



IRS Finalizes Regulations on Defined Benefit Plan Funding and Benefit Restrictions

On October 7, the IRS issued long awaited final regulations on funding and benefit restriction provisions introduced by the Pension Protection Act of 2006 (PPA) for single-employer defined benefit plans. The IRS issued related guidance on September 25 (see our [September 25, 2009 For Your Information](#)).

Introduction

The [final IRS regulations](#) modify and finalize two sets of proposed regulations issued in 2007 (see our [October 4, 2007](#) and [January 11, 2008 For Your Information](#)), and also reflect changes made by the Worker, Retiree and Employer Recovery Act of 2008 (WRERA) (see our [December 15, 2008 For Your Information](#)). These regulations are quite lengthy, detailed, and complex, and provide much needed guidance. They left many areas of the proposed regulations unchanged, clarified wording, and added new provisions to resolve unaddressed situations. This *For Your Information* discusses the most significant changes from the proposed regulations. (All references to valuation dates in this *For Your Information* assume that the valuation date is the first day of the plan year. Special rules apply throughout the regulations for valuation dates that are other than the first day of the plan year.)

Final Regulations

Funding Provisions

Target Normal Cost and Funding Target

The definitions of Target Normal Cost and Funding Target were clarified. Target Normal Cost is defined as the present value of benefits, as of the valuation date, that accrue during, are earned during, or are otherwise allocated to service for the plan year. Funding Target is defined as the present value of benefits, as of the valuation date, that have been accrued, earned, or otherwise allocated to service prior to the first day of the plan year. The final regulations provide detailed rules on the allocation of benefits for purposes of calculating Target Normal Cost and Funding Target.

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, and that subtract mandatory employee contributions expected to be made during the year.

BUCK COMMENT. *These regulations fail to clarify whether investment management fees that are withheld by the investment manager before reporting net investment results are plan-related expenses for this purpose, and, if so, how the actuary can practically determine the amounts withheld. The IRS has indicated that this will be addressed in future guidance.*

The final regulations provide that 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 current or future Section 436 benefit restrictions is not permitted.

BUCK COMMENT. *The prohibition against anticipating current or future benefit restrictions is likely intended as a way to improve the plan's funded status over time.*

The final regulations contain a new rule regarding amendments adopted after the valuation date that increase the Target Normal Cost for the plan year. Under this rule, if increasing the plan's Funding Target by the amount of increase in the Target Normal Cost would have prevented the amendment from being allowed under Section 436(c), then the amendment must be taken into account in determining the plan's Funding Target and Target Normal Cost for the plan year.

BUCK COMMENT. *Intra-year plan amendments that would decrease the plan's funding ratio (i.e., increase the Funding Target) to the level that a benefit restriction would apply are generally prohibited from taking effect. The new provision in the regulations prevents avoidance of this prohibition by the adoption of a mid-year amendment that increases only the Target Normal Cost.*

Plan Assets

As under the proposed regulations, contributions for the prior year that are made after the current valuation date are counted in the current year's value of assets by discounting the amount back to the current valuation date (using the effective interest rate for the prior year). The final regulations clarify that such contributions must be made by the deadline for making contributions for the prior plan year.

Importantly, the final regulations provide that any change to a plan's asset valuation method for the 2008, 2009 or 2010 plan year may be made without IRS approval.

BUCK COMMENT. *For 2009, many plan sponsors may decide to use two-year averaging measured quarterly to minimize the impact of poor 2008 investment results, and then to change to a different measurement frequency for 2010 when final 2009 investment results are known.*

Interest Rates

The final regulations clarify that IRS approval is not needed for an initial election to use a lookback month, not to use the transition rates provided in PPA, or to use the full yield curve. However, once elected, IRS approval is needed to change or revoke such an election. Importantly, the final regulations provide automatic approval to change any interest rate election for the 2009 and 2010 plan years.

The final regulations make clear that the use of any lookback month for plans electing to use the full yield curve (instead of segment rates) is not permitted beginning with 2010 plan years. As stated in earlier IRS guidance, lookback months may be used with the election to use the full yield curve for 2008 or 2009 plan years.

