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IRS Issues Guidance on PPA Funding Rules for Single-Employer Defined Benefit Plans

The Pension Protection Act of 2006 (PPA) includes the most comprehensive pension reforms since ERISA's enactment in 1974. These changes include a major overhaul of the funding rules for single-employer defined benefit plans. Plan sponsors must now fund the present value of their plans' accrued benefits and amortize any unfunded liabilities over a 7-year period, using mandated actuarial assumptions. In measuring the liabilities of poorly funded ("at-risk") plans, more conservative assumptions must be used.

For most plans, PPA's funding rules take effect with the 2008 plan year. On December 28, 2007, the IRS issued proposed regulations on measuring plan assets and liabilities which, though not effective until plan years beginning on or after January 1, 2009, can be relied on for 2008 plan years.

Our October 24, 2006 For Your Information *provides an overview of the changes made to the funding rules by PPA and supplements this* For Your Information*.*

Proposed Regulations on PPA Funding Rules

The proposed regulations provide guidance on the measurement of plan liabilities and assets, as well as on the definition of at risk status.

Plan Liabilities

Funding Target and Target Normal Cost. The funding target is defined as the present value of a plan's accrued benefits (akin to "current liability" under pre-PPA law) determined using PPA-prescribed assumptions. The relationship between a plan's funding target and its assets determines the plan's minimum required contribution, maximum deductible contribution, PBGC premiums, and benefit payment restrictions.

The target normal cost is defined as the present value of benefits expected to accrue during the plan year, determined using the same assumptions used for the funding target. Importantly, the proposed regulations clarify that target normal cost includes increases in past service benefits from expected compensation increases during the year.

Benefit Restrictions. The proposed regulations would prohibit the funding target and target normal cost from reflecting any PPA benefit restrictions that apply or might apply in the future. For example, although a plan with assets less than 60% of the funding target may not provide future benefit accruals, that restriction could not be reflected in the calculation of the plan's funding target and target normal cost.

> ***BUCK COMMENT.*** *This requirement is intended to improve the funded position of poorly funded plans. If a benefit restriction were taken into account in calculating a minimum contribution, the funding requirement could be greatly reduced.*

Plan Expenses. The proposed regulations would prohibit the funding target and target normal cost from reflecting actual or expected administrative expenses.

> ***BUCK COMMENT.*** *Generally, the maximum deductible contribution allowed by PPA is sufficiently greater than the minimum required contribution so that plan sponsors wanting to make additional contributions to cover administrative expenses can do so. Sponsors who make additional contributions to cover administrative expenses paid from the plan will create a "prefunding balance," which will provide additional funding flexibility.*

Plan Amendments. Under the proposed regulations, the funding target and target normal cost are generally computed without considering plan changes adopted after the plan's valuation date. However, the option to recognize the full effect of certain amendments adopted after the valuation date but no later than 2½ months after the end of the plan year has been retained.

> ***BUCK COMMENT.*** *Under the pre-PPA rules, the valuation could reflect plan amendments on a pro-rata basis for the portion of the year the amendment was in effect.*

Lump Sums. If a plan pays lump sum benefits that are larger than the minimum required under Section 417(e), the valuation must use assumptions that recognize that excess value.

> ***BUCK COMMENT.*** *The requirement to take into account the amount that plans pay in excess of the minimum lump sum is a significant change from pre-PPA rules (under which current liability was not allowed to reflect the value of the increased benefit).*

Discount Rates. PPA offers three alternative sets of discount rates to calculate funding target and target normal cost – (1) a full yield curve, (2) three "segment rates" for the periods 0-5 years, 5-20 years, and over 20 years (with each segment averaged over the latest 24 months), and (3) a three-year phase-in of the segment rates. The plan sponsor must notify the plan's Enrolled Actuary in writing which set of discount rates to use.

> ***BUCK COMMENT.*** *For 2008, the phased-in segment interest rates have a lower third segment than the regular segment rates and are likely to produce higher liabilities and possibly higher minimum required contributions. Recent increases in bond yields may make liabilities calculated using the full yield curve the lowest of the three choices as of January 1, 2008. However, because the full yield curve uses no averaging, its use can cause greater volatility in the liabilities over time than the use of segment rates. In*

selecting discount rates, plan sponsors should understand the interplay of contributions with PBGC premiums and benefit restrictions.

Plan Assets

Under the proposed regulations, plans must value assets at either fair market value or an average of fair market values calculated at evenly spaced intervals over a 24-month or shorter period that precedes the valuation date. Each fair market value used in the average must reflect contributions, benefit payments, and expenses from the date of the market value through the valuation date. The value of plan assets must fall within a corridor of 90% to 110% of the fair market value of assets on the valuation date.

For example, acceptable averages for a valuation date of January 1, 2008 include —

- the average of January 1, 2008 and January 1, 2007 fair market values
- the average of January 1, 2008, January 1, 2007 and January 1, 2006 fair market values
- the average of semi-annual, quarterly or monthly fair market values over the previous one or two years.

The plan sponsor should notify the plan's Enrolled Actuary in writing which asset method to use.

BUCK COMMENT. *The proposed regulations prohibit pre-PPA asset "smoothing" methods, even though they do not systematically overstate or understate fair market value. Assets determined under a new "averaging" method will generally be lower than assets valued at fair market value, but less volatile over time. This will result in generally more stable but higher contributions and a greater risk of being subject to benefit restrictions. Plan sponsors must decide if the added stability of contributions generated by an averaging asset method is worth the increased contributions, higher PBGC premiums, and greater risk of benefit restrictions. The proposed regulations provide no guidance on how or how often a sponsor may change the asset valuation method.*

At-Risk Plans

In calculating the funding target and target normal cost for at risk plans, it must be assumed that any participant who can retire during the next 11 years does so at the end of the year and chooses the most valuable form of payment. Plans that were at risk in at least two of the four preceding plan years must also load the funding target and target normal cost by specified amounts. This will further increase the contributions required for chronically at risk plans.

A plan is "at risk" for 2008 if plan assets are less than 65% of the funding target for 2007. The proposed regulations provide rules for calculating plan assets and funding target for the 2007 plan year which are consistent with those previously provided for benefit restrictions.

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***BUCK COMMENT.** Because PPA and the proposed regulations make 2008 the earliest year for at risk determinations, the additional loads for chronically at risk plans cannot apply before the 2010 plan year.*

Conclusion

In the proposed regulations, the IRS has taken a practical approach to implementing PPA's funding requirements and provide a basic framework under which plans may proceed. There are remaining issues that have not been addressed (e.g., regarding rules for plans that merge) and over the next year many questions of specific application will arise.

Buck's consultants are prepared to help you review the implications of these proposed regulations and develop suitable strategies for funding your plan.