December 2015

PENSION ANALYST

Importance information-Plan administration and operation

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IRS issues final minimum required contribution rules for defined benefit plans

Who's affected

The final minimum required contribution rules affect sponsors of qualified single-employer and multiple employer defined benefit plans. These final rules do not affect multiemployer, governmental plans or church plans that do not elect to be covered by ERISA ("non-electing church plans").

The IRS also provided final rules pertaining to excise taxes that apply to single-employer, multiple employer and multiemployer plans for failure to satisfy the minimum funding rules for defined benefit plans.

Background and summary

The Pension Protection Act of 2006 (PPA) imposed new funding requirements on single-employer and multiple employer defined benefit plans that apply for plan years beginning on or after January 1, 2008. In 2008, the IRS issued proposed rules on the minimum funding requirements. The proposed rules provided guidance on how to determine minimum required contributions and quarterly installment payments. Plans could rely on the proposed rules for purposes of satisfying the PPA funding rules until final rules were published.

On September 9, 2015, the IRS issued the final minimum required contribution and excise tax rules. The final rules are similar to the proposed rules but issue additional guidance regarding:

- Allocation of unpaid contributions;
- Plan terminations; and
- Standing elections to use credit balances for quarterly contributions.

Action and next steps

The final rules affect plan funding and administration. The final rules on minimum required contributions apply to plan years beginning on or after January 1, 2016. For plan years beginning before 2016 and after 2007, plans may rely on either the final regulations or the proposed regulations published on April 15, 2008.

The final excise tax rules apply to taxable years beginning after 2007, but only with respect to plan years beginning on or after January 1, 2008. They do not apply to any taxable years ending before the publication of the proposed rules on April 15, 2008.

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Minimum required contributions

To satisfy plan funding rules, defined benefit plans must comply with the minimum required contribution requirements. The amount of the minimum required contribution for a plan year depends on whether the value of plan assets equals or exceeds the plan's funding target for the plan year. If the plan's assets are less than the funding target, the minimum required contribution for the year is equal to the plan's target normal cost plus the amortization of the funding shortfall. If the plan's assets equal or exceed the funding target, the minimum required contribution is the target normal cost, which is reduced by the plan assets in excess of the funding target. Plan assets must be reduced by any credit balances, if applicable.

The final rules contain the following definitions:

- **Funding target**: 100% of the present value of all benefit liabilities accrued to date.
- **Target normal cost**: The present value of benefit liabilities expected to accrue during the plan year, including increases in past service benefits attributable to current year increases in compensation.
- **Funding shortfall**: The excess of the plan's funding target over the plan's assets (reduced by any credit balance, if applicable).

Funding shortfall amortization

If a plan has a funding shortfall for a plan year, the shortfall must be amortized in level annual installments over the seven-year period beginning with that plan year. The amortization installments are determined using the interest rates that apply for the plan year for which the shortfall is established. These installments are not redetermined in later plan years to reflect changes in interest rates for those plan years.

Short plan year funding amortization

Amortization installments are prorated for a short plan year. However, the regulations do not prorate the target normal cost for a short plan year. Instead, the determination of the target normal cost reflects actual benefits that accrue or are expected to accrue during the plan year. The final regulations also provide guidance for the treatment of installments made in later plan years to take into account the proration of the installments for short plan years. In general, a "short plan year" is a plan year that is less than 12 months.

Payment of minimum required contributions

In general, the payment of a minimum required contribution for a plan year can be made:

- No earlier than the first day of the plan year; and
- No later than 8½ months after the close of the plan year.

If the minimum required contribution is made on a date other than the valuation date for that plan year, the payment is adjusted for interest accruing for the period between the valuation date and the payment date, at the plan's effective interest rate for that plan year. If the contribution is paid after the valuation date, the contribution is discounted to the valuation date using the plan's effective interest rate. However, if the contribution is paid before the valuation date (in the case of a small plan), the contribution is increased for interest at the same interest rate.

A plan's "valuation date" must be the first day of the plan year, except in the case of a small plan. A small plan may designate any date during the plan year as its valuation date. A "small plan" is a plan sponsored by an employer that had 100 or fewer participants in all defined benefit plans (other than multiemployer plans) sponsored by the employer or members of the employer's controlled group.

