PRUDENTIAL RETIREMENT. INTELLIGENT SOLUTIONS, WORKING FOR YOU.

Pension ANALYST

Important Information Plan Administration and Operation December 2007

IRS Issues Guidance for Certain Underfunded Defined Benefit Plans

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 defined benefit plans covered by ERISA, the Pension Protection Act of 2006 (PPA) established new funding requirements. Plans that do not meet specific funding percentage levels are subject to specific benefit restrictions. The IRS recently issued proposed rules for determining funded status and applying the new benefit restrictions. These proposed rules provide guidance on the:

- Ability and timing of a plan sponsor's election or requirement to apply a funding credit balance toward the contribution requirements;
- Steps certain underfunded plans must follow to make benefit payments while restrictions are in place; and
- Actuarial certifications.

This *Pension Analyst* discusses the PPA benefit restrictions that apply to single-employer and multiple employer defined benefit plans for plan years beginning on or after January 1, 2008, in an effort to help plan sponsors determine the future actions needed to keep their plans in compliance with ERISA and the Internal Revenue Code. Some of the items may require plan sponsors to make plan amendments.

ACTION AND NEXT STEPS The proposed rules affect plan funding, design, and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and discuss the new law's impact on their plans with their enrolled actuary and legal counsel. Prudential Retirement's enrolled actuaries are well prepared to respond to your inquiries regarding the effect of the new law on your plan.

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One of PPA's primary goals was to strengthen defined benefit plan funding levels. To that end, the new law imposes additional restrictions on certain benefit payments, benefit increases, and benefit accruals when a plan is underfunded or is in danger of becoming underfunded. Since the benefit restrictions are tied to a plan's funding level, this publication first discusses funding balances, followed by a discussion of the benefit restrictions and strategies for avoiding those restrictions.

Funding Balances

Under PPA, a plan's funding standard carryover balance and prefunding balance are collectively known as "credit balances." In certain situations, plan sponsors may use credit balances to reduce required contributions for a plan year.

Establishment and Maintenance of Credit Balances

If a plan has 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." A funding standard carryover balance may be maintained until it is reduced to zero.

In addition, an employer may establish a "prefunding balance" consisting of new contributions made in excess of the minimum required contribution for a plan year beginning on or after January 1, 2008. For the 2008 plan year, the prefunding balance is zero and an employer may elect to add some or all of the excess contribution made to a plan for each plan year to the prefunding balance as of the first day of the next plan year. However, any contribution specifically earmarked to avoid the application of a benefit restriction is not taken into account in determining the amount of contributions made towards the minimum requirement.

Credit balances must be adjusted at the beginning of a plan year to reflect the actual rate of return on plan assets during the prior plan year.

Use of Credit Balances to Offset Minimum Funding Requirements

An employer may elect to 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 year funding ratio was at least 80%. When using credit balances in this manner, the plan sponsor must use the funding standard carryover balance in full before using the prefunding balance.

Plan sponsors should consult with their plan's enrolled actuary on the possible use of any existing credit balance maintained by the plan beginning in the 2008 plan year.

Impact on Funding Target Attainment Percentage

In general, a plan's funding target attainment percentage (FTAP) is the ratio of the value of plan assets for the year, reduced by all credit balances, to the plan's funding target for the year. However, if an employer elects to reduce the amount of any credit balance to avoid the application of a benefit restriction, the value of plan assets used in calculating the FTAP is increased because the credit balance reduction will be less. Again, a plan sponsor must use the funding standard carryover balance in full before using the prefunding balance.

In addition, the rules provide that 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 those 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.

Employer Elections

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

- 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 amount of credit balance involved;
- Irrevocable; and
- Made on or before the due date (including extensions) for the filing of the plan's Form 5500 for the plan year to which the election relates. However, any election to reduce the credit balance to avoid a benefit restriction must be made by the end of the plan year to which the election relates.

Treatment of Multiple Employer Plans

In the case of a multiple employer plan, the rules apply separately for each employer under the plan, as if each employer maintained a separate plan. As a result, each participating employer may have a separate credit balance under the plan and would make its own election to use a credit balance.

Benefit Restrictions

In general, single-employer and multiple employer defined benefit plans that do not meet specific funding percentage levels are subject to certain benefit restrictions for plan years beginning on or after January 1, 2008. These restrictions apply at a later date to plans maintained pursuant to collective bargaining agreements ratified before January 1, 2008.

General Rules

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 accelerated benefit payments (e.g., lump sum payments); and
- Ongoing benefit accruals,

when a plan's adjusted funding target attainment percentage (AFTAP) is less than a specified percentage.

A plan's AFTAP is its FTAP, 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.

The proposed rules provide that the unpredictable contingent event benefit restriction, the benefit improvement restriction, and the benefit accrual restriction do not apply to a new plan during its first five plan years. In addition, plans that froze benefit accruals on or before September 1, 2005, are not subject to the accelerated payment restriction.

