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Internal Revenue Service

Employee Plans Technical Advice Memorandum

CP:E:EP:A:1

Area Manager

Through EP Special Review

Taxpayer's Name:
Taxpayer's Address

Taxpayer's Identification Number:
Year Involved:

Conference held: December 18, 2000

Company =
Plan 030 =
Plan
Plan 001 =
Plan 032 =

Issue

Is Plan 030 fully funded for the 9312 plan year and subsequent plan years or is there an accumulated funding deficiency, as defined in § 412 of the Internal Revenue Code?

Facts

The Company established Plan 030 effective January 1, 1980. The Company also maintained Plan 001 and Plan 032. The plans are qualified defined benefit plans subject to the requirements of section 412 of the Code. The plan year for each plan was the calendar year. The funding method for all three plans was the unit credit funding method, with the actuarial value of the assets determined as the fair market value of the assets. The actuarial assumptions used for the plans were the same in some respects and differed in other respects. The valuation date for each of the plans was January 1, the first day of the plan year. In October 1993, the actuarial valuation reports summarizing the results of the January 1, 1993, actuarial valuation were prepared and transmitted to the Company.

Effective December 10, 1993, Plan 030 and the Plan 001 were merged, as defined in § 414(l) of the Code, into Plan 032. The name of Plan 032 was changed to the Plan 030 and Plan 001 had a short plan year beginning January 1, 1993 and ending December 10, 1993. The valuation date for each of the three plans was January 1, 1993.

The Schedule B of Form 5500 that was filed for Plan 030 for 1993 ("the 1993 Schedule B") shows a normal cost (on line 9b) of $350,254, which was pro-rated to reflect the portion of the plan year through December 10, 1993. The 1993 Schedule B also shows a credit balance of $11,114[1] (on line 9n) and a funding deficiency of $323,750 (on line 9o) in the funding standard account. The attachment to the Schedule B states that due to the merger with the Plan 032 that "the contribution that would have been due to this plan could not be made because the merged plan is fully funded."

Applicable Law

Section 404(a)(1)(A) of the Internal Revenue Code sets out the rules under which deductible limits are derived for defined benefit pension plans. It further states that, in determining the amount deductible under these rules, the funding method and the actuarial assumptions used are to be the same as those used under § 412, and that the maximum amount deductible for a year shall be an amount equal to the full funding limitation for the year determined under § 412 of the Code.

Section 412(a) of the Code provides the rules under which the minimum required contribution to a defined benefit pension plan is determined. A plan to which § 412 applies shall have satisfied the minimum funding standard for the plan for a plan year if, as of the end of such plan year, the plan does not have an accumulated funding deficiency. The term "accumulated funding deficiency" means for any plan year the excess of the total charges to the funding standard account for all plan years (beginning with the first plan year to which § 412 applies) over the total credits to such account for such years.

Section 1.404(a)-14 of the Income Tax Regulations provides rules for determining the deductible limit under § 404(a)(1)(A) of the Code for defined benefit plans. Section 1.404(a)-14(f)(3) of the regulations provides

[1] This entry appears to be in error based on subtracting the full funding limitation credit from total credits instead of subtracting total charges from total credits.

that, regardless of the actual time when contributions are made to a plan, in computing the deductible limit under § 404(a)(1)(A)(ii) and (iii) the normal cost and limit adjustments shall be computed as of the date when contributions are assumed to be made ("the computation date") and adjusted for interest at the valuation rate from the computation date to the earlier of (i) the last day of the plan year used to compute the deductible limit for the taxable year, or (ii) the last day of the taxable year. Section 1.404(a)-14(k) of the regulations provides that the deductible limit may not exceed the full funding limitation. The rules under § 412 and paragraphs (d), (e), and (f) of § 1.404(a)-14 are to be used to determine the full funding limitation.

