

Maximum Deductions For Pension Plans

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DC Plans – Elective Deferrals

- **PLR 201229012**
- “... an employee who is treated as benefitting (for 410(b) purposes) under a section 401(k) plan for a plan year, but who is not eligible for any employer contributions other than elective deferrals, would not be considered a beneficiary of the trust for purposes of section 404(a)(3)(i)(I) since section 404(n) of the Code requires the limits on deductible contributions to be applied without regard to the existence or absence of elective deferrals ...”
- “... Accordingly, the deductible limit under section 404(a)(3)(A) of the Code ... is determined based on compensation paid or accrued during the taxable year to all employees who are beneficiaries under ... the Plans during the taxable year... taking into account only those employees who have allocations other than elective deferrals ...”



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DC Plans – Elective Deferrals

- While a PLR is not a Revenue Ruling and cannot be relied upon except by the taxpayer requesting the PLR, I believe this ruling is the correct interpretation of Section 404(n).
 - “Elective deferrals ... shall not be subject to any limitation contained in paragraph (3), (7), or (9) of subsection (a) ... and such elective deferrals shall ***not be taken into account in applying any such limitation to any other contributions.***” (emphasis added)
- So, an employee only eligible to make 401(k) deferrals is not a beneficiary for this purpose.



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DB Plans

- Maximum deduction greater of:
 - §430 minimum [§404(o)(1)(B)]
 - §404(o)(2) amount [§404(o)(1)(A)]
 - With respect to each plan year ending with or within the taxable year
 - **Similar language in §404(a)(1) pre PPA**



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DB Plans – Effect of Overlapping Plan/Tax Year

- Plan Year \neq Tax Year
 - Limit based on plan year *beginning* within tax year
 - Limit based on plan year *ending* within tax year
 - Weighted average of above based on number of months of each plan year falling within tax year
 - Reg. §1.404(a)-14(c)
 - **Is this still a valid reg post PPA 2006?**
 - **Absent contrary guidance seems reasonable to assume it is still valid**



Defined Benefit Plans

- §404(o)(2) amount = sum of:
 - Target normal cost,
 - Funding target, and
 - **Cushion amount**, over
 - Actuarial value assets
 - *Reduced by un-deducted contributions?*
 - *Pre-PPA Reg. Section §1.404(a)-14(d)(2)(i)*
 - §404(o)(2)(A)



Defined Benefit Plans

- Reg. Section §1.404(a)-14(d)(2)(i)
 - “There must be excluded from the total assets of the plan the amount of any plan contribution for a plan year ... that has not been previously deducted, even though that amount may have been credited to the funding standard account ...”
 - Does this still apply? - Would certainly make sense that it should



Cushion Amount

- IRC 404(o)(3)(A)(ii)(I):
 - The cushion amount for any plan year is the sum of—
 - (i) 50 percent of the funding target for the plan year, and
 - (ii) the amount by which the funding target for the plan year would increase if the plan were to take into account—
 - (I) increases in compensation which are expected to occur in succeeding plan years



Cushion Amount

- When calculating 50% cushion, plans with less than 101 participants exclude from funding target any liability due to benefit increases for HCEs from amendments “made or effective” (whichever is later) in last 2 years
 - IRC §404(o)(4)



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Cushion Amount

- Number of participants determined aggregating all DB plans of all related employers [§404(o)(4)(B)]
 - But exclude employees of non-related employers in such plans (e.g. if multiple employer or multiemployer plan)
 - Greybook Q&A 1998-6



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Cushion Amount

- Under similar pre-PPA rule, 2 year period measured from beginning of Plan Year for which liability determined
- Ex. §412(c)(8) amendment adopted 3/15/04 effective 1/1/03 increases benefits for HCEs
 - When measuring §404(a)(1)(D) limit for 2006 benefit increases applicable to such amendment may not be considered
 - Greybook Q&A 2002-3
 - Note different result if amendment adopted before 1/1/04
 - e.g. if amendment adopted 12/31/03 two year rule would not apply for 2006 and such benefits considered in measuring 2006 UCL limit



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Cushion Amount

- In same question IRS also indicated:
 - Limit does apply to multiemployer plans with 100 or less participants
 - Short plan year not considered a full year
 - i.e. 2 years = 24 months
 - COLA adjustments under §§401(a)(17) and 415(b) not considered amendments
 - Date amendment 'made' = date adopted



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Cushion Amount

- Is adoption of plan an amendment?
 - No – Notice 2007-28, Q&A 5
 - BUT, employer must not have maintained DB plan covering HCE covered by new plan during past 2 years
- Query as to determination of HCE status
 - Year of amendment? (my vote)
 - Year deduction being determined?



