Pension Analyst

Important Information | **Plan Administration and Operation** | **January 2010**

IRS issues benefit restriction regulations

Who's affected

These developments affect sponsors of and participants in qualified single-employer and multiple employer defined benefit plans. They do not affect multiemployer plans, governmental plans or church plans that do not elect to be covered by ERISA ("non-electing church plans").

Background and summary

For plan years beginning on and after January 1, 2008, the Pension Protection Act of 2006 (PPA) imposed new benefit restrictions on plans that do not meet specific funding percentage levels.

In early 2008, the IRS advised plan sponsors that for the 2008 plan year, they only needed to apply a reasonable interpretation of the law. In addition, the IRS provided transitional guidance for plan years beginning before final regulations became effective.

Recently, the IRS issued final regulations for applying the new benefit restrictions. These regulations incorporate changes made to the PPA rules by the Worker, Retiree and the Employer Recovery Act of 2008 (WRERA) and provide guidance regarding:

- The various types of restrictions that may apply;
- The impact of these rules on plan amendments;
- Participant notice requirements; and
- Techniques to avoid the application of benefit restrictions.

This *Pension Analyst* discusses the final regulations that apply to single-employer and multiple employer defined benefit plans in an effort to help plan sponsors determine the future actions necessary to keep their plans in compliance with ERISA and the Internal Revenue Code.

Action and next steps

The final regulations affect plan design and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and discuss the impact of these complex regulations on their plans with their enrolled actuary and legal counsel.

The final regulations are effective for plan years beginning on or after January 1, 2010. For plan years beginning before January 1, 2010, plans may comply with either these final regulations or the 2007 proposed regulations.

In this issue

In general, single-employer and multiple employer plans that do not meet specific funding levels are subject to certain benefit restrictions. Under PPA, restrictions apply to:

- The payment of unpredictable contingent event benefits (e.g., plant shutdown benefits);
- The adoption of plan amendments that increase or improve benefits;
- The payment of prohibited payments (e.g., lump sum payments); and
- Ongoing benefit accruals.

However, during the first five plan years of a plan's existence *only* the prohibited payments restriction applies. The final regulations clarify that, for this purpose, "plan years" include plan years when the plan was maintained by a predecessor employer. Plans that froze benefit accruals on or before September 1, 2005, are not subject to any of these restrictions.

Measurement date

The final regulations introduce the term "measurement date" to identify the dates on which a benefit restriction may apply or cease to apply. For example, if a prohibited payment restriction applies to the plan as of the measurement date, but that restriction ceases to apply at a later measurement date, then the restriction does not apply to benefits with annuity starting dates that occur on or after the second measurement date.

A plan may be amended to provide participants who had annuity starting dates within a benefit restriction period with the opportunity to elect new forms of benefit once the benefit restriction is removed. If a participant elects a new form of benefit, he is treated as having a new annuity starting date and the election is subject to the spousal consent rules.

Impact on plan terminations

The final rules also address the impact of these benefit restrictions on terminated plans. In general, any restriction in effect immediately before the plan termination date continues to apply. However, the restrictions do not apply to prohibited payments that are made to carry out the termination of the plan. *For example, a plan sponsor's purchase of deferred annuities from an insurer in connection with a standard plan termination is permitted.*

Contingent event benefits

As required by PPA, the final regulations prohibit a plan from paying unpredictable contingent event benefits, such as plant shutdown benefits, if the plan's adjusted funding target attainment percentage (AFTAP) is less than 60% or would be less than 60% as the result of paying such benefits. A plan's AFTAP is expressed as a percentage of the plan assets over the funding target for the plan year, adjusted by adding to both plan assets and the funding target the value of annuities purchased for all non-highly compensated employees for the preceding two years.

This restriction expires as of the first day of the plan year in which the plan sponsor makes a plan contribution equal to the:

- Minimum required contribution; and
- Amount necessary to pay for these benefits or an amount to satisfy the 60% funding requirement.

Benefit increases

The final regulations prohibit the adoption of plan amendments that increase benefits or establish new benefits if the plan's AFTAP is less than 80%, taking the amendment into account. However, this restriction does not apply if the employer makes contributions to the plan to either completely fund the benefit increase or satisfy the 80% funding requirement. In addition, the restriction does not apply if the plan's benefit formula is not based on a participant's pay, as long as the increase reflects the increase in average wages of plan participants.

In general, if an amendment increases benefits for both currently employed participants and terminated participants, all covered participants must be included in determining the increase in average wages, even though the terminated participants will have no increase or decrease in wages.

Alternatively, an employer may adopt two amendments, one that increases benefits for currently employed participants and another that increases benefits for terminated participants. As a result, if the plan's benefit formula is not based on a participant's pay the amendment that increases benefits for currently employed participants (based only on wages of those current employees) may not be subject to benefit restrictions, but restrictions will apply to the amendment affecting terminated participants (who have no increases in wages).

