Part XI: Money Purchase and Target Benefit Plans

1101. What is a money purchase plan?

As part of the general classification of defined contribution plans, in which the contribution rather than the retirement benefit is defined, the contributions to profit sharing plans are discretionary. Defined contribution plans also include money purchase and target benefit plans. The main difference between these plan types and profit sharing plans is that contributions to money purchase and target benefit plans are mandatory. If the required contribution to a money purchase or target benefit plan is not made when due, there is an excise tax to the extent minimum funding standards are not satisfied.

*Minimum funding standards* define the minimum contribution required to satisfy benefits provided for in a defined benefit plan or the contributions to a money purchase or target benefit plan. Contributions to all “pension” plans (money purchase, target benefit, and defined benefit) must be made by eight and one-half months after the end of the plan year to meet the minimum funding standards.[[1]](#footnote-1) If the contribution is not made, an excise tax is imposed equal to 10 percent of the funding deficiency. If the deficiency is not corrected, the Internal Revenue Service (IRS) has the authority to impose an additional 100 percent excise tax.[[2]](#footnote-2)

A pension plan, including money purchase, target benefit, and defined benefit plans, must provide for “definitely determinable benefits”[[3]](#footnote-3) for its employees in order to be considered a qualified plan under the Internal Revenue Code (Code). To be definitely determinable, the benefits must be provided to the employees through fixed (mandatory) contributions that are determined without reference to profits.[[4]](#footnote-4)

*Definitely determinable benefits* can be loosely defined as the ability of an outside party to read the plan document and determine the contribution or benefit for the employee given the employee’s compensation for the period defined in the plan. The determination of the benefit in a defined benefit pension plan or the contribution in a defined contribution pension plan is not subject to discretionary control.

Consistent with the purpose of pension plans, withdrawals may not be taken before death, disability, attainment of normal retirement age, termination of employment, or termination of the plan. If the plan allowed for distributions during active employment but before retirement, the benefits would no longer be definitely determinable.[[5]](#footnote-5)

1102. What are the contribution limits in a money purchase plan?

In a money purchase plan, the deductible limit for the plan sponsor is 25 percent of total compensation when compensation is limited to $265 ,000 for any one employee (for 2015 ) and the contribution is limited to $53 ,000 (for 2015 ).

*Example 1.*Following is an example of a simple money purchase plan that provides for a contribution of 25 percent of compensation. Harold and John are owners of the company. All others are employees.



A basic money purchase plan does not maximize the benefits for the owners of the company. Because a contribution of 25 percent of compensation exceeds the maximum allowable annual addition (currently the lesser of 100 percent of compensation or $53 ,000) for Harold, his contribution is capped at $53 ,000, the dollar limit.

*Example 2.* In a money purchase plan with a contribution formula of 20 percent rather than 25 percent Harold receives the same contribution; however, all other employee contributions are reduced.

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By changing the contribution formula, Harold still has $53 ,000 allocated to his account but the total contribution for rank-and-file employees goes down by $7,800 ($39,000 – $31,200); however, John’s contribution also goes down by $5,000.

In the plan shown in Example 2, forfeitures (the nonvested portion of terminated employees’ accounts) should be used to reduce contributions even though the plan may allow forfeitures to be reallocated to the remaining participants. If the forfeitures are reallocated, Harold cannot share in those forfeitures because he is already at the maximum annual addition of $53 ,000.

1103. Can a money purchase plan take Social Security into consideration in calculating contributions for employees?

Social Security integration, or *permitted disparity*, can be applied to money purchase plans the same way as it is applied to profit sharing plans. If the money purchase plan is designed to be integrated at the 2015 Social Security wage base of $118,500 , which is adjusted annually. See Appendix H for current wage bases), the following is the result (see Q 7004):



1104. What is a target benefit plan?

In the preceding examples, the contributions are all allocated based on compensation. If two other variables—the age of the participant and length of service—were added, the result would be a target benefit plan, which is a hybrid plan. It begins as a defined benefit plan, i.e., the plan defines the resulting retirement benefit in the form of monthly retirement income. After the contributions are calculated, there is no change to those contributions other than as a result of changes in compensation.

Consider a parallel financial calculation that is used regularly (see Part XX).

