulations also refers to Part 2530 of the Labor regulations for the purpose of computing service for vesting.

Labor regulation section 2530.210(c)(1) provides (with the omission of several exceptions not relevant here) that all covered service with an employer or employers maintaining the plan must be taken into account in determining an employee's service for eligibility to participate and vesting purposes. Covered service is defined by section 2530.210(c)(3)(ii) of the Labor regulations as service with an employer or employers maintaining the plan within a job classification or class of employees covered by the plan.

In this case, when an employer fails to make required contributions, there is neither a change in job classification nor a change in the class of employees covered by the plan. Accordingly, if service after the Trustees terminate an employer as an Employer is to be considered noncovered service it must be because such employers are no longer considered employers maintaining the Plan. As we concluded above, however, because the collective bargaining agreements require the employers to contribute to the Plan even after the Trustees terminate their status as Employers, such employers continue to be considered Employers maintaining the Plan. Therefore, service with a terminated employer is covered service within the meaning of Labor regulation section 2530.210(c)(3)(ii), and such service must be taken into account for participation and vesting purposes. If the Plan failed to take into account future service with a terminated employer whose collective bargaining agreement requiring contributions is still in effect, it would not satisfy the requirements of Labor regulation section 2530.210 and Code sections 410 and 411.

In addition, section 1.401-1(b)(1)(i) of the Income Tax Regulations provides that pension plan benefits must be

definitely determinable. Rev. Rul. 74-385, 1974-2 C.B. 130, provides, in part, that in the case of a pension plan, benefits will be considered definitely determinable if the plan contains an express formula under which each participant's benefit can be computed and such formula is not subject to employer discretion. Rev. Rul. 74-385 further provides that the same degree of definiteness is required for the contributions under a money purchase pension plan as a defined benefit plan.

A money purchase pension plan, although a pension plan, is a defined contribution plan, which, under section 414(i) of the Code, provides "benefits based solely on the amount contributed to the participant's individual account, and any income, expenses, gains, and losses ... which may be allocated to such participant's account." Consequently, in order to determine whether the requirements under section 1.401-1(b)(1)(i) have been met, the plan's allocation formula as well as contribution formula must be considered. The formula by which total contributions actually made to the plan are allocated to the plan's individual accounts must be related to the contributions each employer is required to make pursuant to a collective bargaining agreement. Therefore, the Plan provisions in this money purchase pension plan tying allocations to actual contributions made on an employee's behalf violate the definitely determinable requirement, because allocations to an employee's account are contingent on whether the employer made contributions on behalf of the employee.

Issue Two

Section 2.02 of the Plan provides that after each Valuation Date, the Trustees shall determine the amount in each Employee's Individual Account as of such Date, and that such amount shall be equal to (a) the amount in his Individual Account as of the preceding Valuation Date, multiplied by the Investment Factor, plus (b) the Employer Contributions made on his behalf and received by the Fund since the last preceding Valuation Date, minus the per capita administrative expenses during the period.

Section 3.01 states that upon the happening of any event calling for payment of any annuity, lump sum amount, or other benefit from this Fund, the amount to be paid shall be the Employee's Accumulated Share, determined as of the last preceding Valuation Date, plus Employer Contributions made on his behalf and received by the Fund since such Date.

As noted above, Rev. Rul. 74-385 provides that in the case of a pension plan, benefits will be considered definitely determinable if the plan contains an express formula under which each participant's benefit can be computed and such formula is not subject to employer discretion. Although the Plan in this

case contains a formula by which contributions are fixed and a formula by which contributions are allocated to participant accounts, for purposes of determining participants' benefits, benefits are actually determined under the formulas only to the extent that the employer makes required contributions. Therefore, the Plan provisions tying the amount in an employee's Individual Account and Accumulated Share to employer contributions made on behalf of the employee and received by the Fund results in a level of benefits within the discretion of the employer, and thus fails to satisfy the requirement of section 1.401-1(b)(1)(i) of the regulations.

