Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), money purchase pension plans offered employers an attractive vehicle for maximizing deductible contributions to a qualified defined contribution plan. Employers could effectively deduct contributions to a money purchase plan in an amount up to 25 percent of the compensation paid to employees actively participating in the plan, while deductions for contributions to profit-sharing plans were limited to 15 percent of compensation. EGTRRA increased the general limit on deductible contributions to a profit-sharing plan to 25 percent of the compensation of all participants. As a result, employers that previously maintained money purchase plans may want to consider replacing those plans with profit-sharing plans.

In considering whether to substitute a profit-sharing plan for a money purchase plan, it is important to understand the limits that apply to plan contributions and other restrictions on plan operations. As noted above, the Internal Revenue Code (IRC) generally limits the total deductible contributions to a profit-sharing plan to 25 percent of the compensation of all participants. Money purchase plans are also now subject to the same limit. In contrast, prior to EGTRRA, the general deduction limit for money purchase plans was determined under IRC Section 404(a)(1) and was based on the amount required to be contributed under the plan formula, rather than a specific percentage of compensation. Pre-EGTRRA, the effective limit on deductions for money purchase plan contributions derived from one of two rules. First, if an employer contributed to both a money purchase plan and either a profit-sharing plan or a defined benefit plan for the same employees, the maximum deductible contribution to the plans generally would be 25 percent of the compensation of the participants under IRC Section 404(a)(7). Second, under IRC Section 404(j), both profit sharing and money purchase plans are subject to a rule that the deductions for an employer’s defined contribution plans may not exceed the amount that may be allocated to the participants under the limits of IRC Section 415.
IRC Section 415 is important not only because it may effectively limit the deductions, but also because Section 415(c) restricts the contributions that may be allocated to any individual participant under any combination of defined contribution plans. Before EGTRRA, this 415 limit was the lesser of $30,000 or 25 percent of compensation; following EGTRRA, it is the lesser of $40,000 or 100 percent of compensation. Finally, the maximum compensation that may be taken into account for any participant in applying the deduction limits or in making allocations under a defined contribution plan is now $200,000, as adjusted for cost of living, while prior to EGTRRA, this amount was $170,000.4

While these interrelated rules are quite complicated, the bottom line is that for an employee earning $160,000 or more, the EGTRRA changes allow the employer to make the maximum IRC Section 415 contribution of $40,000 as a deductible contribution under a profit-sharing plan (i.e., $160,000 x 25 percent = $40,000). In contrast, before EGTRRA, an employer would have had to contribute to a money purchase plan or a combination of a money purchase plan and a profit-sharing plan to be able to allocate the maximum contribution under IRC Section 415 to these plan participants.

In addition, because the IRC saddles money purchase plan sponsors and participants with obligations and procedural requirements that are not generally applicable to profit-sharing plans, the employer may prefer to replace the money purchase plan with a profit-sharing plan if the employer previously maintained a money purchase plan primarily to maximize contributions. Most significantly, while profit-sharing plans can generally be designed to provide employers with great flexibility in determining the amount of annual contributions, a money purchase plan must provide for a fixed formula under which contributions are required to be made.5 Absent timely adoption of a plan amendment to reduce the formula and advance notice of the change to participants, a money purchase plan sponsor cannot contribute less than called for under the formula without obtaining a waiver of the minimum funding standard from the Internal Revenue Service. Employers that do not obtain a waiver but still fail to make timely contributions are subject to a substantial excise tax.6

Regulations also prohibit distributions from a money purchase plan before the earlier of normal retirement age or termination of employment (i.e., in-service distributions, such as hardship distributions). In addition, distributions from a money purchase plan must be paid in the form of a joint and survivor annuity for the life of the participant and his or her spouse unless both the participant and the spouse consent to another form of payment, and other requirements of the joint and survivor annuity rules of IRC Section 401(a)(11) apply to these plans. With money purchase plans remaining subject to these restrictions and the EGTRRA changes in the deduction rules, money purchase plans now offer little or no advantage over profit-sharing plans for many employers.