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Plans not at-risk

- Plans NOT at-risk, IRC §404(o)(2) amount not less than:
 - FT, as if plan at risk; plus
 - TNC, as if plan at risk; less
 - Actuarial value of assets (unreduced by pre-funding or carryover balances)
 - IRC §404(o)(2)(B)
 - Cash balance plan allowing for immediate LS should be able to use this rule to get deduction for full contribution in year 1



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Plans not at-risk

- At risk rules
 - FT & TNC, *determined in normal manner*, but with additional assumptions, PLUS
 - Load of \$700 per participant added to FT
 - Load of 4% of Non-at risk amt added to FT & TNC
 - Loads only if at risk 2 of prev. 4 years
 - **Application of loads to 404(o)(2)(B) rule? – likely reasonable to add loads absent contrary guidance**
 - IRC §§ 430(i)(1)(A); 430(i)(1)(C); 430(i)(2)
 - Reg §§ 1.430(i)-1(c)(2) ; 1.430(i)-1(d)(2)



Plans not at-risk

- Additional assumptions used for at-risk FT/TNC
- All employees eligible to commence distribution within 10 years after current year assumed to retire at earliest retirement date (ERD) and commence (most valuable form of) distribution at ERD
- ERD is earliest date participant may receive fully vested immediate distribution (Reg. §1.401(a)-20 QA 17(b))
 - Not before end of current year
- IRC §430(i)(1)(B)(i); Reg §§ 1.430(i)-1(c)(3)(ii)(C) / 1.430(i)-1(d)(2)(i)



Use of Cushion– Example

- Example – “One Big Hit” trial lawyer
 - Age 58 at 1/1/15, **15 years prior svc**
 - No other employees – Reg. §1.401(a)(4)-5(a)(3) N/A
 - Wants to retire 12/31/2019 at age 62
 - Consistently earned \$250K annually
 - 2015 will earn \$550K
 - Likely back to \$250K in 2016 →
 - And he needs it all to live
 - Wants to shelter the \$300K excess
 - But with no future obligation



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Use of Cushion– Example

- Adopts DB plan
 - Normal retirement age 62
 - Monthly benefit \$100 per year of service
 - Benefit at 1/1/15 effective date \$1,500
 - Annual accrual thereafter \$100
 - Total benefit at retirement \$2,000
 - Assume lump sum, 5% 2015 417(e) table
 - B.O.Y. valuation
 - January 2015 unadjusted S1 – 1.22%



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Use of Cushion– Example

- FT = \$221,074
 - $1,500 * 156.595 * 1.0122^{(-5)}$
- TNC = \$14,738
 - $100 * 156.595 * 1.0122^{(-5)}$
- Max deduction = \$346,349
 - $(221,074 * 1.5) + 14,738$
- Deposit of \$300,000 will be enough to cover all 20 years of benefits assuming 1% ROR



Use of Cushion– Example

- i.e. benefit at age 62 will be \$2,000
- Value (liability) at age 62 (assuming current table) will be \$313,190 ($2,000 * 156.595$)
- At 1% ROR assets will grow to \$315,303
- Greater growth fine
 - Maximum lump sum under IRC 415 at age 62 with 5 years in plan exceeds \$1.3 million



Combined Plan Limits – IRC §404(a)(7)

- Applies where employer contributes to both DB and DC plan for same tax year [IRC §404(a)(7)(A)]; AND
- At least one employee is a beneficiary in both plans [IRC §404(a)(7)(C)(i)]
 - “Beneficiary” in DC plan means current employer \$\$
 - “Beneficiary” in DB plan means accrued benefit
 - At least that’s my take



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Combined Plan Limits – IRC §404(a)(7)