The Plan provisions also fail to satisfy section 411 of the Code. Section 411 established minimum participation and vesting standards based on years of service. Income Tax Regulations section 1.411(a)-6 provides that the rules for computing service for vesting are in Part 2530 of the Department of Labor regulations. As discussed above in Issue One, Labor regulation section 2530.210(c)(1) generally provides that for purposes of determining vesting all covered service with an employer maintaining the plan must be taken into account. An employer that is required by the plan document or collective bargaining agreement to contribute to the plan is an employer maintaining the plan for purposes of determining an employee's years of service, whether or not the required contributions are made. Accordingly, the Plan provisions in this case, which relate an employee's Individual Account and Accumulated Share to employer contributions actually made fail to satisfy section 411. This is because under the Plan, an employee's vesting is determined on a basis other than years of service.

Issue Three

Section 3.02(a) of the Plan provides that if an employee has had no employer contributions made to his Individual Account for any period of 12 consecutive months, he shall be eligible to receive his Accumulated Share in the form of a qualified joint and survivor annuity, a single life annuity, a fixed monthly annuity in equal installments not in excess of 120 months until his Accumulated Share is exhausted, or in a single sum as the employee and spouse, if any, may elect. Upon payment to the employee of the entire amount in his individual account all rights of the employee and liabilities of the Fund to the employee shall cease.

Section 1.401-1(b)(1)(i) of the Income Tax Regulations provides that a pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually life, after retirement. A pension plan may provide for the payment of

a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization or medical expenses (except medical benefits described in section 401(h)).

In this case, if an employer fails to make its contributions to the Plan for 12 consecutive months, the Plan entitles the employees to immediately receive payment of amounts from their Individual Accounts under the pension plan, with no retirement or termination of employment restrictions as to the commencement of payment. This results in a violation of section 1.401-1(b)(1)(i) of the regulations, which requires a plan be designed to provide benefits for employees or their beneficiaries after retirement. Therefore, the Plan's provision to pay benefits following 12 months of delinquent employer contributions does not satisfy section 1.401-1(b)(1)(i) of the regulations.

Finally, the Plan violates the requirement for definitely determinable benefits under regulation section 1.401-1(b)(1)(i) because of the Plan provision that disregards service for employees who have taken a distribution, without reference to whether or not they are still covered employees with an employer maintaining the plan. Thus, the Plan's benefit formula is based upon actual rather than required employer contributions and is subject to employer discretion, as prohibited by Rev. Rul. 74-385.

Issue Four

The provisions in sections 1.05, 1.06, 5.03, 2.02, 3.01, and 3.02(a) of the Plan (discussed above in issues one through three), which condition employees' benefits under the plan upon whether required employer contributions are or are not made to the Trust, violate sections 401, 410, and 411. These defects, which affect the qualified status of the Plan beginning January 1, 1976, were in the Plan in similar form when it received a favorable determination letter on October 3, 1977. They appeared again in the plan effective January 1, 1985.

Section 7805(b) of the Code states that the Secretary may prescribe the extent to which a ruling or regulation, relating to the Internal Revenue laws, shall be applied without retroactive effect. Section 15.05 of Rev. Proc. 90-4, 1990-1 C.B.-1 410 (formerly section 14.05 of Rev. Proc. 83-36, 1983-1 C.B. 763), provides that, except in unusual circumstances, the revocation or modification of a determination letter will not be applied retroactively if (1) there has been no misstatement or omission of material fact, (2) the facts subsequently developed are not

materially different from the facts on which the determination letter was based, (3) there has been no change in the applicable law, (4) the letter was originally issued with respect to a prospective or proposed transaction, and (5) the taxpayer directly involved in the determination letter acted in good faith reliance upon the letter and the retroactive revocation would be to the taxpayer's detriment.

In this case, the deficient plan provisions were in existence at the time the Plan received its favorable determination letter of October 3, 1977, and the Trustees operated the Plan according to its terms in reliance on the determination letter. Consequently, total relief with respect to these defects is appropriate for the period beginning January 1, 1976, the plan year the Plan was amended to comply with ERISA.