An employer that wishes to replace its money purchase plan with a profit-sharing plan essentially has three choices. First, it can terminate the money purchase plan and allow participants to take a distribution or roll over their accounts to an existing or newly established profit-sharing plan or...
who have no vested account balance are deemed to have received a full distribution (i.e., what is known as a “zero dollar cashout”). Under the cashout provision, the account balances of terminated participants with no vested benefits and the nonvested portion of the account balances of those participants with partially vested benefits will be forfeited before plan termination, and the plan will not be required to vest these amounts. An employer may amend a money purchase plan to include such a cashout provision at any time before plan termination. Of course, the nonvested account balances that cannot be cashed out and that are not otherwise distributed (e.g., the accounts of participants with balances in excess of $5,000, actively employed participants, or participants who cannot be located) will still need to be vested upon termination, but the inclusion of a cashout provision may significantly reduce the cost of this vesting requirement.

Termination of Money Purchase Plan
While plan termination may initially appear to be the obvious solution to eliminate a money purchase plan that has outlived its usefulness, an employer should be aware of a number of issues that the termination may raise before settling on this course of action.

Vesting. As an initial matter, IRC Section 411(d)(3) requires any plan that is terminated, including a money purchase plan, to vest any participant who has an undistributed account balance that has not been forfeited as of the plan’s termination. Generally, a participant’s account balance is not forfeited until the participant’s employment has terminated for five years or the participant has received a distribution of the vested portion of his or her account, and the vesting requirement upon plan termination applies even though a former participant’s account balance has been reallocated to the accounts of other participants. Depending on the application of forfeitures under the plan and the size and demographics of a plan’s participant population, the cost of providing full vesting upon plan termination could be a significant expense for the employer and could pose an operational challenge.

To minimize the cost of full vesting, money purchase plans that have not already done so should adopt a cashout provision under which account balances with a value of $5,000 or less are automatically distributed to participants who have terminated employment, as permitted under IRC Section 411(a)(11). The cashout provision should specifically provide that participants who have no vested account balance are deemed to have received a full distribution on the day of plan termination, and that these amounts will be forfeited before plan termination, and the plan will not be required to vest these amounts. An employer may amend a money purchase plan to include such a cashout provision at any time before plan termination. Of course, the nonvested account balances that cannot be cashed out and that are not otherwise distributed (e.g., the accounts of participants with balances in excess of $5,000, actively employed participants, or participants who cannot be located) will still need to be vested upon termination, but the inclusion of a cashout provision may significantly reduce the cost of this vesting requirement.

Administrative Issues. Plan termination is a relatively simple procedure. The plan document should include a provision indicating, at least in general terms, the parties who have the authority to terminate the plan. Often the document will simply say the employer may terminate the plan, in which case, the employer’s board of directors or other governing body should take appropriate action, such as by adopting a corporate resolution terminating the plan.

If the plan is individually designed, the employer should apply for a determination letter from the IRS on the IRS Form 5310. Although a plan is not required to obtain a determination letter upon termination, the IRS has indicated informally that it targets for audit plans that are terminated without obtaining a letter. The IRS can identify that a plan has been terminated when the plan files its final annual Form 5500, on which the administrator must check a box indicating that the plan has been terminated.) A standardized prototype plan that did not receive an initial determination letter, however, need not apply for a letter upon termination, and it will not increase the risk of being audited by failing to do so. A terminating plan must be amended to comply with all changes to the applicable qualification requirements that become effective before the date set by the employer for plan termination even if the plan would have otherwise had an extended period to adopt the changes if the plan had not been terminated. For example, a plan with a plan year beginning July 1 that is terminated on March 1, 2003 must be amended by that date to comply with the EGTRRA changes that became effective with respect to the plan on July 1, 2002 (or earlier), even though the employer would have until June 30, 2003 to adopt good faith EGTRRA amendments and until the end of the 2005 plan year to make final EGTRRA changes if the plan were not being terminated.