- Consider ‘carve out’ DB & 401(k) trying to avoid 404(a)(7) combined limit while allowing everyone to defer
 - Recall IRC §404(n):
 - “Elective deferrals ... shall not be subject to any limitation contained in paragraph (3), (7), or (9) of subsection (a) ... and such elective deferrals *shall **not** be taken into account in applying **any** such limitation **to any other contributions.***” (emphasis added)



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Combined Plan Limits – IRC §404(a)(7)

- Employer sponsors DB plan & 401(k) PS plan
 - Employees in DB plan eligible for just deferrals in 401(k) PS plan
 - Other employees in 401(k) PS plan receive PS contributions (but are not in DB plan)
 - i.e., absent deferrals no one benefits in both plans
- 2005 IRS/ASPPA Q&A #21 IRS indicated that the combined plan limit did not apply
 - **Of course it doesn't** – 404(n) controls
 - ***BUT this requires conclusion that deferral only participants are NOT beneficiaries in DC plan***
 - *And therefore comp. not considered in DC limit – above PLR*



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Combined Plan Limits – IRC §404(a)(7)

- Deduction limited to greater of:
 - 25% of compensation paid to beneficiaries of the plans (i.e. either plan) during the tax year; or
 - contributions to DB plan to extent not in excess of minimum funding requirement
 - Not less than funding target over actuarial value of assets (Note absence of TNC)
 - IRS has indicated that MAP/HATFA does apply for this purpose (IRS phone forum)
- IRC §404(a)(7)(A)



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Combined Plan Limits – IRC §404(a)(7)

- Limit does not apply -
 - To extent employer contributions to DC plan do not exceed 6% of compensation (of DC plan ‘beneficiaries’)
 - IRC §404(a)(7)(C)(iii)
 - To multiemployer plans
 - IRC §404(a)(7)(C)(v)
 - To PBGC plans
 - IRC §404(a)(7)(C)(iv)



Combined Plan Limits – IRC §404(a)(7)

- Notice 2007-28
 - Q&A 8 - where DC contributions exceed 6% of comp, only DC contributions over 6% considered in determining 25% limit
 - Effectively translates to 31% limit
 - BUT, only consider compensation of DC beneficiaries in determining the 6%
 - How much do you have to allocate to someone to count their comp?
 - » \$5 for a \$260K employee??



Combined Plan Limits – IRC §404(a)(7)

- DB Plans exempt from PBGC coverage
 - Plans of professional group if plan never covered more than 25 active participants
 - Physicians, dentists, D.O.s, O.D.s, lawyers, CPAs, P.E.s, architects, actuaries, others where license requires “advanced study”
 - Not APAs, QPAs, RIAs, CLUs, real estate prof, etc.
 - ERISA Title IV § § 4021(b)(13), 4021(c)(2)



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Combined Plan Limits – IRC §404(a)(7)

- DB Plans exempt from PBGC coverage
 - Plans covering only “substantial” owners
 - A “substantial owner” is an individual who (at any time during the prior 60-months) owns:
 - the entire interest in a sole proprietorship
 - more than 10% of either a capital or profits interest in a partnership, or
 - more than 10% in value of either the voting or all stock of a corporation
 - ERISA Title IV § § 4021(b)(9), 4021(d)



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Combined Plan Limits – IRC §404(a)(7)

- Attribution rules of IRC § § 1563 and 414(c) apply in determining ownership
- Under IRC § 1563(e) “An individual shall be considered as owning stock owned ... by ... his children who have not attained the age of 21 years, and, if the individual has not attained the age of 21 years, the stock owned ... by ... his parents”
- Children not deemed to own the stock of their parents via above rules are not “substantial owners” and therefore could cause coverage
- 60-month rule basically requires child to be age 26 for this rule to cause coverage



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Combined Plan Limits – IRC §404(a)(7)

- Spreadsheet on following page developed by Mike Preston whom I thank very much for allowing me to share with you all!