With regard to the defects described in Issues 1 and 2, and the definitely determinable defect in Issue 3, the period for section 7805(b) relief ends as of the effective date of Revenue Ruling 85-130, 1985-2 C.B. 137, with respect to the Plan. Although Rev. Rul. 85-130 did not change existing law, it did clarify the law concerning pension plan requirements under the definitely determinable requirement and Code sections 410 and 411, and thus prospectively cut off any reliance on the Plan's determination letter under Rev. Proc. 83-36. Section 13.04 of Rev. Proc. 80-30, 1980-1 C.B. 685, generally provides that the publication of a revenue ruling will not adversely affect the prior qualification of a plan, but that a conforming amendment must be adopted before the end of the first plan year that begins after the revenue ruling is published, effective as of the beginning of such plan year. Consequently, pursuant to Rev. Proc. 80-30, the Plan was not entitled to reliance on its determination letter, after January 1, 1986, the Plan's first plan year following the publication of Rev. Rul. 85-130.

With respect to Issue 3, the distributable events limitations defect under section 1.401-1(b)(1)(i) of the regulations was present when the Plan received its determination letter. The Trustees relied on the determination letter in good faith until the Plan defect was discovered. There has been no change in the law or the facts relating to this defect. This technical advice memorandum will be the first notice to the taxpayer of the defect.

The Plan Trustees have agreed to adopt amendments to correct the defects found in Issues 1, 2, and 3, effective January 1, 1985.[2]

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[2]The National Office has reviewed these amendments and determined that they satisfy the requirements of section 401(a) of the Code.

Issue Five:

A plan amendment has been proposed restating the Plan as a profit-sharing plan, effective October 1, 1989. Accordingly, under section 1.3 of the Plan, the term "contributions" would mean "the payments to the Fund made by Employers by the terms of the Collective Bargaining Agreements..." Section 2.02 would provide that the "amount in each Employee's Individual Account as of [each Valuation Date] ... shall be equal to ... (b) The Employer Contributions made on his behalf and allocated to his Individual Account since the last preceding Valuation Date..."

The Plan Trustees have also proposed certain alternatives for handling delinquent contributions, such as treating them as investment yield losses or as administrative expenses, for the purpose of increasing account balances to amounts required to be contributed under collective bargaining agreements.

Section 414(i) of the Code states, in relevant part, that a defined contribution plan means a plan which provides for benefits based solely on the amount contributed to the participant's account, and any income expenses, gains and losses, and any forfeitures of account of other participants which may be allocated to such participant's account.

Section 1.401-1(b)(1)(ii) of the regulations states, in relevant part, that a profit-sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among participants and for distributing the funds accumulated under the plan. A formula is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant.

Rev. Rul. 80-155, 1980-1 C.B. 84, holds that a defined contribution plan is required to provide for distributions of trust earnings in accordance with amounts stated or ascertainable and credited to participants, and that trust funds must be allocated to participants' accounts in accordance with a definite formula.

Under section 1.401-1(b)(1)(ii) of the regulations, a profit-sharing plan's allocation formula for contributions is acceptable so long as it allocates only contributions made to the plan, and does so on a definite, determinable, and nondiscriminatory basis. The satisfaction of section 1.401-1(b)(1)(ii) is consistent with the definition of a defined contribution plan under section 414(i) of the Code.

Whether an employee receives an allocation under the proposed allocation formula depends upon whether an employer

actually contributes to the plan. Thus, an employee who was eligible to participate in the plan would fail to receive an allocation if the employee's employer failed to contribute to the plan on the employee's behalf. This element of employer discretion results in the allocation formula failing to be a definite allocation formula within the meaning of section 1.401-1(b)(1)(ii) of the regulations. Since employees who participate in a multiemployer plan are considered to be employed by a single employer for plan qualification purposes, the allocation formula in a multiemployer plan must allocate employer contributions to all employees eligible to participate in the plan according to a definite formula.

Furthermore, the alternatives raised by the Trustees for substituting investment earnings for employer contributions required but not received, either by treating such delinquencies as investment yield losses or as an administrative expense, are impermissible. The effect of these alternatives would be to recharacterize investment earnings as contributions, which would violate section 1.401-1(b)(1)(ii) of the regulations and Rev. Rul. 80-155.