204(h) Notice. Section 204(h) of the Employee Retirement Income Security Act (ERISA) requires that participants receive advance notice of the termination of a money purchase plan. Specifically, this rule states that a money purchase plan cannot be amended to provide for a significant reduction in the rate of future benefit accruals unless affected individuals (and employee organizations representing those individuals) are provided with a notice describing the reduction within a “reasonable time” before the effective date of the plan amendment. Inevitably, when a money purchase plan is terminated, it is being amended to cease contributions and, thus, reduce future benefit accruals.

Under proposed regulations, the advance notice generally must be provided at least 45 days before the effective date of the plan amendment, although special rules apply for small plans. All participants and alternate payees who are affected by the plan termination must receive the notice. Also, the notice must be provided by a method that is “reasonably calculated to result in actual receipt” by the participants and may not be provided by posting.

The proposed regulations prescribe that the notice must include sufficient information to allow participants to understand the effect of the plan amendment and
the approximate magnitude of the expected reduction. In particular, the notice is required to describe the affected provisions of the plan before the plan amendment, describe these provisions as amended and state the effective date of the amendment, all of which should be relatively simple in the case of the termination of a money purchase plan.

If the plan administrator fails to give the required notice, IRC Section 4980F imposes an excise tax of $100 per day for each individual affected by the termination who does not receive a 204(h) Notice. The employer, not the plan, is responsible for payment of any excise tax. What is more significant, ERISA Section 204(h)(6) provides that in the event of an “egregious failure” to provide the required notice, the provisions of a terminated plan must be applied as if the termination had not occurred. However, special rules may allow an employer that acts reasonably and promptly corrects any failure to provide timely advance notice to avoid the excise tax.

**Other Notice Issues.** If the plan applies for a determination letter as suggested above, it must provide participants (and all other “interested parties”) with notice of the plan’s application for a determination letter upon termination. Also, as for any plan amendment, participants must be provided a summary of material modifications (SMM) explaining any significant amendments to the plan within 210 days after the close of the plan year in which the amendment is adopted. In many cases, the plan will terminate and its assets will be distributed before the time for providing this notice expires. As a practical matter, the employer will have to inform participants of their right to obtain a distribution because the plan is terminating, and the SMM can usually be incorporated into this notice.

**Distribution Issues.** Upon the termination of a money purchase plan, participants are entitled to a distribution of their assets, and in most cases, they are happy to take a distribution. A money purchase plan, however, cannot require a participant to take a distribution upon termination of the plan if the participant's account balance is greater than $5,000. If a participant fails or refuses to take a distribution of his or her account balance from a terminating plan, this may lead to additional complications.

Generally, the anti-cutback rules in IRC Section 411(d)(6) prohibit a plan from eliminating an optional form of benefit even when the plan terminates, unless the employer took advance action to amend the plan to eliminate installments and certain other optional forms as permitted under Treas. Reg. §1.411(d)-4, Q&A-2(e). However, because this rule does not allow the elimination of joint and survivor annuities under a money purchase plan or certain other options (most commonly, options related to the timing of payment), at least these optional forms of benefit must be preserved in some manner after plan termination for any participants who fail to take a distribution.

If the employer maintains another defined contribution plan, the regulations indicate that it is acceptable to transfer the accounts of participants who have not taken a distribution to the other plan. Essentially, the money purchase plan spins off that portion of the plan associated with its remaining assets, and that portion is merged with the other plan. This transfer of assets, however, is fraught with all of the problems otherwise associated with a plan merger, which are discussed in greater detail below, such as the need to account separately for the transferred assets and the requirement that benefits associated with these assets be paid in accordance with the options available under the money purchase plan, including the joint and survivor annuity rules. Alternatively, the trustees of the plan may purchase annuity contracts from an insurance company for participants who fail to take a distribution. These annuity contracts must include all of the distribution options available under the money purchase plan at the time of termination, and the trustees must be certain that the contracts purchased meet the fiduciary requirements of ERISA.