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Determination of 404(a)(7) limitation in case where plan year equals fiscal year:

1 Enter Compensation (limited to 401(a)(17)) for those in DB plans only:	60000
2 Enter Compensation (limited to 401(a)(17)) for those in DC plans only:	30000
3 Enter Compensation (limited to 401(a)(17)) for those in both DB and DC:	265000
4 Enter Minimum Required Contribution for DB plan	100000
5A Enter Funding Target:	340000
5B Enter Actuarial Value of Assets:	230000
5C Calculate Funding Target less Actuarial Value of Assets:	110000
6 Enter amount deposited to DB plans	150000
7 Enter amount deposited to DC plans	23700
8 Enter maximum deductible DB contribution under 404(o) without considering 404(a)(7)	250000
9 Calculate maximum deductible DC contribution	73750

Per Notice 2007-48 Q&A 8, the 404(a)(7) limit is calculated as follows:

A Is amount deposited to DC plans [7] greater than 6% of DC comp (6% * ([3]+[2])): Yes

B If [A] is No, skip to [G]

C Calculate amounts deposited to DB [6] not in excess of greater of MRC [4] or FT less AVA [5C] 110000

D Calculate 25% of DB or DC comp: 88750


E Maximum of [C] or [D] 110000

F Total deduction available (sum of [E] and 6% of DC comp) Use this: 127700

G Deductible amount to DB plan 150000


H Deductible amount to DC plan 23700

I Total deduction available: Ignore this: 173700




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Cash Balance/401(k) Combo

	Compensation	Age
HCE 1 – owner	\$ 265,000	57
HCE 2 – non owner	265,000	44
NHCE 1	30,000	30
NHCE 2	30,000	46
NHCE 3	30,000	60
NHCE 4	30,000	60
NHCE 5	30,000	41
NHCE 6	30,000	31
Total	\$ 710,000	



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Cash Balance/401(k) Combo – Ex.1 DC over 6%

- Components of Design – DC plan
 - 3% non-elective safe harbor 401(k)/PS
 - Maximize Owner
 - 3% total to non-owner HCE
 - Additional 4% PS to NHCEs (7% with SH)
 - Suggest no safe harbor to HCEs
 - HCEs defer max, NHCEs do not defer
 - Same for all examples



Cash Balance/401(k) Combo – Ex.1 DC over 6%

- Components of Design – DC plan
 - For PS allocation each participant in own group for flexibility & gateway requirements
 - No last day or hour requirement for PS allocation
 - If not 401(k) SH possibly use 501 hours or last day
 - Combo designs generally require loss of requirements such as 1,000 hours and last day for PS allocation
 - Gateway must go to any NHC receiving allocation of employer DC or accrual in DB (more later)
 - 5% Top-Heavy in profit sharing plan



Cash Balance/401(k) Combo – Ex.1 DC over 6%

- Components of Design – DB plan
 - Cash balance plan with pay credits as follows:
 - Owner - \$160,000 (exclude non-owner HCE)
 - NHCEs – 2.5% of compensation
 - Interest crediting rate = 5% (same for all examples)
 - Plan AE = 5%, 2015 417(e) table



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Cash Balance/401(k) Combo – Ex.1 DC over 6%

- Components of Design – DB plan (same for all)
 - NRA later age 62 / 5th anniv. participation
 - Should be same as DC
 - Though likely fine if DC earlier
 - Require 1,000 hours to receive pay credit
 - May not have an EOY requirement in a DB plan
 - Would violate DOL requirement that year of service with 1,000 or more hours may not be ignored for benefit accrual
 - DOL Reg § § 2530.204-1; 2530.204-2



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Cash Balance/401(k) Combo – Ex.1 DC over 6%

	PS/SH	Cash Balance	Total Employer	401(k)	Total
HCE 1	\$ 35,000	\$160,000	\$ 195,000	\$ 24,000	\$ 219,000
HCE 2	7,950	-0-	7,950	18,000	25,950
NHCE 1	2,100	750	2,850		2,850
NHCE 2	2,100	750	2,850		2,850
NHCE 3	2,100	750	2,850		2,850
NHCE 4	2,100	750	2,850		2,850
NHCE 5	2,100	750	2,850		2,850
NHCE 6	2,100	750	2,850		2,850
Total	\$ 55,550	\$164,500	\$220,050	\$ 42,000	\$ 262,050



Cash Balance/401(k) Combo – Ex.1 DC over 6%

- Employer total (\$220,050) less than 31% of compensation
 - $\$710,000 * 31\% = \$220,100$