Likewise, the Plan Trustees' proposed amendment under section 2.07 of the Plan, concerning a "Reduction in Individual Accounts", is an unacceptable provision in either a money purchase or a profit-sharing plan. Under that amendment, each individual account would be reduced pro-rata by the amount by which the total amounts in all individual accounts plus amounts previously established for expenses and reserves exceeded the total net assets of the fund. Section 414(i) of the Code states that benefits in a defined contribution plan are based on contributions made to a participant's account and any income, expenses, gains and losses, and any forfeitures of accounts of other participants allocated to the participant's account. Section 414(i) does not provide for the adjustment of such benefits due to an excess of account balance amounts over net assets in the fund.

The final proposed amendment, under section 4.10 of the Plan, provides that in no event shall any of the amendments to the Plan, including amendments to the money purchase plan and the proposed amendments to a restated profit-sharing plan, result in the accrued benefits of any employee being less on any date after such amendments became effective than they would be in the absence of such amendments. This provision complies with the requirement of section 414(l) of the Code, which provides, in part, that in the case of any transfer of assets or liabilities of such plan to any other trust plan, each participant in the plan must (if the plan then terminated) receive a benefit immediately after the transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the transfer (if the plan had then terminated).

In addition, the proposed amendment under section 4.10 of the Plan satisfies section 1.411(d)-4, Q&A-3, of the regulations, which provides that benefits protected from reduction by section 411(d)(6) of the Code may not be eliminated by reason of transfer or any transaction amending or having the effect of amending a plan or plans to transfer benefits between and among defined benefit plans and defined contribution plans. We note that it follows that certain qualification requirements applicable to a money purchase pension plan must be preserved with respect to accrued benefits present in a pension plan at the time the plan is amended to a profit-sharing plan. For example, such amounts must remain subject to the restrictions on in-service distributions after the effective date of the amendment; under section 1.401(a)-20, Q&A-5, the survivor annuity requirements apply to all accrued benefits held for a participant with respect to whom the plan is a transferee plan unless there is an acceptable separate accounting between the transferred benefits and all other benefits under the plan.

CONCLUSIONS

(1) Consistent with sections 410 and 411 of the Code and the definitely determinable benefits provision of section 1.401-1(b)(1)(i) of the regulations, the Plan provisions allowing the Trustees to terminate an employer's status as a Contributing Employer because the employer failed to make contributions required under the collective bargaining agreement of a bargaining unit to the Fund, may not operate to deny eligibility, vesting, and contribution allocations to the employees of the terminated employer.

The Plan Trustees have agreed to adopt an allocation formula which is based on allocations that are proportionate to the contributions required from each employer. (A formula based on allocation rates slightly below required contributions would also have been acceptable, an approach that facilitates the avoidance of funding deficiencies; other reasonable, nondiscriminatory allocation formulas which are related to required contributions under the Plan may also be acceptable.) However, to the extent that contribution delinquencies result in a failure to meet the allocation formula, a funding deficiency under section 412 of the Code would arise, and would be subject to excise taxes under section 4971. The allocation of investment earnings realized in a particular year to make up for employer contributions required but not received, violates the definitely determinable benefits requirement, and is therefore impermissible. The application of forfeited amounts to substitute for required contributions which have not been made is permissible. In the event that allocations are made for which required contributions are not received, Rev. Rul. 78-223, 1978-1 C.B. 126, explains three acceptable methods for the recognition of such allocated amounts in participant

individual accounts. These three methods, although described in relation to funding waivers, also provide guidance for plans in which a disparity arises between allocations and assets due to contribution delinquencies.

(2) Because the Plan provisions defining the amount in an employee's Individual Account and his or her Accumulated Share depend upon the extent to which employer contributions are actually made on the employee's behalf and received by the Fund, they violate section 411 of the Code and the definitely determinable provision of section 1.401-1(b)(1)(i) of the regulations.

(3) The Plan provision making employees eligible to receive benefit payments, without regard to termination from employment, upon an employer's failure to make contributions for 12 consecutive months, violates the definitely determinable requirement and the distributable events limitation of section 1.401-1(b)(1)(i) of the regulations.

