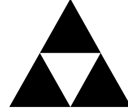

AMERICAN ACADEMY *of* ACTUARIES

July 2, 2003

Ms. Carol D. Gold
Director, Employee Plans TE/GE
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224-0002

Re: Good Faith Compliance

Dear Ms. Gold:

On behalf of the Pension Committee of the American Academy of Actuaries,[1] I would like to take this opportunity to express our concerns about the role of "good faith compliance" in matters affecting the design and operation of qualified plans. Some of these issues arise as a result of legislated changes in the Internal Revenue Code, while others come under review because of the Service's ongoing review of technical matters.

We understand that the Service does not currently have enough resources to fully address all of these outstanding issues, and has been stretched to its limits in dealing thoughtfully with major issues such as the need to provide guidance in connection with cash balance plans, modifying the determination letter process to deal with redrafted plan documents to conform with the so-called GUST and EGTRRA requirements, the potential need for more suitable disclosure information to plan participants, etc.

In these circumstances, we recognize that we will be called upon with much greater frequency to advise plan sponsors regarding issues before the Service has provided guidance. Many of our clients are companies that are finding it more and more difficult to continue sponsoring defined benefit pension plans. We realize that we must help them operate their plans with a reasonable degree of operational comfort. At present, we find ourselves unable to do so without fearing subsequent financial sanctions by the Service many years later.

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

This responsibility is particularly difficult when dealing with the many gray areas in determining minimum required pension contributions under IRC Section 412 and maximum tax-deductible contributions under IRC Section 404. Historically, good faith compliance has been critical in consulting with our clients on matters of this sort. When the Service has published no official guidance, we often try to help our clients develop a reasonable interpretation based on all of the information available to us, including informal contact with the Service via telephone and live conversations, as well as through Service presentations for professional organizations.

If, at a later date, the Service issued official guidance that was different from prior informal guidance (or provided new and different informal guidance), our clients have generally been subject to the new methodology on a prospective basis and retroactively subject to a good faith compliance standard when no official guidance had been provided. An example of this is Revenue Ruling 2003-83, which was issue on June 30, 2003. It addressed an area where the proper procedure had been unclear, but the effect was prospective only.

Due to its potential precedent-setting significance with respect to the implication for good faith interpretations, we would like to the use the attached Technical Advice Memorandum (200312025; 412.00-00) as an illustration of our concerns. Regulation Section 1.412(c)(2)-1(e)(2) indicates that, "for plan years beginning prior to November 12, 1980, the amounts required to be determined under section 412 may be computed on the basis of any reasonable actuarial method of asset valuation which takes into account the fair market value of the plan's assets, even if the method does not meet all of the requirements of paragraphs (a) through (c) of this section."

Based on our review of this TAM, we have a number of concerns:

- If the same analysis underlying the TAM was the basis of the development of the rules outlined in Section 4.07 of Rev. Proc. 99-45 and Section 4.07 of Rev. Proc. 2000-40, then we believe that the decision process in developing those rules may have been flawed and that the Service should reconsider those rules and modify them.

- We understand that there may have been certain concerns about deductibility that contributed to the decision process in developing those rules. We believe that a simpler solution could have been developed that would result in better policy.

- We understand that certain employees of the Service had, in many public forums and private conversations, agreed with and supported the treatment used by the enrolled actuary in the situation addressed by this TAM. We understand, further, that there was a discussion of the specific situation with the Service and that the discussion and the Service's advice were noted on the applicable Schedule B.

- With respect to this specific TAM, we believe the analysis is flawed and that the TAM should be revoked and replaced with a more appropriate analysis.

We acknowledge that the Service can change its attitude regarding the acceptable treatment of specific issues, but we are distressed at the thought that a plan sponsor's actions taken before any public announcement of the prospective rule change could be penalized in any way for non compliance. Actions of this sort, at the very least, undercut the plan sponsor's reliance on "good faith" interpretation.