**Timing of Plan Termination.** Finally, the timing of a plan termination presents two potential pitfalls for unsuspecting employers. First, the IRS requires that a qualified plan sponsor intend that the plan be permanent, and it uses an unwritten rule of thumb that a plan should be in existence for five years to demonstrate this intent. Nonetheless, even if the money purchase plan being terminated was in existence for fewer than five years, the EGTRRA changes in law and the employer’s desire to replace the plan with a profit-sharing plan should satisfy the IRS that the money purchase plan was not established as a tax shelter or to otherwise abuse the qualified plan rules.

The second timing concern relates to the rule in Rev. Rul. 89-87 that termination of a plan is not complete until all of the assets in the trust have been distributed to participants. This ruling requires that the complete distribution of all assets must occur “as soon as administratively feasible” following the date set by the employer for the plan’s termination. Whether a distribution occurs as soon as administratively feasible depends on all the facts and circumstances, but a distribution that is not completed within one year of the date set by the employer for plan termination is presumed not to have been made as soon as administratively feasible. The IRS has indicated that acceptable reasons for delay include waiting for the IRS to issue a favorable determination letter (provided application for the letter is timely made) and circumstances beyond the control of plan fiduciaries that prevent the distribution.

If the assets of the plan are distributed promptly, Rev. Rul. 89-87 provides that the sponsor is not required to amend the plan to comply with changes in the qualification requirements that become effective between the date of termination set by the employer and the final distribution of assets. All of the requirements of ERISA, however, continue to apply during this period, and the plan is subject to all of ERISA’s reporting, disclosure and fiduciary
requirements. In addition, general plan administration must continue as normal during this period. Participants and beneficiaries who become entitled to distributions because of termination of employment, disability or death are entitled to a distribution of their benefits just as in the case of an ongoing plan. Note also that while the Form 5500 for an ongoing plan is generally due seven months after the end of the plan year, the final Form 5500 for a terminating plan is due seven months after the assets of the plan have been distributed.

**Plan Merger or Conversion by Plan Amendment**

As an alternative to terminating a money purchase plan, an employer can merge the money purchase plan into a new or existing profit-sharing plan, or it can convert the money purchase plan into a profit-sharing plan by amending the plan. If the plan resulting from the merger or amendment covers substantially all of the participants who were covered under the existing money purchase plan, the employer is not required to fully vest the account balances of participants. Participants continue to vest in their accounts in the same manner as they did before the merger or amendment.

**Administrative Issues.** As an administrative matter, merging or amending a money purchase plan into a profit-sharing plan should be quite easy. As for plan termination, the plan document should include general rules prescribing the process for amending the plan, and the employer should follow this process for merger or amendment. In most cases, to merge a money purchase plan, the sponsor of the plan must take appropriate corporate action (usually a resolution or consent of the company’s board of directors or members) authorizing the merger of the plan into a profit-sharing plan as of a particular date.

The corporate action should also recite that the merger is made pursuant to IRC Section 414(l)(1), which provides that each participant in a plan must receive a benefit immediately after a merger that is equal to or greater than the benefit he or she would have been entitled to receive immediately before the merger. (Compliance with IRC Section 414(l)(1) is rarely a problem when two defined contribution plans are merged because all of the assets in the plans are allocated to individual accounts that are preserved during the course of the merger.) In addition, the corporate action should provide for any necessary amendments to the profit-sharing plan receiving the transferred assets, for example, to preserve optional forms available under the money purchase plan. Certain other significant amendments are discussed below.

To convert a money purchase plan into a profit-sharing plan, the existing money purchase plan must simply be amended, usually in the form of an amendment and restatement, into a profit-sharing plan. For either a merger or a conversion, however, the employer should take care to avoid some common pitfalls.