The benefit increase restriction also does not apply to a plan amendment that increases vesting percentages to comply with ERISA requirements, such as plan termination amendments, partial plan termination amendments or vesting increases required by the top-heavy rules.

Prohibited payments

Under the final regulations, a plan cannot make a prohibited payment for participants with annuity starting dates occurring when the:

- Plan has an ATFAP of less than 60%; or
- Employer is in bankruptcy and the plan's AFTAP is less than 100%.

A "prohibited payment" is any:

- Payment exceeding the monthly amount payable under a single life annuity (plus any social security supplements) to a participant or beneficiary whose annuity starting date occurs during a period when the benefit restriction is in effect;
- Payment for the purchase of deferred annuities from an insurer to pay benefits; and
- Other payment specified by the IRS.

The most common prohibited payment is a lump sum payment. The final regulations also clarify that prohibited payments include any transfer of assets and liabilities to another plan maintained by the same employer (or a member of its controlled group) made to avoid the application of benefit restrictions.

If a plan's AFTAP is between 60% and 80%, the plan cannot make a prohibited payment if the amount of the payment exceeds the lesser of:

- 50% of the amount that could be paid in the optional form that includes the prohibited payment; or
- The present value of the participant's maximum PBGC guarantee.

The final regulations clarify that this determination is based on the specific optional form of payment. If the optional form of payment provides payments greater than the amount payable under a straight life annuity, then the excess amount is a prohibited payment.

The IRS has also clarified that a plan that offers optional forms of payment must allow participants to elect to:

- Receive the unrestricted portion of an optional form of payment;
- Begin receiving payments under another optional form; or
- Defer their payment starting dates.

A participant may only delay his payment starting date if the plan document provides this option. In addition, any delay in the payment starting date must comply with plan qualification requirements such as the minimum required distribution rules.

The final regulations also allow plans to offer special optional forms of payment during the period that a benefit restriction is applied. For example, a plan may permit individuals who begin receiving benefit payments during this period to elect, within a specified period after the restriction ceases to apply to the plan, to receive the remaining benefit in the form of a single-sum payment equal to the present value of the remaining benefit. However, any such election is considered a new annuity starting date and is subject to the spousal consent rules.

Benefit accruals

The final regulations also restrict benefit accruals if a plan's AFTAP is less than 60%. In this situation, the plan must freeze all future benefit accruals as of the valuation date for the plan year. However, the restriction ceases to apply as of the first day of the plan year in which the plan sponsor contributes to the plan an amount equal to:

- The minimum required contribution; and
- An amount to satisfy the 60% funding level.

A plan may be amended to provide that any benefit accruals that were limited during the restricted period will be credited under the plan once the restrictions no longer apply. However, this provision is permitted only if the:

- Restricted period is 12 months or less; and
- Plan's enrolled actuary certifies that the AFTAP for the plan would not be less than 60% taking into account the restored benefit accruals.

Impact on plan amendments

The final regulations provide that if plan amendments cannot take effect as the result of benefit restrictions, they are treated as never adopted, unless the plan provides otherwise. *For example, a plan amendment that increases benefits pursuant to a collective bargaining agreement can provide that if the plan amendment does not take effect due to benefit restrictions, it will take effect at the earliest time it is permitted to take effect.*

If an amendment does not go into effect as of its intended effective date due to benefit restrictions, but is permitted to go into effect later in the plan year due to additional contributions or a certification of the AFTAP for the plan year, then the plan amendment must automatically take effect as of the first day of the plan year, or, if later, the original effective date of the amendment.

Notice to participants

A plan administrator must provide a written notice to participants and beneficiaries within 30 days after the:

- Date that the plan becomes subject to a shutdown benefit restriction or prohibited payment restriction; and
- Valuation date for the plan year for which the plan's AFTAP is less than 60% or is presumed to be less than 60%.

The IRS expects to issue participant notice guidance in the future. Until that guidance is provided, the IRS has indicated, in its October 2009 Employee Plans News that plans do not have to provide a benefit restriction notice to participants and beneficiaries in pay status when the ability to elect a lump sum payment is restricted. This should reduce costs, administrative burdens and participant confusion.

Earlier this year, the DOL published final regulations that authorize the assessment of civil penalties, not to exceed $1,000 per day for each violation by any person, against plan administrators, for failure to provide participants and beneficiaries with the notice of benefit restriction.

