



Pension Analyst

Important Information

Plan Administration and Operation

January 2010

IRS issues final defined benefit plan funding regulations

Who's affected

These developments affect sponsors of 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

The Pension Protection Act of 2006 (PPA) made extensive changes to the minimum funding requirements for defined benefit plans, including the determination of assets and liabilities for purposes of applying these new funding rules.

Recently, the IRS issued final regulations providing guidance regarding the new funding requirements. In addition, the final regulations incorporate changes made to PPA by the [Worker, Retiree and Employer Recovery Act of 2008 \(WREERA\)](#). The final regulations provide guidance regarding:

- Calculation of target normal cost;
- Automatic approval of a change in the asset valuation methods and interest rate basis;
- Rules regarding the establishment and use of credit balances; and
- Standing elections regarding the use of carryover balances.

This *Pension Analyst* discusses these final regulations 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 funding, 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

[Target normal cost and funding target](#)

[High 25 limitation](#)

[Insurance contracts](#)

[Plan provisions](#)

[Actuarial assumptions](#)

[Valuation date and valuation of plan assets](#)

[Valuation date](#)

[Valuation of plan assets](#)

[Transition relief](#)

[Determination of present value](#)

[Interest rates](#)

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[Election to use alternative rates](#)
[Special rules for plans in at-risk status](#)
[Special early retirement assumptions](#)
[Credit balances](#)
[Establishment and maintenance of credit balances](#)
[Use of credit balances to offset minimum required contributions](#)
[Employer elections](#)
[Multiple employer plans](#)
[Next steps](#)

For minimum funding purposes, the minimum required contribution for a single-employer plan that is not in at-risk status is the sum of the plan's target normal cost and the shortfall and waiver amortization charges for the plan year.

Target normal cost and funding target

In general, a plan's "target normal cost" is the present value of all benefit liabilities under the plan that accrue during, are earned during or are otherwise allocated to service for the plan year. The final regulations clarify that this valuation must take into account benefits that are accrued, earned or otherwise allocated to service beginning with the first day of the plan year through the valuation date, plus benefits that are expected to accrue during the remainder of the plan year. As a result, the target normal cost for a plan with a valuation date other than the first day of the plan year must reflect actual benefits earned before the valuation date. In addition, target normal cost is:

- Increased by the amount of plan-related expenses to be paid from plan assets during the plan year; and
- Decreased by the amount of mandatory employee contributions to be made over the plan year.

However, a plan's target normal cost cannot be less than zero.

The regulations also provide the following related definitions:

- A plan's "funding target" is the present value of all benefits that accrue during, are earned during or are otherwise allocated to years of service before the first day of the plan year.
- A plan's "funding target attainment percentage" (FTAP) is a fraction, where:
 - The numerator is the value of plan assets for the plan year minus the plan's funding balances; and
 - The denominator is the funding target for the plan year.

The determination of the funding target and the target normal cost for a plan year must take into account any limit on restricted benefits with respect to any annuity starting dates that were before the valuation date, but must not take into account any limits on restricted benefits for annuity starting dates on or after the valuation date.

High 25 limitation

The final regulations contain rules regarding restrictions that arise as a result of benefit limits imposed on certain highly compensated employees (the "high 25 limitation"). In determining the funding target and target normal cost, plan sponsors must take into account any payment restrictions to highly compensated employees to the extent that benefits were not paid or will not be paid because of a limitation that applied before the valuation date.

In addition, a limited benefit that was paid before the valuation date but with suitable security (such as an escrow account) provided to the plan must be treated as distributed and is not included in the funding target for liability purposes. At the same time, plan assets do not include the security that was provided to allow the benefit to be paid.

Insurance contracts

In general, a plan's funding target and target normal cost must reflect the liability for benefits that are funded through insurance contracts held by the plan and the plan's assets must include the value of the corresponding insurance contracts. Alternatively, a plan may exclude the liability for benefits provided under insurance contracts purchased from a state-licensed insurance company, but only to the extent that a participant's or beneficiary's right to receive these benefits is an irrevocable contractual right based on premiums paid to the insurance company before the valuation date.

However, the final regulations clarify that this alternative treatment is not available if the plan trustee can surrender a contract to the insurer for its cash value because the participant's or beneficiary's rights to receive those benefits are not irrevocable. In this situation, the liability for benefits provided under the contract must be taken into account in

determining the plan's funding target and target normal cost and the contracts cannot be excluded from plan assets.

