

Pension ANALYST

Important Information

Plan Administration and Operation

July 2008



IRS Issues Minimum Required Contribution Rules For Defined Benefit Plans

WHO'S AFFECTED These developments affect sponsors of qualified single-employer, multiple employer and multiemployer defined benefit plans. They do not affect 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 after December 31, 2007, single-employer defined benefit plans covered by ERISA, are subject to [new funding requirements](#), which typically increase minimum required contributions. Recently, the IRS issued proposed rules for determining minimum required contributions. These proposed regulations also provide guidance on the:

- Determination of shortfall amortization payments;
- Determination of quarterly contributions; and
- Use of credit balances to eliminate or reduce contributions.

Defined benefit plans that do not satisfy minimum funding requirements are subject to excise taxes. The IRS has also provided guidance for single-employer, multiple employer and multiemployer plans regarding interest and excise taxes on late payments.

This *Pension Analyst* discusses the guidance provided in the proposed regulations in an effort to help plan sponsors determine future actions needed to keep their plans in compliance with ERISA and the Internal Revenue Code.

ACTION AND NEXT STEPS The proposed regulations affect plan funding and administration. The proposed regulations on minimum required contributions generally apply to plan years beginning on or after January 1, 2009. When the regulations are finalized, plans will be permitted to apply them for plan years beginning in 2008. However, for plan years beginning in 2008, plans may rely on the proposed regulations for purposes of satisfying the PPA funding rules.

The proposed excise tax regulations do not have a specific effective date but generally have the same effective date as the proposed minimum required contribution regulations. The excise tax regulations apply to taxable years beginning on or after January 1, 2008, but only for those plans for which the minimum funding rules apply.

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The Pension Protection Act of 2006 (PPA) made extensive changes to the minimum funding requirements for single-employer and multiple employer defined benefit plans. Previously, the IRS issued guidance on the use of [credit balances](#) and the [measurement of assets and liabilities](#). The IRS has now provided an additional piece of guidance with the publication of proposed regulations on minimum required contributions.

Minimum Required Contributions

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 balance, if applicable.

The proposed regulations introduce the following new definitions that apply to plans that are not in ["at-risk"](#) status:

- **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.

The proposed regulations provide a transition rule, which takes into account only a certain portion of the funding target when determining whether a shortfall amortization must be established for plan years beginning before January 1, 2011. However, the transition rule does not apply to any plan year beginning after December 31, 2008 if:

- A shortfall amortization was required for any preceding year;
- The plan was not in effect; or
- The plan was subject to additional funding requirements in the 2007 plan year.

The proposed regulations do not provide guidance for determining whether a plan has a funding shortfall for the 2007 plan year for purposes of determining whether the plan must make required quarterly installments

for the 2008 plan year. Plans must make this determination based on a reasonable interpretation of the law. PPA technical corrections legislation pending in Congress would provide guidance on the determination of the funding shortfall for the 2007 plan year.

Short Plan Years

The 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 proposed regulations also provide guidelines for the treatment of installments made in later plan years to take into account the proration of these installments for short plan years. In general, a “short plan year” is a plan year that is less than 12 months long.

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 that same interest rate.

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 may designate any day 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, which 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.

A plan sponsor may apply the plan’s prefunding balance or funding standard carryover balance towards the payment of quarterly installments.

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.

The proposed regulations provide special rules in the case of a short plan year for determining the amount of the required annual payment, the number and due dates of installments and the amount of those installments.

Late Payments

If a plan sponsor does not pay the full amount of a quarterly installment that is due after the plan's valuation date, interest must be paid on the underpayment. The rate of interest payable is the plan's effective interest rate for the plan year plus five (5) percentage points and is applied for the period beginning on the installment due date and ending on the date of payment. The amount of underpayment on which interest is payable is equal to the:

- Excess of the required installment; over
- Amount (if any) of the installment contributed to or under the plan on or before the due date for the installment.

Contributions must be credited against unpaid required installments in the order in which those installments were due.

Liquidity Requirements

A 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. Generally, this required 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. An employer cannot use funding balances or contribute illiquid assets to remedy a liquidity shortfall.

"Liquid assets" means 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

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 the right to receive payments from the contract in order to pay benefits for any plan participant without restrictions).

When applying the additional [5% interest](#) adjustment to a quarterly installment underpayment, the liquidity increment for the quarter must be treated as unpaid until the end of the quarter in which the installment payment due date occurs, regardless of when it is contributed. If a contribution is less than the total amount needed to satisfy both the standard quarterly contribution requirement and the liquidity requirement, the contribution must first be used to satisfy the quarterly contribution requirement.

A 10% tax is imposed on any liquidity shortfall that is not paid by the due date for the quarterly contribution installment for that quarter.

Multiple Employer Plans

These 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 minimum required contribution. Some employers may have to make required quarterly contributions while others may not.

Taxes on Failure to Make Minimum Required Contributions

An excise tax applies to any failure to meet the minimum funding requirements. In the case of a single-employer plan, the tax is 10% of the total [unpaid minimum required contributions](#) for all plan years that remains unpaid as of the end of any plan year ending with or within the employer's tax 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 any plan year ending with or within the taxable year. The deficiency may be attributable to the delinquency of one or several employers in making required contributions to the plan under the terms of the collective bargaining agreement.

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. To correct an unpaid minimum required contribution, the employer must make a contribution that, when discounted to the valuation date for the plan year for which the unpaid contribution is due, equals or exceeds the unpaid minimum required contribution. To calculate this amount, the plan must apply the plan's effective interest rate and the late quarterly interest rate, if applicable.

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. To correct an unpaid accumulated funding deficiency as of the end of the plan year, the plan must contribute an amount equal to the accumulated funding deficiency adjusted with interest. The appropriate rate of interest is the plan's valuation interest rate for the period between the end of the plan year and the date of the contribution.

Next Steps

Plan sponsors should carefully read the guidance discussed in this *Pension Analyst*. If you have questions about the new funding requirements, you should contact the plan's enrolled actuary. If applicable, plan sponsors should consult with their plan's enrolled actuary about the use of any available credit balances to satisfy the contribution requirements.

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