(4) Relief under Code section 7805(b) has been granted for the period January 1, 1976, to December 31, 1985, for Issues 1 and 2, and for the definitely determinable requirement in Issue 3. Relief under Code section 7805(b) has also been granted with respect to the distributable limitations defect in Issue 3 for the period January 1, 1976, to 31 days after the date of this technical advice memorandum, provided the Plan is amended to correct the distributable limitations defect, effective no later than 31 days after the date of this technical advice memorandum, within 91 days of the date of this technical advice memorandum.

(5) With respect to the Plan Trustees' proposal to amend the Plan prospectively to a profit-sharing plan, the amendments defining contributions and basing their allocation to employee accounts on contributions made to the plan is impermissible and must be revised consistent with the analysis in this technical advice memorandum. The Trustee proposals to substitute investment earnings for delinquent contributions, by treating delinquent contributions as a loss to investment yield or as an administrative expense deducted from investment yield, would violate section 1.401-1(b)(1)(ii) of the regulations. In addition, the Plan's proposed amendment to reduce account balances by the amount by which they exceed the net assets of the fund fails to satisfy the requirements of section 414(i) of the Code for either a money purchase or a profit-sharing plan.

$$\left(\frac{\$802 - \$500}{\$900.10 - \$500}\right) = \$5,397.$$

[¶ 19,462] **Rev. Rul. 78-223, I.R.B. 1978-24, 10.**

Waiver of minimum funding standards.—Rules are provided that apply to a defined contribution plan for which the minimum funding requirement for a particular plan year has been waived in whole or in part.

Back references: See Finding Lists.

SECTION 1. PURPOSE

This Revenue Ruling provides rules concerning (a) determination of the required amount of contributions to a defined contribution pension plan for plan years following the plan year in which the minimum funding requirements are waived pursuant to section 412(d) of the Internal Revenue Code of 1954 and section 303 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, and (b) the allocation of waiver payments, which are the amortization amounts described in section 412(b)(2)(C) of the Code or section 302(b)(2)(C) of ERISA. This Revenue Ruling applies only until regulations on this subject are effective. The rules contained in this Revenue Ruling do not apply to multiemployer plans within the meaning of section 414(f) of the Code. However, similar principles apply for such plans.

SEC. 2. BACKGROUND INFORMATION

.01 A defined contribution plan, described in section 412(a) of the Code, is subject to the minimum funding requirements of section 412 of the Code.

.02 A defined contribution plan, described in section 301 of ERISA, must satisfy the minimum funding requirements of section 302 of ERISA.

.03 Section 412(d) of the Code and section 303 of ERISA permit the Internal Revenue Service to waive, subject to certain limitations, the minimum funding requirements.

SEC. 3. GENERAL RULES

The following rules apply to a defined contribution plan for which the minimum funding requirement for a particular plan year has been waived in whole or in part. These rules are applicable until the total plan assets equal the sum of the adjusted account balances (described below).

.01 Adjusted Account Balances.—When the minimum funding requirement is waived in whole or in part with respect to a plan year under a defined contribution pension plan, those participants who would otherwise have received greater allocations to their individual accounts under the plan (hereafter referred to as "affected participants") must be, to the extent reasonably possible, restored to the position in which they would have been had the waived amount been contributed. There are several methods which satisfy this requirement. Each of the methods requires the maintenance of an adjusted account balance for each participant. The adjusted account balance is the account balance that a participant would have had, had the waived amount been contributed. The methods differ in the manner in which the adjusted account balance is computed. The plan must specify the method to be used. Two acceptable methods are described below.

Under one acceptable method, the actual yield method, the adjusted account balance is increased or decreased periodically at the actual rate of investment return experienced by the plan for such period. This method probably best approximates what the account balance would have been had the waived amount been contributed. Under this method, however, the employer assumes the investment risk of funding for the actual investment experience. If the fund has a high yield, the employer must fund more than if there is a low yield.