Cash Balance/401(k) Combo – Ex.2 DC not over 6%

- Components of Design – DC plan
 - 3% non-elective safe harbor 401(k)/PS
 - \$22,050 Owner
 - 3% total to non-owner HCE
 - Additional 4% PS to NHCEs (7% with SH)
- Components of Design – DB plan
 - Cash balance plan with contribution credits as follows:
 - Owner - \$200,000 (exclude non-owner HCE)
 - NHCEs – 2.5% of compensation



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Cash Balance/401(k) Combo – Ex.2 DC not over 6%

	PS/SH	Cash Balance	Total Employer	401(k)	Total
HCE 1	\$ 22,050	\$200,000	\$ 222,050	\$ 24,000	\$ 246,050
HCE 2	7,950	-0-	7,950	18,000	25,950
NHCE 1	2,100	750	2,850		2,850
NHCE 2	2,100	750	2,850		2,850
NHCE 3	2,100	750	2,850		2,850
NHCE 4	2,100	750	2,850		2,850
NHCE 5	2,100	750	2,850		2,850
NHCE 6	2,100	750	2,850		2,850
Total	\$42,600	\$204,500	\$247,100	\$ 42,000	\$ 289,100



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Cash Balance/401(k) Combo – Ex.2 DC not over 6%

- Employer total (\$247,100) > 31% of comp (\$220,100)
- But DC not in excess of 6% of comp:
 - 6% * \$710,000 = \$42,600 = Employer DC
 - 25%/31% limit therefore not applicable
 - Important that HCEs receive employer \$\$\$ in DC to use comp. In applying 6% limit



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Cash Balance/401(k) Combo – Ex.3 DB PBGC Covered

- Components of Design – DC plan
 - 3% non-elective safe harbor 401(k)/PS
 - Maximize Owner
 - 3% total to non-owner HCE
 - 4% PS to NHCEs
- Components of Design – DB plan
 - Cash balance plan with contribution credits as follows:
 - Owner - \$200,000 (exclude non-owner HCE)
 - NHCEs – 2.5% of compensation



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Cash Balance/401(k) Combo – Ex.3 DB PBGC Covered

	PS/SH	Cash Balance	Total Employer	401(k)	Total
HCE 1	\$ 35,000	\$200,000	\$ 235,000	\$ 24,000	\$ 259,000
HCE 2	7,950	-0-	7,950	18,000	25,950
NHCE 1	2,100	750	2,850		2,850
NHCE 2	2,100	750	2,850		2,850
NHCE 3	2,100	750	2,850		2,850
NHCE 4	2,100	750	2,850		2,850
NHCE 5	2,100	750	2,850		2,850
NHCE 6	2,100	750	2,850		2,850
Total	\$ 55,550	\$204,500	\$260,050	\$ 42,000	\$ 302,050



Cash Balance/401(k) Combo – Ex.3 DB PBGC Covered

- *Assumes not Dr/Professional as under 25 active participants*
 - *ERISA §4021(b)(13)*
 - *Run any of these scenario through your testing software and you'll see they pass all testing*



DB Exception to Excise tax

- IRC 4972(c)(7)
- “In determining the amount of nondeductible contributions for any taxable year, an employer may elect for such year not to take into account any contributions to a defined benefit plan ...”
- OK, so, why would they not elect?
 - And HOW do you elect?



Year Deductible

- Plan contribution deemed made on last day of preceding taxable year if payment on account of such **taxable year** and made not later than due date for filing tax return for such taxable year (including extensions)
 - §404(a)(6)



Year Deductible

- In order for §404(a)(6) to apply (allowing deduction in tax year prior to year of deposit):
 - Contribution must be treated as a contribution actually received on last day of tax year would be treated; and
 - No later than due date of tax return, employer either:
 - designates payment in writing (to PA or trustee) as “on account of” employer’s “preceding taxable year”; or
 - claims payment as deduction on tax return for preceding taxable year
- Revenue Ruling 76-28



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Year Deductible

- Note from above “Contribution must be treated as a contribution actually received on last day of tax year would be treated”
 - This would seem to disallow prior year deduction for amounts contributed pursuant to post year-end corrective amendment under Reg. §1.401(a)(4)-11(g)
 - Further, from §1.401(a)(4)-11(g)(5)
 - “... the amendment is not given retroactive effect for purposes of section 404 ...”