BUCK COMMENT. *Many sponsors of calendar year plans will want to use the October 2008 yield curve (first applicable to November valuations) for 2009, and change to segment rates for 2010. Unless bond yields increase dramatically during the remainder of 2009, the September segment rates will produce the lowest Funding Target as of January 1, 2010.*

At-Risk Plan Assumptions

The proposed regulations provided that to value benefits for at-risk plans, active participants who would be eligible for an immediate distribution within 10 years following the current plan year must be assumed to terminate at their earliest retirement date and commence benefits in the optional form that results in the highest present value. The final regulations retain this provision, and further require that it apply to all participants (i.e., active participants, terminated vested participants, beneficiaries). Also, all participants (not just those eligible for an immediate distribution within the next 11 years) must be assumed to commence benefits in the optional form that results in the highest present value whenever they are assumed to retire.

BUCK COMMENT. *These provisions were expected in the final regulations.*

In general, for plans that are part of a controlled group with significant underfunding, changes in actuarial assumptions that result in a very large decrease in funding shortfall (determined without taking into account effects of changes in interest rate and mortality) require IRS approval. The final regulations provide that for the first year a plan is no longer at-risk, automatic approval is given to use the actuarial assumptions that were used for the year immediately prior to becoming at-risk (provided that the plan had been at-risk for less than five years).

Prefunding and Funding Standard Carryover Balances

Offset of Minimum Required Contributions

The final regulations shorten the deadline under the proposed regulations for making an election to apply funding balances toward minimum required contributions from the due date for filing the Form 5500 for the plan year (with extensions) to the due date for making contributions for the plan year.

Offset of Required Quarterly Installments

The regulation takes a new approach for offsetting quarterly installments against funding balances, generally treating such offsets as occurring on the valuation date in amounts equal to their discounted value using the plan's effective interest rate for the year.

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 to the minimum contribution is the discounted value of the amount elected 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 offset to the funding balance is the discounted value of the amount elected from the date of the election to the valuation date at the effective interest rate. The difference in these two discounted values represents the "penalty" for the late election.

BUCK COMMENT. *Late elections to apply funding balances to quarterly installments may create PBGC and participant notice requirements, subject to future regulations.*

An election regarding funding balances must generally be irrevocable. However, if the sponsor has elected to offset the minimum required contribution (including quarterly installments) by specified amounts that exceed the minimum contribution, an election to revoke those previous elections to the extent of such excess is permitted if the revocation is made before the end of the plan year. If the revocation is not made by that deadline, then funding balances will be reduced by the entire amount specified in the initial elections.

BUCK COMMENT. *The end-of-plan-year deadline for the revocation election appears to limit its effectiveness to those situations where the results of the valuation are fixed by that deadline, even though the methods and assumptions to be used for such valuation are not finalized until the filing of the Schedule SB for the plan year (sometime during the following year).*

Ordering Rule for Elections

According to the final regulations, elections to increase, reduce or use funding balances are generally reflected in chronological order. Exceptions to this rule include –

- Any election or deemed election to reduce funding balances for the current year is deemed to occur on the valuation date for the current year and before any election to offset the minimum required contribution for the current year.

BUCK COMMENT. *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 and their actuaries should be careful to avoid the situation in which a retroactive deemed reduction of a funding balance causes a quarterly installment to be retroactively late or missed entirely.*

- If an election to apply funding balances to the prior year's minimum funding requirement is made after an election (or deemed election) for the current year that reduces or applies funding balances, the amounts elected for the current year retain precedence under the ordering rule. They are discounted from the dates of the elections to the valuation date for the current year using the plan's effective interest rate for the current year, and then discounted to the prior year's valuation date using the actual rate of return for the prior year. That discounted value is subtracted from the prior year's funding balances; the remainder

is then rolled forward using the plan's effective interest rate for the prior year to determine how much funding balance is available to be applied against the prior year's minimum funding requirement.

BUCK COMMENT. *Because PPA applies two different interest crediting rates to funding balances (the plan's effective interest rate within a plan year, and the plan's actual return on assets from one plan year to the next), the regulations provide rules for calculating interest when funding balances are applied to current year contribution requirements and then subsequently applied to prior year contribution requirements (e.g., the first two quarterly installments for 2011 followed by the final contribution for 2010). The difference in interest rates may provide the opportunity for arbitrage, which can be avoided (if desired) by making all elections to apply funding balances to the prior year's minimum before any election (or deemed election) to use funding balances for the current year.*

Content of Elections

The final regulations provide that elections to use balances generally must include the specific dollar amount without conditions or expression by formula, and must be made no later than the last date for making the minimum required contributions for a year (i.e., 8-1/2 months after end of the plan year).