*Example.* John would like to save for a larger house. He determines that he can handle a monthly mortgage payment of $1,500. To do that, based on the price range of the house he can afford, he would have to put down a deposit of $50,000. John is hoping to accumulate the down payment in five years through an investment in mutual funds that he projects will appreciate by 10 percent annually after taxes. John has decided that if the mutual fund does not perform as expected, he will adjust his annual deposit so that at the end of the five-year period he will have the $50,000. Here is the result of John’s plan:

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| *End the Year* | *Deposit* | *End-of-Year*  *Appreciation* | *Expected*  *Balance* | *End-of-Year*  *Balance* |
| 1 | $ 8,190 | $ 819 | $ 9,009 | $ 9,009 |
| 2 | $ 8,190 | $ 1,300 | $ 18,499 | $ 18,919 |
| 3 | $ 8,610 | $ 2,100 | $ 29,209 | $ 29,820 |
| 4 | $ 8,801 | $ 4,560 | $ 42,570 | $ 41,811 |
| 5 | $ 7,431 |  | $ 50,001 | $ 50,000 |

In year 2 the investment underperformed. Ten percent of the first year’s balance of $9,009 plus 10 percent of the second year’s contribution of $8,190 would be $1,720. The investment appreciated by $1,300, a shortfall of $420. To make up the shortfall, John added to the third year’s deposit, bringing it to $8,610 ($8,190 plus $420). In year 3 the investments underperformed again. John expected a return of $2,711 (10 percent of the second year’s balance of $18,499 plus 10 percent of the third year’s contribution of $8,610) but only realized a gain of $2,100. The shortfall of $611 is made up in the fourth year’s contribution of $8,801 ($8,190 plus $611). In year 4, the gain was more than expected, so the fifth year’s contribution was reduced, and John has his $50,000 at the end of five years.

The situation in the above example is similar to the way a defined benefit plan operates. A reserve is calculated that is sufficient to fund the employee’s retirement benefit. Each year the employer’s contribution is adjusted based on actual changes in the operation of the plan, including employee salaries, the rate of return of the plan investments, and employee turnover.

A target benefit plan adjusts only for salary. In the mortgage example the contribution would not change unless the “reserve” of $50,000 was changed. This would be parallel to a salary increase that would increase the benefit and therefore the contribution in a target benefit plan. If the salary does not change, the contribution does not change.

Because a target benefit plan is a hybrid plan, i.e., it refers to benefits to calculate initial contributions, it must satisfy several conditions to comply with the nondiscrimination rules for benefits:[[6]](#footnote-6)

1. The employee’s benefit must be determined based on a straight life annuity beginning at normal retirement age, usually age sixty-five.

2. The employee must earn his or her benefit evenly over future service up to retirement age as adjusted for changes in compensation.

3. Service before the date of participation in the plan may not be credited to the employee for the determination of benefits to satisfy the safe harbor requirements.[[7]](#footnote-7)

4. The retirement benefit must be a flat benefit earned over no fewer than twenty-five years or a unit benefit per year of future service up to twenty-five years.[[8]](#footnote-8)

5. Forfeitures must be used to reduce employer contributions.

6. Employee voluntary contributions may not be used to fund the stated retirement benefit.

Following these rules creates a safe harbor target benefit plan that is nondiscriminatory by design.

1105. How are contributions calculated in a target benefit plan?

The example below outlines the steps for calculating the contributions for a targeted benefit plan.

*Example.* Assume the following for a plan that is effective January 1, 2014:

1. The employee’s salary is $45,000.

2. The employee’s age is forty-five and date of birth is January 1, 1969.

3. The employee’s date of participation is January 1, 2014.

4. The annuity purchase rate is $109.60 (per the 1983 Individual Annuity Mortality table at 8 percent; use of this factor must be defined in the plan document).

5. The assumed investment rate of return is 8 percent. If the actual return varies, the employee’s benefit will be different than projected but the contribution will not change.