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Year Deductible

- A payment may be designated as on account of preceding taxable year (as provided above) at any time on or before the due date (including extensions) of tax return for such year
 - SO, where return first filed without taking deduction, amended return may be filed claiming deduction if filed before (extended) due date
 - CONVERSELY, if deduction claimed on preceding year return for post year-end deposit, employer may not amend return to push deduction to current year



Year Deductible

- Presume that:
 - payment made within 8 ½ months after year-end
 - treated as prior year deposit for §412 (minimum funding)
 - not deducted on prior year tax return, and
 - nothing in writing designates contribution is “on account of” prior tax year
- How about deposit made 10/15 (within 404(a)(6) period for Sole Prop) for calendar year plan?
- Can contribution be “on account of” one year for minimum funding purposes and another year for deduction purposes?



Year Deductible

- Revenue Ruling 77-82
 - Taxpayer allowed to take deduction in 1975 for contribution made within §404(a)(6) period, but count for §412 (minimum funding) in 1976 (§412 did not apply until years beginning after 1975)
 - Service cited following language in Temp. Reg. §11.412(c)-12(c)(2) (allowing 8½ month post year-end period to satisfy minimum funding in case of pension plans other than single employer DB plans):



Year Deductible

- “The rules of this section relating to the time a contribution ... is deemed made for purposes of ... section 412 are independent from the rules contained in section 404(a)(6) relating to the time a contribution ... is deemed made for purposes of claiming a deduction for such contribution under section 404.” [Temp. Reg. §11.412(c)-12(c)(2)] (emphasis added)



Year Deductible

- PLR 9107033:
 - For 1988 company maintained three plans – a money purchase plan, a PS plan and a DB plan
 - Contributions to three plans exceeded §404(a)(7) limit
 - Company wished to treat certain contributions to DB plan made after year-end but prior to extended due date of tax return (and minimum funding deadline) as 1988 contributions for §412 but as 1989 for §404
 - Citing Temp. Reg. §11.412(c)-12(c)(2) and RR 77-82, Service allowed taxpayer to treat contributions in above manner



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Year Deductible

- Note that with contribution considered §404 contribution for subsequent year, limits of §404 for following year will apply
 - and they will apply to all amounts designated as being “on account of” such subsequent year
 - i.e., contribution is not added to following year’s limit - it becomes deductible within such limit
 - (Presumably) Reg. §1.404(a)-14(d)(2)(i) will require that contribution be excluded from assets when determining deductible amounts for subsequent year



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Year Deductible

- 2011 Greybook Q&A 7
- A company has a calendar taxable year and sponsors a pension plan with a calendar plan year. Which of the following combinations are acceptable for a contribution made during the 2010 §404 contribution grace period (January 1, 2011 to September 15, 2011)?
 - a) Deduct in 2010, reflect on 2010 Schedule SB?
 - b) Deduct in 2010, reflect on 2011 Schedule SB?
 - c) Deduct in 2011, reflect on 2010 Schedule SB?
 - d) Deduct in 2011, reflect on 2011 Schedule SB?



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Year Deductible

- 2011 Greybook Q&A 7 (cont)
- **RESPONSE**
- a), c), and d) are acceptable. IRC §404(a)(6) deems a contribution made after the last day of a taxable year to be made on the last day of a taxable year if the payment is made on account of such taxable year. A contribution is considered to be on account of the 2011 plan year when reported on the 2011 Schedule SB and thus cannot be deducted on the sponsor's 2010 tax return
- COMMENTARY TO FOLLOW



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Year Deductible

- I respectfully disagree that (b) is not acceptable
- IRC 404(a)(6) and 76-28 do not require contribution to be on account of preceding plan year
- They require it to be on account of preceding tax year
- As detailed above, there is plenty of authority (e.g. RR 77-82) providing that they can be different
 - e.g. as in (c) where on 2010 SB but 2011 tax return
- If a contribution is within deductible limit for preceding year, and is made by due date of preceding year tax return, it should be deductible in preceding year irrespective of treatment for funding purposes