BUCK COMMENT. *The ability to make these elections as late as 8-1/2 months after the end of the plan year eliminates the problem in the proposed regulations of not knowing the specific amounts needed at the time the first and, often, the second quarterly installments are due. However, late elections are still subject to an additional 5% penalty interest discount to the date the installment was due.*

Standing Elections

The final regulations also provide that standing elections may be made by a sponsor to (i) use balances toward minimum required contributions to the extent needed to avoid excise tax on unpaid contributions, or (ii) add the maximum amount possible to the prefunding balance each year. 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, or if there is a change in the enrolled actuary for the plan.

BUCK COMMENT. *Many plan sponsors will want to make the first standing election noted above to avoid excise taxes. Unfortunately, the 5% penalty interest on late quarterly installments is not an excise tax and cannot be avoided by a standing election – sponsors can take steps to avoid late quarterly installments through specific elections or actual contributions for that purpose. Sponsors and their actuaries should carefully evaluate whether to make the second standing election noted above.*

Benefit Restriction Provisions

Terminated Plans

The final regulations provide that any benefit restrictions in effect immediately before a plan termination will continue to apply. However, limitations on accelerated benefit payments do not apply to payments made to carry out a plan termination (e.g., the purchase of annuities under a standard termination).

Unpredictable Contingent Events

The final regulations provide that if unpredictable contingent event benefits are not permitted to be paid (due to the Section 436 limitations on unpredictable contingent benefits) after the occurrence of an unpredictable contingent event during the plan year, but are permitted to be paid later in the plan year as the result of a special contribution to the plan or an AFTAP certification for the plan year, then the contingent event benefits must automatically become payable retroactively to the period they would have been payable. If the contingent event benefits do not become payable during the plan year, then the plan is treated as if it did not provide those benefits, unless a plan amendment provides otherwise.

BUCK COMMENT. *Plan sponsors should decide whether they want to preserve unpredictable contingent event benefits on a case-by-case basis (amending the plan each time) or amend the plan once to automatically roll-forward all unpredictable contingent event benefits until the plan's AFTAP improves sufficiently to allow them to be paid. Plan sponsors should also decide on a case-by-case basis what the deferred unpredictable contingent event benefit should be, given that it will be payable at a later point in time than originally intended.*

Collectively Bargained Plans

PPA provides that collectively bargained plans are deemed to elect to reduce their credit balances in an amount sufficient to prevent any benefit restriction from applying. For this purpose, the proposed regulations defined a plan to be collectively bargained if at least 25 percent of the plan's participants are members of collective bargaining units. The final regulations retain this definition but also provide that a plan is collectively bargained if at least 50 percent of the employees benefiting under the plan (generally, those accruing benefits) are members of collective bargaining units.

Limitations on Plan Amendments Increasing Liabilities

The final regulations clarify that the automatic restoration of benefit accruals (pursuant to a plan provision) that were 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 as a plan amendment subject to the Section 436 limitations on plan amendments if benefit accruals ceased for a period of 12 months or less and the certified AFTAP after the accruals are restored was at least 60 percent.

Also, the final regulations provide that if a plan amendment does not go into effect as of its effective date due to the Section 436 limitations on plan amendments, but is permitted to take effect later in the plan year as the result of a special contribution to the plan or an AFTAP certification for the plan year, then the amendment must take effect as of the later of the first day of the plan year or the effective date of the amendment. If the amendment cannot take effect during the plan year, then it must be treated as if it were never adopted, unless the plan provides otherwise (e.g., a plan provision stating that such an amendment will take effect as soon as permitted under Section 436.)

Limitations on Accelerated Benefit Payments

The final regulations clarify that for a participant who elects a form of benefit that includes a prohibited payment under Section 436, the plan must allow the participant to defer the payment to a later date *only* if it is allowable under the terms of the plan.