Quarterly contributions

If a plan has a funding shortfall for the preceding plan year, the plan sponsor must make quarterly contributions to the plan. The quarterly installment is equal to 25% of the required annual payment. The required annual payment is equal to the lesser of:

- 90% of the minimum required contribution for the current plan year; or
- 100% of the minimum required contribution for the preceding plan year.

The quarterly installments are due on the 15th day:

- Of the fourth plan month;
- Of the seventh plan month;
- Of the tenth plan month; and
- After the close of the plan year.

Standing elections for quarterly contributions

A plan sponsor may apply the plan's credit balance towards the payment of quarterly contributions.

Unlike the proposed rules, the final rules allow a plan sponsor to provide a standing election in writing to the plan's enrolled actuary to use the plan's credit balance to satisfy any unpaid portion of a required quarterly contribution. The standing election must be based on the quarterly installment amount equal to 25 percent of the minimum required contribution for the preceding plan year.

Any standing election is deemed to occur on the later of the:

- Last day for making the required installment; and
- Date the standing election is provided to the enrolled actuary.

A standing election remains in effect for the plan until either:

- It is revoked; or
- The plan's enrolled actuary is changed.

A plan sponsor may also suspend a standing election for the remaining installments for the plan year by providing a written notice to the plan actuary that the standing election will not apply for the remainder of the plan year. In addition, once the minimum required contribution has been determined for the current year, a plan sponsor may revise the standing election for the remaining installments for a plan year by providing to the plan actuary in writing a replacement formula election to use the credit balance.

Allocation of contributions

If a plan has unpaid minimum required contributions that are still unpaid when a contribution is made, the contribution is treated as a contribution for the earliest plan year for which there is an unpaid minimum required contribution to the extent necessary to correct that unpaid contribution. If the contribution exceeds the amount necessary to correct the unpaid minimum required contribution, then the excess will be applied to the next unpaid minimum required contribution. The allocation to the earliest year with unpaid minimum required contributions is automatic and must be reported on the actuarial report, Schedule SB, “Single-Employer Defined Benefit Plan Actuarial Information” of Form 5500, Annual Return/Report of Employee Benefit Plan for the earliest plan year for which a timely contribution could be allocated.

If a plan has no unpaid minimum required contributions for prior plan years at the time when a contribution is made, or a portion of the contribution corrects all unpaid minimum required contributions, the remainder of the contribution which is not used to correct an unpaid contribution may be designated as a contribution for either that prior plan year or the current plan year. The plan sponsor must report this designation on Schedule SB for the plan year for which the contribution is designated. Once reported on Schedule SB, the contribution cannot be re-designated for an earlier or later plan year, unless the IRS publishes guidance, which provides for an exception.

Late payments

The final rules provide that any late quarterly installment or any late election to use the funding balances to satisfy a quarterly payment must be discounted for interest from the date of the late contribution or election to the due date using an interest rate equal to the plan’s effective interest rate for the plan year plus 5 percentage points.

Plan termination rules

The final rules clarify that the rules for short plan years apply for the year of termination by specifying that if a plan terminates before the last day of the plan year, the plan is treated as having a short plan year that ends on the termination date. As a result, minimum required contributions are prorated based on the short plan year.

In addition, if a plan terminates before the plan’s valuation date, the valuation date must be changed to be within the short plan year. IRS rules provide that automatic approval is granted to a change in the valuation date if the change is required by the minimum required contribution rules. Any minimum required contribution is due 8 ½ months after the termination date.

Termination date

If a plan is subject to the Pension Benefit Guaranty Corporation’s (PBGC) insurance program, the plan termination date is established under ERISA.

If a plan is not subject to PBGC insurance, the termination date is the termination date established by the plan administrator, provided the termination date is not earlier than the date on which all actions necessary to effect the plan termination are taken.

However, a plan is not treated as terminated on the termination date if the plan assets are not distributed as soon as administratively feasible after that date, which is based on all the relevant facts and circumstances. The final rules provide that if the distribution of plan assets is not completed within one year following the plan’s termination date, it is presumed that distributions have not been made as soon as administratively feasible.