Techniques to avoid benefit restrictions

In general, there are four methods a plan sponsor may use to avoid or end one or more benefit restrictions. A plan sponsor may:

- Make an additional contribution for the current plan year to end or avoid the application of an unpredictable contingent event benefit restriction, a plan amendment restriction or a benefit accrual restriction. Any contribution made on a date other than the valuation date must be adjusted for interest. A plan sponsor may not elect to use a credit balance as a current year contribution for this purpose. In addition, the contribution cannot be recharacterized to satisfy the minimum required contribution requirement.
- Provide security to the plan as plan assets. For this purpose, the plan's AFTAP is determined by treating any security as a plan asset by the valuation date. However, this security is not taken into account as a plan asset for any other purpose. Acceptable forms of security are:
    - Bonds issued by a corporate surety that is acceptable under ERISA; or
    - Cash or U.S. government bonds that mature in three years or less, held in escrow by a bank or an insurance company.
- Reduce the plan's credit balance in an amount sufficient to avoid the restriction; or
- Make an additional contribution for the prior plan year.

The final regulations also provide new rules regarding the replacement of a security. For example, if security has been provided to the plan, the plan sponsor may provide new security and later or simultaneously have the original security released. This replacement can only occur if the new security is an acceptable security as described above and the amount of the new security is no less than the amount of the original security, determined at the time the original security is released.

Actuarial certification and presumptions

The final regulations provide a series of presumptions that apply before the enrolled actuary certifies the plan's AFTAP. If a plan was subject to restrictions during the prior year, the plan's AFTAP for the current year is presumed to be the same as for the preceding year until the plan's enrolled actuary certifies the AFTAP for the current year. The enrolled actuary's certification must be provided to the plan administrator in writing.

If an enrolled actuary does not certify the AFTAP for the current plan year by the fourth month of the plan year (e.g., April 1 for a calendar plan year), the AFTAP is presumed to be 10% lower than the prior plan year's level if the plan's AFTAP for the prior plan year was between 60% and 70% or between 80% and 90%. Otherwise, the AFTAP remains the same until certified by the plan's enrolled actuary or until the first day of the 10^{th} month. If a plan's actuary does not certify the plan's AFTAP by the first day of the 10^{th} month of the plan year (e.g., by October 1 for a calendar year plan), the AFTAP is presumed to be less than 60% as of that date.

A plan's enrolled actuary may issue a certification during the first nine months of a plan year stating that the plan's AFTAP is within a certain range ("range certification") that is either:

- Less than 60%;
- 60% or higher, but less than 80%;
- 80% or higher; or
- 100% or higher.

If the plan's enrolled actuary has issued a range certification for the plan year but does not issue a certification of the specific AFTAP for the plan year by the last day of the plan year, the AFTAP for the plan is retroactively deemed to be less than 60% as of the first day of the 10^{th} month of the plan year.

If the enrolled actuary issues a certification that is superseded by a later AFTAP certification, that later percentage must be applied from the original certification date. A change in a plan's certified AFTAP is a material change if a plan's operations with respect to benefit restrictions, taking into account any actual contribution and funding elections made by the plan sponsor, would have been different based on the later AFTAP determination for the plan year.

However, a change in the AFTAP is considered to be immaterial if it merely reflects a change in the funding target for the plan year or the value of the adjusted plan assets after the date of the enrolled actuary's certification. Other immaterial changes include:

- Additional contributions made by the plan sponsor for the preceding plan year;
- A plan sponsor's election to reduce the prefunding or funding standard carryover balance;
- A plan sponsor's election to apply the prefunding or funding standard carryover balance to offset the prior plan year's minimum required contribution;
- A change in the funding method or actuarial assumptions, where the change required approval of the IRS; or
- Unpredictable contingent event benefits because the employer makes a required contribution.

Collectively bargained plans

Under the final regulations, a collectively bargained plan must reduce its credit balance if this would avoid restrictions on benefit accruals, benefit increases, or contingent event benefits. If a plan covers both collectively-bargained and non-collectively-bargained employees, it will be considered a collectively bargained plan if:

- At least 25% of the *participants in* the plan are members of collective bargaining units for which the benefit levels under the plan are specified under a collective bargaining agreement; or
- At least 50% of the *employees benefiting under* the plan are members of collective bargaining units for which the benefit levels under the plan are specified under a collective bargaining agreement.

Multiple employer plans

The final benefit restriction 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 have its own funding target. In addition, benefit restrictions could apply differently to participants who are employees of different employers under a multiple employer plan.

Next steps

The final regulations do not address issues such as participant notices on benefit restrictions or the impact of the benefit restriction rules on mergers and spinoffs. The IRS intends to issue additional regulations on these topics. We will keep you informed on these developments as future guidance is issued.

The final regulations are extremely complex. If you have questions about them and their application to your plan, you should contact your plan's enrolled actuary to determine if plan administrative or funding changes may be needed. The plan's enrolled actuary is in the best position to provide assistance regarding compliance with these new rules.

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