**Form 5310-A.** If a money purchase plan is merged into a profit-sharing plan, both the money purchase plan and the plan into which it is being merged must timely file a Treasury Form 5310-A (“Notice of Plan Merger or Consolidation, Spinoff or Transfer of Plan Assets or Liabilities”) if the money purchase plan has an unamortized minimum funding waiver or an unallocated suspense account.

**Preservation of Money Purchase Plan Attributes.** Because neither a merger nor a conversion entitles participants to a distribution of their account balances, the IRS has ruled that the assets and liabilities attributable to a money purchase plan must be accounted for separately and must retain their attributes as money purchase plan assets and liabilities. Specifically, accounts must remain subject to the joint and survivor annuity provisions of IRC Sections 401(a)(11) and 417. In addition, the new or amended profit-sharing plan must not permit distributions of the money purchase plan accounts before retirement, death, disability, severance from employment, or termination of the plan.

This requirement lays a potential trap for the unwary. In the event a money purchase plan is merged into a profit-sharing plan, it is essential to amend the profit-sharing plan either before or simultaneously with the merger to provide that the assets attributable to the money purchase plan will not be distributable before the events described above. Failure to amend the profit-sharing plan before the merger will cause the profit-sharing plan to violate the qualification requirements of IRC Section 401(a), and this problem will be difficult to correct. Any attempt to amend the profit-sharing plan after the merger to eliminate an in-service form of distribution will give rise to a violation of IRC Section 411(d)(6), which prohibits the elimination of optional forms of benefit, with only limited exceptions, as indicated above. Regulations provide that once the assets of the money purchase plan become subject to a provision in the profit-sharing plan permitting an in-service distribution, the in-service distribution becomes a protected form of benefit that cannot be eliminated.

**204(h) Notice.** The IRS has ruled that the discontinuance of mandatory contributions to a money purchase plan following the merger or amendment of a money purchase plan into a profit-sharing plan is a significant reduction in the rate of future benefit accruals requiring advance notice under ERISA section 204(h). Generally, the rules for 204(h) Notice of an amendment are similar to the rules for notice of plan termination described above. In the case of an amendment, it is important that the notice include sufficient information to explain the effect of the plan amendment. Proposed regulations require that the notice describe the provisions of the plan both before and after the plan amendment and also state the effective date of the amendment. For an amendment merging or converting a money purchase plan into a profit-sharing plan, this should be fairly straightforward — the notice should describe the contribution formula under the money purchase...
Evaluating Options

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Plan and should explain how contributions will be determined under the profit-sharing plan as of the effective date of the merger or conversion.

The consequences of a failure to give notice of an amendment are similar to the consequences of a failure relating to a plan termination. For an egregious failure to provide advance notice, ERISA section 204(h)(6) requires that the plan be applied as if the amendment gave the participant the greater of (i) the benefit to which he or she would have been entitled if the plan had not been amended, or (ii) the benefit under the plan as amended.

Freezing Contributions

Another alternative for the employer with an unwanted money purchase plan is simply to freeze the existing plan by ceasing all future contributions.

204(h) Notice. Freezing the plan, by definition, will cause a significant reduction in the rate of benefit accruals; therefore, the plan administrator must provide a 204(h) Notice to all individuals affected by the amendment in the manner and at the time discussed above. The failure to provide a timely 204(h) Notice may result in the sanctions discussed above.

Vesting. Because a money purchase plan is subject to the minimum funding standards of IRC Section 412, it is not required to fully vest all participants at the time contributions to the plan are discontinued. Participants may continue to vest...
in their account balances under the plan on the same schedule that applied before the contributions ceased. Employers, however, commonly vest participants in their benefits under the plan when contributions are frozen. In addition, the plan document may require full vesting when contributions are discontinued, even though the IRC does not require this for money purchase plans; for example, prototype plans that use one basic plan document for money purchase and profit-sharing plans often include such a provision.