Under the proposed rules, the benefit restrictions apply separately for each participating employer in a multiple employer plan, as if each employer maintained a separate plan. As a result, the benefit restrictions could apply differently to employees of different employers under a multiple employer plan.

Contingent Event Benefits Restriction

PPA prohibits a plan from paying unpredictable contingent event events, such as plant shutdown benefits, if the plan's AFTAP is less than 60% or would be less than 60% as a result of paying such benefits.

However, this restriction does not apply if the plan sponsor makes additional contributions to the plan or provides security to either:

- Pay for these benefits; or
- Satisfy the 60% funding requirement, based on the calculated liability including the event.

The proposed rules clarify that if such an unpredictable contingent event occurs in a plan year when the restriction does not apply, the related benefit may continue to be paid, even if the plan's AFTAP falls below 60% in a later year. On the other hand, if such an event occurs in a year when the restriction applies, payments may not be made in later years when no restriction applies, unless the plan is amended to permit these additional payments.

Benefit Increases

PPA prohibits 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 (or provides security) 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.

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.

As an alternative, the rules permit an employer to adopt two amendments, one that increases benefits for currently employed participants and another amendment that increases benefits for terminated participants. As a result, the benefit restriction exception applies to the amendment that increases benefits for currently employed participants (based only on wages of those current employees) while the amendment that applies to the terminated participants (who have no increases in wages) is not eligible for the exception.

An amendment that increases vesting percentages to comply with ERISA requirements (such as the PPA requirement for accelerated vesting for cash balance plans) is not subject to the benefit increase restriction.

Accelerated Benefit Payments

Under PPA, there are two types of benefit payment restrictions. A plan will not be able to make accelerated payments for participants with annuity starting dates occurring when:

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

In general, an "accelerated payment" is any payment to a participant or beneficiary that exceeds the monthly amount payable under a single life annuity (plus any social security supplement). The most common example of an accelerated payment is a lump sum payment.

If a participant elects an accelerated payment, the plan must permit the participant to:

- Elect another form of payment available under the plan; or
- Defer the payment to a later date.

If a plan's AFTAP is between 60% and 80%, the plan may generally make one lump sum payment per participant during an entire restricted period. This payment, known as the unrestricted portion, may not exceed the lesser of:

- The present value of the participant's maximum PBGC guaranteed benefit; or
- 50% of the present value of the participant's benefit.

If a participant or beneficiary elects a form of payment that is not available under the plan because of this limitation, the plan must allow that individual to either:

- Defer payment to a later date; or
- Split the benefit into unrestricted and restricted portions, with the unrestricted portion payable under any optional form of payment otherwise available under the plan.

Once a plan is no longer subject to this restriction, benefit payments will continue to be paid in the form previously elected unless the plan permits the participant to make a new election. However, any new election is considered a new annuity starting date and must comply with the qualified joint and survivor notice and consent requirements.

Unfortunately, the proposed rules do not provide guidance on the treatment of mandatory cash-out payments when lump sums are restricted. Congressional leaders have introduced a PPA technical corrections bill that would exempt mandatory cash-outs from the lump sum payment restriction. Until that bill is passed and signed into law, it appears that mandatory cash-out payments are subject to this restriction.

Benefit Accruals

PPA also imposes a restriction on benefit accruals that is related to the plan's funding status. If a plan's AFTAP is less than 60%, the plan must freeze all future benefit accruals as of the earlier of the date the plan's enrolled actuary certifies that the AFTAP is less than 60%, or the first day of the tenth month of the plan year if no certification has been done. The IRS recently announced in the November issue of *Employee Plans News* that the notice required for amendments restricting benefits will satisfy both the timing and content requirements for a notice of benefit accrual reduction ("204(h) notice").

The restriction on benefit accruals does not apply if the plan sponsor makes contributions to the plan to satisfy the 60% funding level or provides additional security.

A plan may be amended to provide that any benefit accruals that were limited under the restricted period will be credited under the plan once the limitation no longer applies. However, if a plan provides for the restoration of benefit accruals for the limitation period, the plan is treated as having adopted an amendment that increases plan liabilities if the limitation period exceeds 12 months. As a result, the plan would then be subject to the contribution or security requirements for the benefit increase restrictions, as described above.

Actuarial Certification

For purposes of determining whether any of the new benefit restrictions apply for a plan year, a plan is considered to have the same AFTAP as it had in the prior plan year, until an actuarial certification is completed for the current plan year, subject to the adjustments discussed below.

If an enrolled actuary does not certify the AFTAP for the current plan year by the first day of the fourth month of the plan year (e.g., by April 1 for a calendar plan year), the AFTAP is immediately deemed to be 10% lower than the prior plan year's level. Any benefit restrictions resulting from this decrease apply beginning on this date and remain in effect until the actuarial certification is completed. In addition, this deemed reduction in the AFTAP could also generate a compelled waiver of a portion of any existing credit balance.

