

Pension ANALYST

Important Information

Plan Administration and Operation

May 2008



IRS Issues Plan Valuation Regulations For Single-Employer 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 The Pension Protection Act of 2006 (PPA) established [new funding requirements](#) for defined benefit plans covered by ERISA. PPA also made extensive changes to the minimum funding requirements.

On December 31, 2007, the IRS issued proposed regulations on the determination of assets and liabilities for purposes of applying these new funding rules. These proposed regulations provide guidance on the:

- Determination of the funding target and normal cost;
- Valuation date;
- Valuation of plan assets; and
- Interest rates.

The regulations also provide guidance on the actuarial assumptions that must be used for determining the funding target and making other computations for [certain underfunded](#) defined benefit plans in “at-risk” status.

This *Pension Analyst* discusses the new funding requirements that apply to single-employer and multiple employer defined benefit plans 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.

ACTION AND NEXT STEPS The proposed regulations affect both plan funding and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and discuss the contents of this publication with their legal counsel and their plan’s enrolled actuary.

The proposed regulations are effective for plan years beginning on or after January 1, 2009. Since the regulations are only proposed, plan sponsors are not required to comply with them. However, plan sponsors that do comply with these regulations before 2009 in the administration and funding of their plans are assured that the IRS will consider their plans to be in compliance with the new rules. Any more restrictive rules continued in the final regulations will apply on a prospective basis.

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Target Normal Cost and Funding Target

PPA amended the Internal Revenue Code to define the minimum required contribution for a single-employer plan that is not in at-risk status as the sum of the plan's target normal cost and the shortfall and waiver amortization charges for the plan year.

PPA also introduced the following new definitions that apply to the new funding rules:

- **Target normal cost:** The present value of all benefit liabilities expected to accrue during the plan year, including increases in past service benefits attributable to current year increases in compensation.
- **Funding target:** The present value of all benefits accrued or earned as of the beginning of the plan year.
- **Funding shortfall:** The excess of the plan's funding target over the plan's assets.

The benefits taken into account in determining the funding target and target normal cost are all benefits earned, including retirement-type and ancillary benefits. As currently proposed, the determination of the funding target and the target normal cost for a plan year cannot take into account any:

- [Benefit restrictions or anticipated benefit restrictions for certain underfunded plans](#); or
- Plan administrative expenses paid or expected to be paid from plan assets for a plan year.

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.

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 become effective during that plan year. However, the actuary can elect to recognize retroactive amendments adopted within 2½ months after the end of the plan year.

Valuation Date

All determinations with respect to the minimum required contribution, such as the funding target, target normal cost and plan assets and liabilities, must be made as of the plan's valuation date. 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 sponsored by an employer that has 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.

A small plan may designate any day during the plan year as its valuation date. Since the selection of a valuation date by a small plan is part of the plan’s funding method, it may be changed only with the consent of the IRS.

Valuation of Plan Assets

The value of plan assets is generally the fair market value of those assets on the valuation date. The fair market value of an asset is determined as the price at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

A plan may determine the value of plan assets on the valuation date as the average of the fair market value of assets on the valuation date and the adjusted fair market value of assets determined on an earlier date. However, the averaging period cannot be longer than 24 months and the resulting average value must be between 90 and 110 percent of the fair market value of plan assets. 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 timing of contributions. If a plan sponsor makes a required contribution for a preceding plan year after the valuation date for the current plan year, the present value of the contribution (determined as of the valuation date for the current plan year, using the plan’s effective interest rate for the preceding plan year) is taken into account.

If contributions are made to a small plan for the current plan year before the valuation date, plan assets as of the valuation date must exclude:

- Those contributions; and
- Interest attributable to those contributions.

Actuarial Assumptions

Any present value determination must be made on the basis of actuarial assumptions and a funding method. Each actuarial assumption must be reasonable, taking into account the experience of the plan and reasonable expectations. In combination, the assumptions must offer the actuary’s best estimate of anticipated experience under the plan. Once the actuarial assumptions for a plan year are established, they cannot be changed for that plan year unless the IRS determines that they were unreasonable. Likewise, a funding method may not be changed unless the IRS determines that its use is impermissible.

In general, the actuarial assumptions and funding method used by a plan for a plan year must be established no later than the due date for filing Form 5500 (or the last day of the seventh month after the end of the plan year, in the case of a plan not required to file Form 5500). The filing of the first actuarial report (Schedule SB) for a plan year that reflects the use of actuarial assumptions and a funding method is treated as the establishment of those assumptions and the funding method for that plan year.

Interest Rates

The proposed regulations specify 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 reasonably determined to be payable during the 5-year period beginning on the first day of the plan year;
- The second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial 5-year period; and
- The third segment rate applies to benefits reasonably determined to be payable after the end of the 15-year period.

For Example: If a series of monthly payments is assumed to be made beginning on the valuation date, the second segment rate will apply beginning with the 61st payment and the third segment rate will apply beginning with the 241st payment.

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 that are in the top three quality levels available for the 24-month period ending with the preceding month.

The 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 and may only be adopted or changed with the consent of the IRS.

Transition Rule

For plan years beginning in 2008 and 2009, interest rates used in a valuation are based on a blend of the segment rates and the long term corporate bond rates used for plan years prior to the PPA effective date. The phase-in percentage for 2008 is 33 $\frac{1}{3}$ % of the segment rate for 2008 plus 66 $\frac{2}{3}$ % of the long-term corporate bond rate. The phase-in for 2009 is 66 $\frac{2}{3}$ % of the segment rate plus 33 $\frac{1}{3}$ % of the long-term corporate bond rate. A plan sponsor may elect to have this transition rule not apply and this transition rule does not apply to new plans.

In addition, instead of using the segment rates, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds within the top three quality levels without regard to the 24-month averaging.

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

Special Actuarial Assumptions for At-Risk Plans

PPA requires the application of special actuarial assumptions for [certain underfunded plans](#). Underfunded plans are considered to be "at-risk" if their funded percentage is less than 80%. Under a transition rule for plan years beginning in 2008, 2009, and 2010, the following percentages apply instead of 80%:

Plan Year Beginning in	Applicable Reduced Percentage
2008	65
2009	70
2010	75

Under these special assumptions, 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. All employees are assumed to elect the form of retirement benefit available under the plan that results in the highest present value.

The funding target of a plan that has been in at-risk status for less than five consecutive plan years is generally the sum of:

- The present value of all benefits accrued or earned as of the beginning of the plan year; and
- In the case of a plan that has been in at-risk status for at least two of the four preceding plan years a loading factor which is equal to the sum of:
 - \$700 multiplied by the number of participants in the plan; plus
 - 4% of the funding target determined without regard to the loading factor.

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.

Effective Dates

The proposed regulations apply to plan years beginning on or after January 1, 2009. However, plan sponsors may comply with the proposed regulations for plan years beginning in 2008 for purposes of satisfying the funding requirements and may be assured that the IRS will consider their plans to be in compliance with the new rules. Any more restrictive rules contained in the final regulations will apply on a prospective basis.

Next Steps

Plan sponsors should discuss this guidance with their 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 new funding requirements.

Pension Analyst by Prudential Retirement

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