Under a second acceptable method, the 5% method, the excess of each affected participant's adjusted account balance over such participant's actual account balance is credited at a fixed rate of interest not less than 5% compounded annually. Although this method is more approximate than the actual yield method, this method is simpler. Furthermore, unlike the actual yield method, it provides a known level of costs.

.02 Waiver Payments.—The plan must specify how the amounts necessary to amortize the waived funding deficiency (the waiver payments) are to be determined. The waiver payments so specified should provide for an amortization of the waived funding deficiency over 15 years by level payments. A plan will not fail to satisfy the definitely determinable requirement described in section 1.401-1(b)(1)(i) of the Income Tax Regulations merely because such plan permits discretionary larger contributions, not to exceed the amount needed to make the sum of the account balances equal to the sum of the adjusted account balances. Furthermore, such larger con-

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tributions are currently deductible under section 404(a)(1) of the Code if the plan is qualified.

The interest rate used to determine the amortization schedule must be reasonable. The reasonableness of such interest rate depends on the method of determining the adjusted account balances under subsection .01.

If the actual yield method described in subsection .01 is used, the interest rate should be the best estimate of future investment experience. Unless the alternative method described in subsection .04 is used, the effect of deviations between the assumed interest rate and the actual investment yield are treated as experience gains or losses under subsection .03.

If the 5% method described in subsection .01 is used, the interest rate used to amortize the waived funding deficiency should be the same interest rate used to credit the excess of the adjusted account balances over the actual account balances.

.03 Experience Gains or Losses.—Under the minimum funding standards, except to the extent that a plan is fully funded, experience gains or losses are to be amortized over 15 years rather than immediately and totally applied. Generally, in a defined contribution plan where forfeitures are not anticipated, a forfeiture is an experience gain. In a defined contribution plan that is fully funded, the effect of the full funding limitation is that such forfeitures immediately and totally reduce the required contribution. However, because a defined contribution plan for which a waiver is granted is not fully funded, only a 15-year amortization of such forfeitures may be applied to reduce the required contribution. The interest rate used to amortize experience gains or losses must be the same interest rate used in subsection .02. A plan for which a waiver is granted must specify the treatment of forfeitures.

.04 Alternative Computation of Waiver Payments and Experience Gains or Losses.—In lieu of the separate amortization of the items described in subsections .02 and .03, the following method may be used. In the year after the waiver is granted, the waiver payment adjusted for experience gains or losses equals the amount necessary to amortize over 15 years the excess of the sum of the adjusted account balances over the total plan assets. The interest rate used to determine the amortization must be the same rate that would be used under subsection .02 if subsection .02 applied. In the next year the excess for such subsequent year, if any, is amortized over 14 years. In each succeeding year the amortization period is reduced by one year. No other adjustments to the required contribution are made to take account of experience gains or losses.

.05 Interim Benefits/Allocation.—The plan must specify what benefit payments are available to participants before the total plan assets equal the sum of the adjusted account balances. There are many possible methods that may be employed to satisfy this subsection. Any method must not only define the benefits payable to participants but also include a mechanism for allocating the waiver payments (adjusted for experience gains or losses) to participants. Such method must be consistent with the benefit payout provisions. Paragraphs (1), (2), and (3) provide methods which satisfy this subsection. Paragraph (4) analyzes them. These methods are not an exclusive list of all possible methods. Furthermore, some of the methods may (a) not be appropriate in all cases or (b) be discriminatory within the meaning of section 401(a)(4) of the Code in certain situations.

(1) Immediate Allocation Method.—Under this method waiver payments adjusted for experience gains or losses are allocated immediately to the actual account balances of affected participants. The adjusted account balance of each affected participant may exceed that participant's actual account balance. The plan's distribution provisions limit the distribution of the nonforfeitable portion of the adjusted account balance to the actual account balance. Thus some affected participants may not be able to receive a total distribution of the nonforfeitable portion of their entire account balances; such participants would receive subsequent distributions derived from future waiver payments adjusted for experience gains or losses.