If the actuarial certification is not completed by the first day of the tenth month of the plan year (e.g., by October 1 for a calendar year plan), the plan is immediately deemed to be less than 60% funded. At that point, the applicable benefit restrictions will immediately apply. These restrictions will remain in effect until the actuarial certification is completed for the *next* plan year. For this reason, it is important that sponsors submit plan information as soon as possible in order for the plan's enrolled actuary to complete the plan valuation and actuarial certification.

The enrolled actuary's certification must be provided to the plan administrator in writing.

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 (i.e., at least 60% but less than 80%, at least 80% but less than 100%, or at least 100%). If a range certification is issued, the plan is treated as having an AFTAP at the smallest value within the range.

If the enrolled actuary issues an AFTAP certification that is superseded by a later certified AFTAP, that later percentage must be applied from the original certification date. If the change in the AFTAP is considered to be a material change (i.e., plan operations would have been different based on the later AFTAP determination) and the plan was operated in accordance with the prior AFTAP certification, the plan will not have satisfied the benefit restriction requirements. In the case of an immaterial change, the revised percentage simply applies prospectively from the date of the revised certification.

If Prudential Retirement does not provide actuarial services for your plan but does make benefit payments or provides document services for your plan, you will need to make sure that a copy of the actuarial certification is provided to Prudential on a timely basis to ensure that benefits are not unnecessarily restricted, or prohibited payments made.

Notice Requirements

The plan administrator must provide written notice of the applicable benefit restriction to plan participants and beneficiaries within 30 days after:

- The date the plan becomes subject to a benefit restriction;
- The valuation date for the plan year for which the plan's AFTAP is less than 60% (or, if earlier) the date the AFTAP is presumed to be less than 60%; and
- Such other time as determined by the IRS.

The notice must be provided in writing, but may be provided in electronic or other form to the extent reasonably accessible to the participant. If the plan administrator fails to provide the notice, a civil penalty may be imposed up to $1,000 per day from the time of the failure.

Strategies to Avoid Benefit Restrictions

In general, there are four methods a plan sponsor may use to avoid or terminate a benefit restriction. A plan sponsor may elect to:

- Reduce the credit balance;
- Make an additional contribution for the prior plan year;
- Make a contribution that is specifically designated as a current year contribution; or
- Provide security.

Reduction of the Credit Balance

The proposed rules provide that if a plan would have otherwise been subject to benefit payment restrictions, the plan sponsor is treated as having made an election to reduce the credit balance by the amount needed to increase the AFTAP to the threshold required to avoid the benefit payment restriction. However, this deemed election applies only if the credit balance is large enough to avoid the benefit payment restriction. No credit balance reduction is required if the credit balance amount is not enough to avoid the restriction.

A collectively bargained plan must elect to reduce its credit balance if this would avoid restrictions on benefit accruals, benefit increases and shutdown or contingent benefits.

Current Year Contribution

A plan sponsor may elect to make a current year contribution to avoid a benefit restriction that applies to contingent event benefits, benefit increases and benefit accruals. 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.

Providing Security

A plan sponsor may also provide security to avoid a benefit restriction. For this purpose, the plan's AFTAP is determined by treating any security provided as a plan asset by the valuation date. However, this security is not taken into account as a plan asset for any other purpose.

The forms of acceptable security are:

- Bonds issued by a corporate surety company 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.

Plan sponsors should consult their plan's enrolled actuary regarding the ability to eventually turn this security over to the plan as an actual contribution.

Effective Dates

Since these regulations are neither temporary nor final, plan sponsors are not required to comply with them. However, the IRS has indicated that plan sponsors that do comply with these rules will not be jeopardizing their plans' qualified status if final regulations make significant changes to these proposals. Plan sponsors that choose not to comply with the proposed rule will need to apply their interpretation of the new law to their plans in a reasonable and consistent manner.

In general, the rules regarding credit balances are proposed to apply to plan years beginning on or after January 1, 2008. There is no delayed effective date for collectively bargained plans.

The benefit restriction rules are also proposed to apply to plan years beginning on or after January 1, 2008. However, collectively bargained plans have a delayed effective date. For collectively bargained plans maintained in accordance with one or more collective bargaining agreements ratified before January 1, 2008, the rules will be effective for plan years beginning before the earlier of:

- The later of the date on which the last collective bargaining agreement relating to the plan terminates (without extension) or the first day of the first plan year beginning on or after January 1, 2008; or
- January 1, 2010.

Next Steps

As the 2008 plan year approaches, plan sponsors should review their plan's current funding percentage. They should also begin gathering the required information so that the plan's enrolled actuary can timely issue an actuarial certification and determine if the plan will be subject to any benefit restrictions. If applicable, plans sponsors should consult with their plan's enrolled actuary about the use of any available credit balances to avoid the imposition of benefit restrictions.

If you have questions about the new rules pertaining to credit balances, benefit restrictions or actuarial certifications relating to benefit restrictions, you should contact your plan's enrolled actuary.

Pension Analyst by Prudential Retirement
The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with information on current legislation and regulatory developments affecting qualified retirement plans.

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