Administrative Issues. To freeze contributions to a money purchase plan, the employer must take appropriate action to amend the contribution formula under the money purchase plan to provide that no further contributions will be due. The effective date of the amendment should be at least 45 days after the date on which the 204(h) Notice is provided to affected participants under the plan. The amendment should also provide that no additional employees will become participants.

The most significant drawback to freezing a money purchase plan is that it remains an ongoing plan in all respects. The plan document must be amended to comply with any new qualification requirements that become effective in subsequent years. Summary plan descriptions must be kept up to date and distributed to plan participants. Annual reports must be prepared and filed with the Department of Labor and the IRS, and the plan must continue to process claims and pay benefits just as it did before the freeze. For an employer that wants to rid itself of the administrative burdens of maintaining a money purchase plan in addition to its financial obligations under the plan, simply freezing contributions to the plan offers little advantage.

Evaluating Options

Although employers have a variety of options from which to choose when deciding how to replace a money purchase plan that has outlived its usefulness, none of the options is without cost or inconvenience. With the assistance of its legal counsel or tax advisor, each employer must determine which course of action best accomplishes its desired goals with the fewest possible drawbacks. The chart on page 39 summarizes the key factors that will generally be relevant in evaluating the options.

1. Internal Revenue Code §404(a)(3).
3. Following EGTRRA, IRC Section 404(a)(7) continues to apply if an employer sponsors both a defined contribution and a defined benefit plan for the same employees; it limits deductions to the greater of 25 percent of compensation or the amount needed to fund the defined benefit plan.
4. IRC §§401(a)(17) and 404(f).
6. IRC §4971.
8. ERISA §102(b)(1).

CAROL A. WEISER IS A PARTNER IN THE WASHINGTON, D.C., OFFICE OF SUTHERLAND ASBILL & BRENNAN LLP. SHE CONCENTRATES HER PRACTICE ON EMPLOYEE BENEFITS LAW. HER AREAS OF EXPERTISE INCLUDE QUALIFIED RETIREMENT PLANS, NONQUALIFIED BENEFITS, ERISA, FLEXIBLE BENEFIT PLANS, AND FRINGE BENEFITS. WEISER RECEIVED A BACHELOR’S DEGREE FROM HIRAM COLLEGE AND A LAW DEGREE FROM TEMPLE UNIVERSITY SCHOOL OF LAW. SHE IS A MEMBER OF THE DISTRICT OF COLUMBIA AND PENNSYLVANIA BAR ASSOCIATIONS. FROM 1997 TO 2001, SHE CHAIRMED THE EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION COMMITTEE OF THE AMERICAN BAR ASSOCIATION SECTION OF BUSINESS LAW. SHE CAN BE REACHED AT 1275 PENNSYLVANIA AVENUE NORTHWEST, WASHINGTON, D.C. 20004; (202) 383-0728; OR CWEISER@SABLAW.COM.

ROBERT J. NEIS IS AN ASSOCIATE IN THE ATLANTA OFFICE OF SUTHERLAND ASBILL & BRENNAN LLP. HIS PRACTICE INCLUDES WORK WITH QUALIFIED RETIREMENT PLANS, WELFARE BENEFIT PLANS, AND EXECUTIVE COMPENSATION. BEFORE CONCENTRATING HIS PRACTICE ON EMPLOYEE BENEFITS, HE WAS A LITIGATOR FOCUSING ON INSURANCE AND LABOR ISSUES. NEIS RECEIVED A BACHELOR’S DEGREE FROM MIDDLEBURY COLLEGE AND LAW DEGREE FROM CORNELL UNIVERSITY. HE IS A MEMBER OF THE GEORGIA BAR ASSOCIATION. NEIS CAN REACHED AT 999 PEACHTREE STREET NORTHEAST, ATLANTA, GEORGIA 30309; (404) 853-8270; OR RJNEIS@SABLAW.COM.

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