Revenue Ruling 79-237, 1979-2 C.B. 190, provides guidance as to the applicability of the minimum funding standard to plans that terminate. Rev. Rul. 79-237 generally states that the minimum funding standard applies to a plan until the end of the plan year in which such plan terminates and does not apply to the plan in subsequent plan years. In the case of the termination of a plan, Rev. Rul. 79-237 provides that the normal cost and amortization charges and credits, and the interest charges and credits, are ratably adjusted to reflect the portion of the plan year before the plan terminated. Rev. Rul. 79-237also provided that the extension period of § 412(c)(10) of the Code will not be changed merely because the date of termination precedes the end of the plan year.

Revenue Ruling 82-125, 1982-1 C.B. 64, provides examples of the determination of the full funding limitation. Under Rev. Rul. 82-125, for purposes of § 404 of the Code, the full funding limitation is determined as the excess of (A) the sum of the accrued liability plus the normal cost determined as of the valuation date and increased with interest to the end of the plan year, over (B) the lesser of the fair market value or the actuarial value of the assets as of the valuation date increased with interest to the end of the plan year (with a further adjustment of then subtracting any contribution carryover without an interest adjustment).

Revenue Procedure 87-27, 1987-1 C.B. 769, provides rules for determining the deductible limit when there is a change in the plan year. Section 5 of Rev. Proc. 87-27 provides for an adjustment to the deductible limit for the employer's taxable year when the sum of the number of months of each plan year associated with an employer's taxable year is different from the number of months in the employer's taxable year. The adjustment is obtained by multiplying the sum of the deductible limits for

the associated plan years by a fraction, where the numerator is the number of months in the taxable year and the denominator is the aggregate number of months in plan years associated with such taxable year. Furthermore, the deductible limit for a short plan year is determined by ratably reducing the deductible limit for a 12-month plan year in proportion to the number of months of the short plan year.

Analysis

In general, the minimum funding standard of § 412 of the Code is applied on the basis of a plan year. The minimum funding standard is satisfied for a plan year if the accumulated credits in the funding standard account for the plan year and prior plan years equal or exceed the accumulated charges for the plan year and prior plan years. For a particular plan year, the relevant charges and credits are based upon an actuarial valuation for the plan year. The actuarial valuation determines the normal cost, accrued liability, actuarial asset value, experience gains and losses, and related amortization charges and credits as of the valuation date for the plan year. The data used for the actuarial valuation is the relevant asset values, demographic information, and plan provisions as of the valuation date. Once determined, the relevant charges and credits to the funding standard account are adjusted with interest to the end of the plan year.

As a consequence of choosing a valuation date, the results of the actuarial valuation as of that date are not affected by events occurring after the valuation date. Thus, for example, demographic changes that occur after the valuation date have no affect on the determination of the normal cost for the plan or the accrued liability. Similarly, changes in the value of the plan's assets that occur after the valuation date have no affect on the determination of the actuarial value of the plan's assets. If later events cause a plan to be fully funded (i.e., the full funding limitation is zero) as of the date of the next actuarial valuation, that result does not alter the minimum funding requirement based on the earlier actuarial valuation. Conversely, if the results of the next actuarial valuation show that there is a minimum funding requirement greater than zero as of the next valuation date, that result does not alter the result of the earlier valuation that shows the plan to be fully funded and that no contribution is due.

Under § 412 of the Code, the minimum funding standard applies through the end of the plan year in which the plan ceases to exist. In the case of a plan termination, that year is the plan year in which the plan is terminated. In the case of a merger of the plan with another plan, that year is generally the plan year in which the merger occurs. The valuation date for the plan year beginning January 1, 1993, was January 1, the first day of the plan year. The results of the

valuation indicated that a contribution of $323,750 was needed to avoid a funding deficiency. Following the principles of Rev. Rul. 79-237, such contribution could be made anytime during the 8 ½ month period after the end of the plan year. For this purpose, contributions to the trust after the merger can be counted as contributions to the plan because the trust for the plan has become part of the trust after the merger.