6. The retirement age is sixty-five, and the employee’s projected retirement date is January 1, 2034.

7. The retirement benefit formula is 2 percent per year of service.

The first step in calculating the contribution is to determine the retirement benefit as follows:

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| (Monthly salary × years of participation) × monthly benefit percentage = monthly benefit |
| ($45,000/12) × (20 years) × 2%= $1,500 per month theoretical benefit |

The next step is to calculate the reserve, i.e., the amount necessary to pay the promised benefit:

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| Monthly benefit × annuity purchase rate = Reserve |
| $1,500 × $109.60 = $164,400 |

The last step is to calculate the annual contribution necessary to accumulate $164,400 over the employee’s future service of twenty years (January 1, 2014 to January 1, 2034), assuming an 8 percent return on the investment account.

After this contribution is determined, it does not change unless the employee’s salary changes. If the investments perform better than the assumed investment rate of return of 8 percent, the employee will have a higher benefit. If the investments perform worse, the employee will have a lower retirement benefit. This is consistent with the concept of a defined contribution plan providing an account balance based on contributions and investment performance.

1106. What is the difference between a safe harbor and a non-safe harbor target benefit plan?

The retirement benefit formula for the safe harbor target benefit plan below is 1.185 percent of compensation per year of service, limited to twenty-five years, in accordance with the safe harbor rules.

*Example 1.* Applying the rules regarding crediting of service, each employee will have a benefit equal to his or her future service up to retirement age sixty-five (limited to twenty-five years), multiplied by 1.185 percent of compensation.



Since the plan is top heavy, i.e. more than 60% of the benefits are for the key employees, the non key employees must receive the greater of the calculated deposit or the top heavy minimum of 3.0% of compensation.

The result is quite different when the general test under the nondiscrimination rules for cross-tested plans is used. The plan in Example 2 below provides for a benefit of 1.1679 percent of compensation per year of service up to eleven years, including up to five years of past service. This is the amount of total service Harold will have at retirement age if past service is limited to five years. The limit is five years because in a plan that credits past service, the result must be nondiscriminatory. If total past service was credited, the result might be discriminatory because the owners (highly compensated employees, or HCEs) have much more past service than the employees (nonhighly compensated employees, or NHCEs).

*Example 2.*Although the safe harbor rules do not allow for total past service and require benefits to be credited over twenty-five years, an alternate plan design that satisfies the general test also passes muster. The following is the allocation of the contribution for the redesigned plan.



Here, the NHCEs must receive a minimum contribution of 5 percent of compensation to satisfy the gateway rules for general testing (see Part IV). All the employees receive the 5 percent because the required contribution to fund the monthly benefit would be less than 5 percent for all those employees.

The dollar allocation and percentage share of the contribution is much higher for the owners in this plan than in the safe harbor plan. In addition, the benefit formula of 1.1679 percent per year of service up to eleven years is just the benefit necessary to provide a contribution of $53 ,000 for Harold. Generally, the benefit formula for a target benefit plan is determined by the contribution target, usually for the owner(s). Because this is not a safe harbor design, the plan must now pass the general test under Code section 401(a)(4).

1107. Can the contribution to a money purchase or target benefit plan be adjusted if the employer cannot afford to fund the plan?

Because target benefit plans and money purchase plans are classified as pension plans, contributions are mandatory. What does an employer do during an unexpected business reversal, when it is impossible to meet the minimum funding requirements?

If the downturn is recognized early enough, the plan may be amended to reduce contributions or, in the extreme case, the plan may be terminated. Any plan amendment must be adopted before the end of the plan year. If the participant has worked 1,000 hours or more, the contribution due for the year must be based on the benefit before it was reduced by the amendment. If the amendment is executed and effective early in the plan year, before the participants work 1,000 hours, it reduces the contribution for the current year.

In addition, all participants must be notified of the reduction in future benefit accruals (contributions) at least fifteen days before the effective date of that reduction.[[9]](#footnote-9) The IRS privately ruled that a retroactive plan amendment that had the effect of decreasing participants’ accrued benefits (contributions they had already earned), was permitted only as it pertained to HCEs participating in the money purchase pension plan, but not as it applied to all other participants.[[10]](#footnote-10)

Another alternative is to apply to the IRS for a plan funding waiver. The IRS will grant a minimum funding waiver to a defined contribution plan, i.e., a money purchase or target benefit plan, if the following requirements are met:[[11]](#footnote-11)

1. Affected participants must, to the extent reasonably possible, be restored to the position in which they would have been had the waived amount been contributed. The plan must specify the method to be used, either:

a. The actual yield method, that is, adjusting each participant’s account balance periodically at the actual rate of investment return experienced by the plan; or

b. The 5 percent method, under which each participant’s account is credited at a rate of interest not less than 5 percent compounded annually.