We summarize, below, the technical issues involved in the Technical Advice Memorandum in question. It is difficult to see how the plan actuary's advice (or the plan sponsor's reliance on this advice) was not a "reasonable good faith interpretation" of the issues involved.

Discussion of the Relevant TAM

The Technical Advice Memorandum was based on the premise that regulatory guidance before the promulgation of Rev. Proc. 99-45 made it clear that no events subsequent to the valuation date could have any affect on the valuation results. We disagree with this premise, since Rev. Rul. 77-2 and IRC Section 412(c)(8) clearly provide for situations where the settlor action of a plan amendment subsequent to the valuation date may, at the plan sponsor's election, be recognized, either pro rata or in full, in the valuation – both for determining minimum required contributions and maximum tax deductible contributions, as well as the full funding limitation.

When the cited regulation in the TAM (Regulation Section 1.404(a)-14(f)(3)) is read in conjunction with Rev. Rul. 77-2 and IRC Section 412(c)(8), it would be reasonable to infer that the regulation deals with actuarial gains and losses, while the Rev. Proc. and IRC Section deal with settlor actions. Thus, based on the regulatory and statutory guidance extant before the promulgation of Rev. Proc. 99-45, it would appear reasonable for an enrolled actuary to have treated a plan merger consistent with the alternative methodologies outlined in Rev. Rul. 77-2 and IRC Section 412(c)(8).

Automatic Approval of Actuarial Methodology for Mid-Year Mergers

Section 4.07 of Rev. Proc. 99-45 and Section 4.07 of Rev. Proc. 2000-40 provide rules for dealing with the determination of required contributions in the context of a mid-year merger. Essentially, if an overfunded plan is merged into an underfunded plan, none of the overfunded plan's surplus can be used to reduce the required contribution of the underfunded plan. Consider two calendar year plans with January 1 valuation dates that are merged on July 1. Plan A has $10,000,000 of assets and $5,000,000 of accrued liabilities. Plan B has $2,000,000 of assets and $5,000,000 of accrued liability. Both plans

have $100,000 of normal annualized cost. Neither plan has a credit balance as of the beginning of the year.

Plan A is merged into Plan B. When combined, the plan is overfunded and the full funding limit would be zero. There is no good policy reason to require a contribution. However, under the Rev. Procs., a full year's contribution would be required with respect to the original Plan B, as if no merger had taken place.

If Plan B were allowed to treat the plan merger as a plan amendment and permitted to make a 412(c) election to treat the merger as if it had taken place at the beginning of the plan year, then no contribution would be required.

We understand that there was some concern at the Service that, had Plan B received quarterly contributions before the merger, those contributions would then be deemed nondeductible and would potentially generate an excise tax.

By permitting the plan sponsor to determine the contribution under either of the two methodologies permitted under Rev. Rul. 77-2, as well as the methodology of IRC Section 412(c)(8) treating it as a plan amendment, the plan sponsor could then chose between a full year's contribution to Plan B (as required by the Rev. Proc.), a half-year's contribution to Plan B, or no contribution to Plan B. Thus, the plan sponsor could control the extent to which there would be any issue of nondeductible contributions and excise taxes. Furthermore, the Service could permit the refund of the "nondeductible" contribution just as it permits any other plan to refund nondeductible quarterly contributions made before the completion of the actuarial valuation.

* * * * *

We appreciate your consideration of these issues and would like to discuss with you our concerns, in the absence of regulatory guidance, about good faith compliance and the potential for financial sanctions with retroactive applications by the Service.

Thank you for your consideration of these important issues, and please do not hesitate to contact Heather Jerbi, the Academy's pension policy analyst (202-785-7869 or Jerbi@actuary.org), if you have any questions or comments.

Sincerely,

Donald J. Segal, FSA, MAAA
Chair, Pension Committee
American Academy of Actuaries

Significant Index No. 0412.00-00

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).