In this case, sufficient contributions were not made during the applicable 8 ½ month period. Accordingly, there is a funding deficiency for the plan year.[2] There is a funding deficiency regardless of subsequent events such as contributions made in the next plan year after the end of the 8 ½ month period, or an actuarial valuation for the next plan year that shows the plan to be fully funded. Note, however, these subsequent events have a bearing on whether the funding deficiency has been corrected so as to avoid the 100 percent excise tax of § 4971(b) of the Code. In situations such as this, where a later actuarial valuation shows that the plan is fully funded, the funding deficiency will have been corrected. As a practical matter, therefore, under § 412 of the Code, the taxpayer does not actually have to contribute to the plan an amount equal to the funding deficiency to avoid incurring § 4971(b) tax for the plan year or § 4971(a) tax for later plan years. The only out-of-pocket expense is the 10 percent excise tax of § 4971(a) for the plan year beginning January 1, 1993.

Under § 1.404(a)-14(f)(3) of the regulations, the deductible limit for a defined benefit plan is determined for a plan year based upon the computation date. Generally, as is the case here, the computation date is the valuation date for the actuarial valuation for the plan year. Once the deductible limit is determined as of the computation date, the limit is increased with interest to the earlier of the end of the plan year or the end of the tax year.[3] Events that take place after the valuation date do not affect the deductible limit. Thus, the fact that a plan becomes fully funded at a later date does not affect the deductible limit for the year. Conversely, if the results of the actuarial valuation for the year show the deductible limit to be zero, the fact that the deductible limit for a later year is greater than zero (for example, because of experience losses) does not alter the allowable deduction for the earlier period.

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[2] The funding deficiency appears to be slightly overstated. The credit balance as of the beginning of the year (plus interest on that credit balance) should be applied towards the contribution that would be required. This would reduce the funding deficiency.

[3] The proposed regulations under § 412 are consistent with this procedure. Section 1.412(c)(6)-1(b) of the proposed regulations provides that the assets and accrued liabilities are to be valued at the usual time used by the plan for valuation and projected to the end of the plan year with interest at the valuation rate.

The results of the January 1, 1993, actuarial valuation indicated that $336,839 would be deductible.[4] Consequently, contributions made for the year up to that amount would still be deductible, even if an actuarial valuation as of a later date indicated that the deductible limit was zero. A merger of the plan with another plan is an event that takes place after the valuation date and does not render a contribution for the plan year as nondeductible. Even if the period up to the time of the merger were regarded as a short plan year, the deductible limit would first be ratably reduced and then adjusted upwards pursuant to Rev. Proc. 87-27 producing a deductible limit of $336,839 (see example 1 in § 5.04 of Rev. Proc. 87-27).

In the post-conference submission dated February 16, 2001, the taxpayer argues that the view that there is a funding deficiency is a retroactive application of Rev. Proc. 99-45, 1999-45 C.B. 603. The taxpayer asserts that until the publication of Rev. Proc. 99-45 there was no published guidance for the taxpayer to rely upon (especially concerning mergers). This is not the case. As described above, § 1.404(a)-14(f)(3) provided guidance as to the computation date under § 404(a)(1)(A). The regulation made no exception for a plan that was merged into another plan. Furthermore, Rev. Rul. 82-125 provided examples showing such treatment. The taxpayer can point to no published guidance that would suggest the contrary result.

Conclusion

Plan 030 has an accumulated funding deficiency for the plan year beginning January 1. 1993. The Company is liable for excise tax under § 4971(a) of the Code on account of this accumulated funding deficiency. However, because this accumulated funding deficiency was timely corrected, the Company is not liable for excise tax under § 4971(b) on account of this accumulated funding deficiency. In addition, the Company's liability for excise tax under § 4971(a) with respect to this accumulated funding deficiency relates only to the plan year of Plan 030 beginning January 1, 1993, and not to any subsequent plan years of Plan 032.

This memorandum only applies to the taxpayer involved. Section 6110(j)(3) of the Code provides that it may not be used or cited by others as precedent.

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[4] This amount was determined to be the full funding limitation calculated at the beginning of the plan year plus interest at 8 percent. The full funding limitation limited the amounts determined under paragraphs (i) and (ii) of § 404(a)(1)(A).

This memorandum has been coordinated with the Division Counsel/Associate Chief Counsel Tax Exempt and Government Entities (CC:TEGE:EB:QP1).