The final rules recognize there may be a delay in distributing assets due to:

- Circumstances beyond the control of the plan administrator; or
- The period of time necessary to obtain a determination letter on the plan’s qualified status upon its termination, provided the request for a determination letter is timely and the distribution of plan assets is made as soon as administratively feasible after the letter is obtained.

Liquidity requirements

A plan, other than a small plan, that is subject to the quarterly contribution requirement must make additional quarterly contributions to ensure that a minimum level of liquid assets is available to pay benefits as of the end of each quarter. This minimum level of liquid assets is the amount needed to pay for three years of benefits. An additional quarterly contribution made in liquid assets is due if the plan has insufficient liquid assets to satisfy this minimum level.

The final rules define “liquid assets” as cash, marketable securities and other assets. “Marketable securities” includes such financial instruments as:

- Stocks and other equity interests;
- Debt instruments (including certificates of deposit);
- Options; and
- Futures contracts and other derivatives

for which there is an established financial market.

“Other assets” that are treated as liquid assets are insurance, annuity or other contracts issued by an insurance company that is licensed to do business under the laws of any State, but only if the contract:

- Is a marketable security;
- Provides for substantially equal monthly payments; and
- Is benefit responsive (i.e., the plan has a right to receive payments from the contract in order to pay benefits for any plan participant without restrictions).

Liquidity shortfall

If a plan does not satisfy the liquidity requirements for a quarter, a 10% excise tax is imposed on the shortfall. There is an additional tax if the plan continues to have a shortfall for 5 consecutive quarters. The final rules revise the proposed rules and provide that a payment of a liquidity shortfall is treated as unpaid until the end of the quarter when due. In addition, contribution of liquid assets toward the required installment for a quarter is considered a payment towards any liquidity shortfall for the quarter.

Multiple employer plans

The regulations apply separately for each participating employer in a multiple employer plan, as if each employer maintained a separate plan. As a result, each employer will calculate its own minimum required contribution. Some employers may have to make required quarterly contributions while others may not.

Unlike the proposed rules, the final rules provide that the liquidity shortfall for the plan will be satisfied if the plan is treated as a single-employer plan that is not a multiple employer plan. Otherwise, the liquidity requirement must be applied separately for each employer under the plan. In this case, the value of plan assets as of the end of each quarter must be allocated among the employers sponsoring the plan.

Excise taxes on failure to make minimum required contributions

The regulations impose an excise tax on unpaid minimum required contributions for all years until corrected. In the case of a single-employer plan, the tax is 10% of the total unpaid minimum required contributions for all plan years that remain unpaid as of the end of any plan year ending with or within the employer’s taxable year. Each employer participating in a multiple employer plan is individually subject to this 10% tax, based on its own portion of the plan liabilities. In the case of a multiemployer plan, the tax is 5% of the accumulated funding deficiency as of the end of the plan year ending with or within the taxable year.

An “unpaid minimum required contribution” is any minimum required contribution for the plan year that is not paid on or before the due date for the plan year. An “accumulated funding deficiency” is the amount, determined at the end of the plan year that equals the excess, if any, of the total charges to the plan’s funding standard account for all plan years, over the total credits to the funding standard account for those years.

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To correct an unpaid minimum required contribution, the employer must make a contribution that is discounted to the valuation date for the plan year for which the unpaid contribution is due at the plan's effective interest rate. The regulations provide an ordering rule under which a contribution is attributable first to the earliest plan year of any unpaid minimum required contribution for which a correction has not yet been made.

Next steps

The final rules do not address issues pertaining to corporate transactions, such as mergers and spinoffs. The IRS has indicated that guidance on these outstanding issues will be published in future regulations. Prudential Retirement will continue to monitor IRS activity and will keep you informed when this guidance is available.

Plan sponsors should read the guidance discussed in this publication. If there are questions about the new funding rules or about the use of credit balances to satisfy the contribution requirements, they should contact the plan's enrolled actuary.

Pension Analyst by Prudential Retirement
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