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MWM Consulting Group

Taking Measure of Tomorrow ™

UPDATE

Actuarial and Benefits News

Final Regulations On Funding And Benefit Restrictions Issued By IRS

The Pension Protection Act of 2006 (PPA) changed funding rules for employer sponsored defined benefit plans. These rules were modified further by the Worker, Retiree and Employer Recovery Act of 2008 (WRERA). The Regulations issued by the IRS on October 15, finalize and modify proposed Regulations issued in 2007 and 2008, and clarify interim IRS guidance. Many of the issues under PPA, which these final regulations address, concern how the rules are to be applied to elections by plan sponsors, notices to participants, and limitations on benefits.

Highlights of Funding Regulations

Asset Valuation Method And Yield Curve Election Changes

❖ **Asset Valuation Method and Yield Curve elections permitted for 2008, 2009 and 2010, without IRS approval** ❖

The regulations deal with detailed issues surrounding funding requirements and calculations, benefit restrictions and sponsor elections and timing. Especially helpful are the provisions within the regulations that permit sponsors to change the asset valuation method for the 2008, 2009 and 2010 valuations without IRS approval. Under the regulations sponsors may elect, for example, the smoothed asset method for 2009, and a market value method for 2010, or vice versa. This flexibility is particularly advantageous for the 2009 and 2010 plan years where smoothing may be helpful for 2009, but where market value may be the preferred method for long term funding. On a long term basis, smoothed assets may mitigate some of the effects of volatility upon funding requirements due to asset gains and losses. Generally, however, smoothed assets are expected to introduce a slight negative bias and may not correlate well with bond portfolios constructed to match benefit liability durations (liability driven investments LDI).

After 2010, a change in asset valuation method will require approval which means that the asset valuation method selected for the 2010 plan year should be viewed as the long term election. But for 2009, sponsors may elect to use a smoothed asset method and elect for 2010 to use market value, without approval.

In electing the yield curve basis for discounting liabilities in the 2008, 2009 and 2010 plan years, the regulations provide that IRS approval is not needed for an initial election to use a look back month, not to use the transition rates provided in PPA, or to use the full yield curve. However, once elected, going forward after 2010, IRS approval is needed to change an election. Final regulations provide automatic approval to change an interest rate (yield curve basis) election for the 2009 and 2010 plan years. Use of a look back month for plans electing the full yield curve is not permitted beginning with 2010 plan years. The IRS also clarified that while approval would be required for changes after 2010, plan sponsors using the segmented yield curve for 2010 will have one automatic approval to change to the full yield curve after 2010 should they wish.

Based upon current discount rates, sponsors of calendar year plans may wish to examine whether an election of the segment rates for 2010 is appropriate, given that a change (without approval) to the full yield curve will remain available to them in the future.

Target Normal Cost And Funding Target Definitions Refined

The final regulations incorporate the WRERA-provided adjustments to Target Normal Cost that add plan-related expenses expected to be paid from plan assets during the year for plan years beginning in 2009 and later. The Target Normal Cost is defined as the present value of benefits that accrue during, or are allocated to service for the plan year.

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Clarification in the funding calculation provides details for the Target Normal Cost and Funding Target Liabilities
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The Funding Target is the present value of benefits that have been accrued, earned or allocated to service prior to the first day of the plan year. Benefits not paid or accrued prior to the valuation date as a result of Section 436 benefit limitations are generally excluded from the Funding Target and Target Normal Cost. In addition, the anticipation of future benefit restrictions is not permitted.

Credit Balances And Offset of Required Contributions

The deadline for making an election to apply funding balances toward minimum required contributions is the due date for making contributions for the plan year. The regulations treat quarterly offsets as occurring on the valuation date. However, if the election to apply a funding balance toward a required quarterly installment is made after the due date for the required installment, then the offset is discounted from the date of the election to the due date of the installment at the plan's effective interest rate plus 5 percentage points, and then discounted from the installment due date to the valuation date at the effective interest rate. The difference in these two discounted values represents the "penalty" for the late election. Late elections may also create PBGC and participant notice requirements. An election regarding funding balances must generally be irrevocable. However, if the election to offset by specified amounts exceeds the minimum contribution, an election to revoke those elections is permitted if the revocation is made before the end of the plan year.

Elections to use funding balances are generally reflected in chronological order. Deemed elections to reduce funding balances occur if they would prevent or eliminate a benefit restriction, and can be retroactively applicable when eliminating a benefit restriction. Plan sponsors should be careful to avoid the situation in which a retroactive deemed reduction causes a quarterly installment to be retroactively late. Elections to use balances generally must include the specific dollar amount without conditions, and must be made no later than the last date for making the minimum required contributions for a year. The final regulations provide that standing elections may be made by a sponsor to use balances toward minimum required contributions to avoid excise taxes. A standing election is deemed to occur on the last day available for the election and remains in effect unless revoked on or before the date the election is deemed to occur.

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New rules clarified by the regulations illustrate how credit balances may be used and what elections are required
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Highlights of Benefit Restictions Provisions

Limitations of Plan Amendments Increasing Liabilities

Section 436 under PPA imposes funding based limitations and restrictions upon certain benefits which may be paid from a Plan, and upon the accrual of benefits. Under PPA Plans with an AFTAP less than 60% are restricted from additional benefit accruals. Plans with an AFTAP certification between 60% and 80% have restrictions on the payment of lump sums and other accelerated benefit forms, and cannot increase benefits without making special contributions.

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Automatic restoration of benefit accruals is treated as a plan amendment
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Final regulations clarify that automatic restoration of benefit accruals not permitted to accrue due to Section 436 limitations, is treated as a plan amendment subject to the Section 436 limitations on plan amendments. However, it would not be treated subject to the Section 436 limitations if benefit accruals ceased for 12 months or less and the certified AFTAP after the accruals are restored was at least 60 percent.

AFTAP Certifications

The final regulations specify the content of AFTAP certifications provided by the plan's Enrolled Actuary. The content includes the value of plan assets, the prefunding and carryover balances, the funding target, the amount of any annuity purchases included in the assets and funding target, restored benefit accruals and any other relevant factors. The AFTAP may not be based on assets that include contributions receivable for the prior year that have not actually been made as of the certification date.

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Final Regulations specify content of AFTAP certifications
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Range Certifications

Final regulations permit a range certification to be made during the first nine months of the plan year. If a specific AFTAP is not certified by the end of the plan year, then the AFTAP is retroactively deemed to be less than 60 percent as of the 1st day of the 10th month of the plan year. The final regulations provide detailed rules clarifying the operation of the plan both before and after an AFTAP certification has been issued, including how to reflect deemed elections and special contributions made to avoid benefit limitations.

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Range Certifications may be relied upon for the first 9 months of the plan year.
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The final regulations also provide detailed rules regarding a plan's presumed underfunding prior to an AFTAP certification for the current year. For instance, if a benefit restriction applied on the last day of the prior plan year, and an AFTAP certification was issued during the prior year, the presumed AFTAP on the first day of the current year is that AFTAP. The final regulations provide that if the prior year AFTAP was certified after the 1st day of the 10th month of the prior year, then the plan is treated as if that prior year AFTAP was less than 60 percent.

If an AFTAP certification is issued and then is superseded, the later AFTAP generally must be applied beginning with the date of the first certification.

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