BUCK COMMENT. *Plan sponsors can now decide whether to amend their plans to allow deferral of accelerated payment forms (e.g., lump sums, term certain annuities, and social security level income options) to a later date. There are administrative issues to be considered, such as required actuarial increases for late retirement, minimum required distributions (age 70-1/2), continuing accrual of benefits for phased-retirement plans, and QDRO provisions tied to the participant's benefit commencement date.*

AFTAP at least 60 percent but less than 80 percent. The final regulations clarify how to determine the portion of a benefit that is considered a prohibited payment (and thus possibly restricted). Under the rules, the determination is based on the optional form elected. If any of the payments under the optional form is greater than the amount of a straight life annuity, then the portion of the benefit that is a prohibited payment is the excess of each payment over the smallest payment during the participant's lifetime under the optional form. For this purpose, if no payments would be made to the participant under the option for any period during a participant's lifetime, the smallest payment is considered to be zero.

BUCK COMMENT. *For lump sum or term certain optional forms, the entire benefit would be a prohibited payment. However, for a social security leveling option, only the amount paid before assumed social security commencement that is in excess of the ultimate life annuity would be a prohibited payment, and only that amount could be restricted.*

The final regulations provide clarifications of the complex rules regarding how bifurcated benefits can be paid, and on how the limits apply to benefits paid under social security leveling options.

AFTAP Certifications

The final regulations specify the content of AFTAP certifications provided by the plan's enrolled actuary. The required 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, any unpredictable contingent event

benefits, plan amendments and restored benefit accruals that were taken into account, and any other relevant factors.

Also, 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.

Range Certifications

The final regulations, like the proposed regulations, permit a range certification to be made during the first 9 months of the plan year. In a change from the proposed regulations, 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.

BUCK COMMENT. *The purpose of a range certification is to avoid benefit restrictions resulting from a presumed AFTAP when a specific AFTAP cannot yet be certified due to incomplete or missing information needed to calculate the plan's Funding Target. The final regulations extend the deadline for completing a specific AFTAP for the current year from September 30 to December 31 for calendar year plans.*

Plan Operation

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 to reduce funding balances and special contributions made to avoid benefit limitations.

Presumed Underfunding

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 never certified (and the prior year's AFTAP was less than 60 percent) unless the certification took into account the effect of any unpredictable contingent event benefits permitted to be paid based on unpredictable contingent events that occurred, and any plan amendments that became effective, during the prior plan year but before the certification.

BUCK COMMENT. *Therefore, if a prior year AFTAP was first certified after the 1st day of the 10th month of the prior plan year, and it included the effect of any unpredictable contingent event benefits and plan amendments during the prior year, then that AFTAP will be used as the basis for determining the current year's presumed underfunding – but it will not affect the prior year's presumption of having an AFTAP of less than 60%.*

Change in Certified AFTAP

As under the proposed regulations, if an AFTAP certification (including a range certification) is issued and then is superseded by a subsequent AFTAP certification, the later AFTAP generally must be applied beginning with the date of the first certification. The implication of this depends on whether the change is considered to be material or immaterial. If the change is material, the plan will fail to satisfy the qualification rules. A change is considered to be material if plan operations based on the prior certification would have been different based on the subsequent certification. The final regulations clarify that a change can be material even if the only impact occurs in the following year under the presumed AFTAP rules.

BUCK COMMENT. *By including changes in certified AFTAP that only impact the following year in the definition of “material,” the regulations appear to treat them as plan disqualification events. We do not think this was intended.*

If the difference between the original and revised AFTAPs is the result of certain actions, then the change is deemed immaterial. Under the proposed regulations, these actions included additional contributions made for the prior year or a sponsor’s election to reduce the prefunding or carryover balance after the date of the original certification. The final regulations add to this a sponsor’s election to apply the prefunding or carryover balance to offset minimum required contributions, a change in funding method or actuarial assumptions that required IRS approval, and an unpredictable contingent event or plan amendment for which a special contribution was made.

BUCK COMMENT. *Plan sponsors should carefully evaluate with their actuaries, based on their particular facts and circumstances, the implications of receiving a revised AFTAP certification.*

Guidance Still Needed

Guidance is still needed on related important areas not addressed in the final regulations. The IRS indicates that future regulations will be issued covering many of these areas, such as participant notices about benefit restrictions, quarterly contributions, mergers/spinoffs, and expenses to be included in target normal cost.

Conclusion

Buck’s consultants are ready to discuss the effect these regulations will have on your plans.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.