Plan provisions

In general, the plan's enrolled actuary must determine the funding target and target normal cost based on the plan terms that are adopted no later than the valuation date for the plan year and that take effect during the plan year. *For example, a plan amendment adopted on or before the valuation date for the plan year that has an effective date occurring in the current plan year must be taken into account.*

However, the actuary can elect to recognize retroactive amendments adopted within 2½ months after the end of the plan year. As a result, if an amendment is adopted after the valuation date for a plan year and no later than 2½ months after the close of the plan year but takes effect during that plan year, the amendment may be taken into account in determining the plan's funding target and target normal cost. However, an amendment may not be taken into account if it does not take effect until a future plan year.

Actuarial assumptions

The same actuarial assumptions and funding method must be used for purposes of determining the target normal cost, funding target and benefit restrictions. Each of the actuarial assumptions must be reasonable taking into consideration the experience of the plan and reasonable expectations. The assumptions must reflect the plan's enrolled actuary's best estimate of anticipated experience under the plan.

Once actuarial assumptions have been established for a plan year, those assumptions cannot be changed for that year unless the IRS determines that they were unreasonable. In addition, a funding method cannot be changed for a plan year unless the IRS determines that the use of that funding method is impermissible. Actuarial assumptions and funding methods are established by filing the actuarial report (Schedule SB) of Form 5500. If the Schedule SB is not completed and filed by the deadline, then the prior plan year actuarial assumptions and methods continue to apply, unless the IRS permits or requires other actuarial assumptions or funding methods to be used.

The final regulations now provide an exception to the requirement for IRS approval of changes in actuarial assumptions for plans exiting [at-risk status](#). A plan that is not in at-risk status for the current plan year but was in at-risk status for the prior plan year (and for a total period of less than five consecutive plan years) has automatic approval to use the actuarial assumptions that were used before the plan entered at-risk status in combination with the required at-risk assumptions during the period the plan was in at-risk status.

Valuation date and valuation of plan assets

Valuation date

The determinations of the funding target, target normal cost and the value of plan assets are made as of the valuation date for the plan year. Under PPA, 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" is a plan with 100 or fewer participants on each day of the preceding plan year. For this purpose, all defined benefit plans (other than multiemployer plans) maintained by the same employer or by any member of the employer's controlled group, are treated as a single plan, but only the employer's participants are taken into account.

A small plan may designate any day during the plan year as its valuation date. Since the selection of the valuation date is part of the plan's funding method, any change to that date requires IRS approval.

Valuation of plan assets

The value of plan assets is determined in one of two ways:

- As the fair market value of plan assets determined on the valuation date; or
- As the average of the fair market value of assets on the valuation date and the adjusted fair market value of assets determined for one or more earlier determination dates. However, the value must be between 90 and 110 percent of the fair market value of plan assets.

The fair market value of an asset is the price at which the asset would change hands between a willing buyer and a willing seller, where neither party is required to buy or sell and both have reasonable knowledge of relevant facts.

The method of determining the value of plan assets is part of the plan's funding method and may only be changed with IRS approval.

The regulations provide guidance regarding the treatment of contributions that are made after the valuation date for a plan year that are attributable to a prior plan year. Under these rules, only the discounted present value of the contributions is included in the value of plan assets.

Transition relief

Any change in a plan valuation date or asset valuation method that is made for the first plan year beginning in either 2008, 2009 or 2010 is automatically approved and does not require formal IRS approval.

Determination of present value

Interest rates

The final regulations confirm the interest rates to be used in determining the present value of a plan's target normal cost and funding target. Present value is determined using three interest rates (segment rates), each of which applies to benefit payments expected to be paid during a certain period as follows:

- The first segment rate applies to benefits payable during the five-year period beginning on the first day of the plan year;
- The second segment rate applies to benefits payable during the 15-year period following the initial five-year period (i.e., years six through 20); and
- The third segment rate applies to benefits payable after the end of the 20-year period.

Each segment rate is a single interest rate that is determined monthly by the IRS on the basis of a corporate bond yield curve. The rate reflects the average of yields on investment grade corporate bonds with varying maturities in the top three quality levels available for the 24-month period ending with the preceding month.

Election to use alternative rates

The final regulations describe several elections a plan sponsor may make in order to use an alternative interest rate rather than the segment rates. These elections are made by providing written notice of the election to the plan's enrolled actuary. An alternative rate may be adopted for a plan year without the consent of the IRS. However, once adopted, that rate will apply for that plan year and all future plan years and may be changed only with IRS approval.

Special rules for plans in at-risk status

PPA requires certain underfunded at-risk plans to use special actuarial assumptions. An underfunded plan is considered to be "at-risk" if, for the preceding year its:

- **FTAP** determined using standard assumptions was less than 80%; and
- **FTAP** determined using at-risk assumptions was less than 70%.

Under a special transition rule, the 80% threshold described above is phased-in at: 65% for plan years beginning in 2008, 70% for plan years beginning in 2009, and 75% for plan years beginning in 2010.