(2) Suspense Account Method.—Under this method, waiver payments adjusted for experience gains or losses are credited immediately to a suspense account. The adjusted account balance of each affected participant may exceed that participant's actual account balance. The plan provides that if the nonforfeitable portion of the participant's adjusted account balance exceeds that participant's actual account balance at the time of distribution, that participant will receive the largest amount to the extent that there are then funds in the unallocated suspense account to cover the excess. Thus some affected participants may not be able to receive a total distribution of the nonforfeitable portion of their entire adjusted account balances; such participants would receive subsequent distributions derived from future waiver payments adjusted for experience gains or losses. When the total plan assets equal the sum of the adjusted account balances, the suspense account is allocated to the affected participants so that

the actual account balance of each affected participant equals that participant's adjusted account balance.

(3) Unrestricted Distribution Method.—Under this method, the waiver payments adjusted for experience gains or losses become part of the plan's general assets, and actual account balances are not maintained. When a participant is entitled to a distribution, that participant receives the entire nonforfeitable portion of that participant's adjusted account balance to the extent that the plan's assets are sufficient to make the payment. Thus some participants may not be able to receive a total distribution of the nonforfeitable portion of their entire adjusted account balances; such participants would receive subsequent distributions derived from future waiver payments adjusted for experience gains or losses.

(4) Analysis of Above Methods.—In deciding on a method to satisfy this subsection, two fundamental concerns are: the claim that each participant has to the plan assets, and the desire to have a minimal effect on the normal distribution rules of the plan.

Under the Immediate Allocation Method, each participant will receive precisely what that participant is entitled to. However, this method is the most disruptive to the plan's normal distribution rules (because an affected participant might not receive his entire adjusted account balance before the total plan assets equal the sum of the adjusted account balances).

Under the Suspense Account Method, distributions are not disrupted as much as under the Immediate Allocation Method, but those affected participants who are first entitled to distributions may deplete the suspense account so that other affected participants may not benefit from the waiver payments adjusted for experience gains or losses should the plan terminate.

Under the Unrestricted Distribution Method, the normal distribution provisions of the plan are virtually unaffected. However, this method may deplete the plan assets of all participants whether or not they are affected participants. In the event of a subsequent termination of the plan, certain participants may suffer as a result of this method. Accordingly, this method may not be acceptable unless there is a showing that such subsequent plan termination is extremely unlikely.

[¶ 19,463] Rev. Rul. 78-249, I.R.B. 1978-26, 6.

Disability income exclusion: $15,000 phaseout: Eligibility to claim exclusion: Subsequent years.—The $15,000 adjusted gross income phaseout does not affect the eligibility for the disability income exclusion of a permanently and totally disabled taxpayer who retired in 1977, and did not make an irrevocable election not to claim the exclusion under section 105(d)(3) of the Code. The amount of the taxpayer's adjusted gross income for 1977 reduced the disability income exclusion to zero for that year, but the phaseout will not preclude subsequent years' exclusions.

Back references: See Finding Lists.

In August 1977, an unmarried taxpayer who was 35 years old became permanently and totally disabled, as defined in section 105(d)(5) of the Internal Revenue Code of 1954, and retired on disability. The taxpayer's adjusted gross income for 1977 was $22,000, consisting of $20,000 in wages and $2,000 (20 weeks times $100 a week) in disability retirement payments. The taxpayer, who did not make an irrevocable election not to claim the disability income exclusion, was not entitled to exclude any of the disability payments for 1977, because of the $15,000 adjusted gross income phaseout provision of section 105(d)(3).

Under section 105(d)(3) of the Code, if an eligible taxpayer's adjusted gross income for the taxable year (determined without regard to the disability income exclusion) exceeds $15,000, the amount of the disability income that would otherwise be excludible under section 105(d) for the taxable year is reduced by an amount equal to the excess of the taxpayer's adjusted gross income over $15,000.

Held, the $15,000 adjusted gross income phaseout under section 105(d)(3) of the Code does not affect the taxpayer's eligibility for the disability income exclusion; it affects only the amount of the exclusion available to the taxpayer. Thus, the fact that the taxpayer's exclusion in 1977 was reduced to zero because of the phaseout will not preclude an exclusion in subsequent years.

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