2. The plan must specify the way 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 fifteen years by level payments. The interest rate used to determine the amortization schedule must be reasonable.

3. Experience gains or losses must be amortized over a fifteen-year period rather than immediately.

4. The plan must specify what benefit payments are available to participants before the time the total plan assets equal the sum of the adjusted account balances under an interim benefit method.

These requirements allow the employer to make up the waived contribution with interest over fifteen years, thereby placing the employee in the same position he or she would be in had the contribution not been waived. A plan provision that satisfies these requirements does not necessarily satisfy the Code section 401(a) qualification requirements.

To provide maximum flexibility in obtaining a waiver for a defined contribution plan, the IRS has three alternative procedures. With these procedures, a single request can cover either a waiver ruling only or a waiver ruling and a determination letter confirming that the waiver does not adversely affect the plan’s qualified status.

The alternative procedures are:[[12]](#footnote-12)

1. *Waiver ruling only, without submission of plan amendment*. Under this procedure, the employer can request a waiver ruling only (and not a determination letter) without the submission of a plan amendment by meeting the requirements that apply to defined benefit plans under Revenue Procedure 94-41, except those requirements that apply only to defined benefit plans. Any waiver ruling granted under this procedure will be accompanied by a plan amendment supplied by the IRS that, if adopted, will satisfy the requirements that apply to funding waivers for money purchase and target benefit plans. The waiver will be conditioned on the plan being amended by adoption of that amendment within a reasonable period of time and will contain a caveat stating that the ruling is not a ruling about the effect the plan provision may have on the qualified status of the plan. On receipt of that amendment, the employer may (within 60 days of the date of the letter) request reconsideration of the waiver condition if the amendment is inappropriate.

2. *Waiver ruling only, with submission of plan amendment.* Under this procedure, the employer can request a waiver ruling only (and not a determination letter) with the submission of a plan amendment by meeting the requirements that apply to defined benefit plans under Revenue Procedure 94-41, except those requirements that apply only to defined benefit plans. The application must also include plan provisions necessary to satisfy the requirements that apply to funding waivers for money purchase and target benefit plans. All waivers issued by the IRS under this procedure will contain a caveat indicating that the ruling is not a ruling on the effect that the plan provisions submitted may have on the plan’s qualified status.

3. *Waiver ruling and determination letter request*. The employer can request both a waiver ruling and a determination letter on the effect of any amendment necessary to satisfy the requirements that apply to funding waivers for money purchase and target benefit plans. The submission must include a completed Form 5300 (determination letter application) and related documents, indicate which key district office has jurisdiction of the return, and include the appropriate user fee.

1. . IRC Sec. 412(c)(10)(B). [↑](#footnote-ref-1)
2. . IRC Sec. 4971(a), IRC Sec. 4971(b). [↑](#footnote-ref-2)
3. . Treas. Reg. §§1.401-1(a)(2)(i), 1.401-1(b)(1)(i). [↑](#footnote-ref-3)
4. . Treas. Reg. §§1.401-1(b)(1)(i), 1.401-1(a)(2)(i). [↑](#footnote-ref-4)
5. . Rev. Rul. 69-277, 1969-1 C.B. 116; Rev. Rul. 74-417, 1974-2 C.B. 131. [↑](#footnote-ref-5)
6. . Treas. Reg. §1.401(a)(4)-8(b)(3)(i). [↑](#footnote-ref-6)
7. . Treas. Reg. §1.401(a)(4)-3(b)(2)(v). [↑](#footnote-ref-7)
8. . Treas. Reg. §§1.401(a)(4)-8(b)(3)(A), 1.401(a)(4)-3(b)(4)(i)(C)(2). [↑](#footnote-ref-8)
9. . ERISA §204(h). [↑](#footnote-ref-9)
10. . Priv. Ltr. Rul. 9745026. [↑](#footnote-ref-10)
11. . Rev. Rul. 78-224. [↑](#footnote-ref-11)
12. . Rev. Proc. 94-41. [↑](#footnote-ref-12)