However, the at-risk rules do not apply if a plan had 500 or fewer participants on each day during the preceding plan year. For this purpose, all defined benefit plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of the employer's controlled group, are treated as a single plan.

Special early retirement assumptions

The proposed regulations provided that all employees who are not otherwise assumed to retire as of the valuation date, but who will be eligible to begin benefits in the current year and 10 succeeding plan years, are assumed to retire at the earliest retirement date under the plan, but not before the end of the current plan year.

The final regulations clarify that these early retirement assumptions apply to all participants (employees, terminated vested participants, and beneficiaries) who have not begun receiving payments. In addition, the "earliest retirement age"

cannot be earlier than the age at which the participant's benefit is fully vested. The final regulations also confirm that all participants and beneficiaries who are assumed to retire on a particular date are assumed to elect the optional form of benefit available under the plan that would result in the highest present value of benefits commencing at that date.

Credit balances

Establishment and maintenance of credit balances

Under PPA, a plan's funding standard carryover balance and prefunding balance are collectively known as "credit balances." If a plan had a positive balance in its funding standard account as of the last day of the 2007 plan year, the employer may elect to maintain all or a portion of that amount as a "funding standard carryover balance." In addition, an employer may establish a "prefunding balance" consisting of new contributions made in excess of the minimum required contribution for plan years beginning on or after January 1, 2008.

The final regulations provide that credit balances are adjusted for investment return as of the beginning of the preceding plan year after subtracting amounts used to offset the minimum required contribution for the preceding plan year and after any reduction of balances for the preceding plan year. The actual rate of return on plan assets for the preceding plan year is determined on the basis of fair market value and must take into account the amount and timing of all contributions, distributions and other plan payments made during that period.

Similar to the proposed regulations, the final regulations confirm that the amount of any credit balances must be subtracted from the value of plan assets, unless certain exceptions apply. For example, credit balances are *not* subtracted from plan assets for purposes of determining a funding shortfall if there is a binding agreement with the Pension Benefit Guaranty Corporation (PBGC) that provides that all or a portion of the credit balances cannot be used to offset the minimum required contribution for a plan year. An agreement with the PBGC is taken into account with respect to a plan year only if the agreement was executed before the valuation date for the plan year.

Use of credit balances to offset minimum required contributions

An employer may use some or all of a credit balance to offset the minimum required contribution for the current plan year, as long as the plan's prior plan year funding ratio was at least 80%, determined after the deduction of the prefunding balance from the actuarial value of plan assets. However, the final regulations provide that a plan's funding standard carryover balance must be exhausted before the plan's prefunding balance may be used to offset the minimum required contributions.

Employer elections

An employer's election to use a credit balance must be:

- Irrevocable; and
- Made in writing to the plan's enrolled actuary and the plan administrator and set forth the relevant details of the election including the specific dollar amount involved in the election.

In response to comments, the final regulations permit a plan sponsor to provide a standing election in writing to the plan's enrolled actuary to use the funding standard carryover balance and the prefunding balance as necessary to avoid an unpaid minimum required contribution. The regulations also allow a plan sponsor to provide a standing election in writing to the plan's enrolled actuary to add the maximum amount possible each year to the prefunding balance account. However, no standing elections are allowed for quarterly contributions.

A standing election remains in effect unless:

- It is revoked by notice to the plan's enrolled actuary and plan administrator on or before the date the election is deemed to occur; or
- The plan's enrolled actuary who signs the Schedule SB, Single Employer Defined Benefit Plan Actuarial Information of Form 5500 is not the enrolled actuary named in the standing election.

If there is a change in the plan's enrolled actuary, which results in a revocation of a standing election, the plan sponsor may reinstate the revoked election by providing a replacement to the enrolled actuary by the due date of the Schedule SB of Form 5500.

Although the general rule requires that a plan sponsor's election to use a credit balance is irrevocable, there are exceptions. An election to use a credit balance to offset the minimum required contribution may be revoked to the extent that the amount the plan sponsor elected to offset the minimum required contribution exceeds the minimum required contribution and if the election is revoked in writing to the plan's enrolled actuary and plan administrator by the end of the plan year. The final regulations extend the deadline for making this revocation until the due date (including extensions) of the Schedule SB.

Multiple employer plans

The final funding 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 and may make its own interest rate election. Some employers may be at-risk while others are not.

Similarly, the rules regarding credit balances and [benefit restrictions](#) apply separately for each employer in a multiple employer plan. Thus each participating employer may have a separate credit balance under the plan and would make its own election to use a credit balance. 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 asset smoothing, mergers and spinoffs and types of expenses to be included in the definition of target normal cost. 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 the final regulations, 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 how to comply with the final regulations.

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