Pension Analyst

Important Information | Legislation | March 2009

WRERA provides PPA technical corrections and other changes to single-employer defined benefit plans

Who's affected

These developments affect sponsors of and participants in most 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"). Separate publications discuss the changes affecting multiemployer plans, governmental plans and non-electing church plans.

Background and summary

On December 23, 2008, President Bush signed into law the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA). This new law contains necessary and important technical corrections to the Pension Protection Act of 2006 (PPA) that plan sponsors and employers have requested. For example, WRERA provides technical corrections regarding:

- The determination of target normal cost;
- Payment of small benefits from certain underfunded plans; and
- Cash balance vesting requirements.

In response to the downturn in the economy and market volatility, WRERA also provides welcome funding relief for plan sponsors. For example, the new law provides for "asset smoothing" of plan assets, which allows plans to take expected earnings into account when determining the value of plan assets. In addition, certain plans that are funded below the target funding percentage for a particular plan year, will only need to fund up to the specified funding percentage for that year, instead of 100 percent, as required by PPA.

Action and next steps

The provisions of WRERA impact plan funding, design and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and should discuss the new law's impact on their plans with their enrolled actuary. 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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PPA technical corrections

The following PPA technical corrections have retroactive effective dates as if they had been included in PPA, unless otherwise noted.

Determination of target normal cost

PPA amended the Internal Revenue Code (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 defined *"target normal cost*" as 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.

WRERA now clarifies that a plan's 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, the new law does not provide a definition of "plan-related" expenses. The IRS will need to publish guidance to clarify what plan sponsors can include as a plan-related expense in determining the target normal cost.

This change applies to plan years beginning after December 31, 2008. However, plan sponsors may elect to apply this provision to plan years beginning in 2008.

Valuation of plan assets

Under PPA, effective for plan years beginning after December 31, 2007, a plan may determine the value of plan assets on a valuation date as the sum of the average of the fair market value 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.

WRERA provides that the averaging method is adjusted for expected earnings, which results in "asset smoothing." Expected earnings are determined by the plan's actuary on the basis of an assumed earnings rate for the plan. However, the assumed earnings rate cannot exceed the applicable third segment rate, which is the rate applied to benefits reasonably determined to be payable after the end of an initial 20-year period. Asset smoothing may be helpful to plan sponsors by resulting in smaller required contributions. However, additional guidance is needed from the IRS regarding the application of the segment rate. This provision applies retroactively to plan years beginning after December 31, 2007.

Determination of "at-risk" status

Under PPA, a plan is "at-risk" if the funding target percentage for the preceding plan year is less than:

- 80%; and
- 70%, determined by applying the specified at-risk actuarial assumptions.

The 80% funding is phased-in, with 65% for 2008, 70% for 2009, 75% for 2010 and 80% thereafter.

WRERA clarifies that the phase-in period also applies to the 70% funding target.

Payment of small benefits under certain underfunded plans

Effective for plan years beginning after December 31, 2007, PPA provided that single-employer and multiple employer plans that do not meet specific funding percentage levels are subject to certain benefit restrictions. Under PPA, a plan cannot make accelerated payments for participants with annuity starting dates occurring when the plan's adjusted funding target attainment percentage (AFTAP) is less than 60% or the employer is in bankruptcy and the plan's AFTAP is less than 100%. The most common example of an accelerated payment is a lump sum payment. Unfortunately, IRS proposed regulations did not provide guidance on the treatment of mandatory cash-out payments (e.g., payments with a present value of less than $5,000 or $1,000 if the plan lowered the threshold) when lump sums are restricted.

However, WRERA provides that mandatory cash-out payments are not restricted payments and may be distributed immediately from an underfunded plan. This provision is welcome relief to plan sponsors of underfunded plans that have been pending these small cash-out payments. This change applies retroactively to plan years beginning after December 31, 2007.

Non-spouse beneficiary direct rollovers

PPA allowed non-spouse beneficiaries to make direct rollovers of death benefit payments from qualified defined benefit plans to an IRA. These direct rollovers were available for distributions made after December 31, 2006.

IRS Notice 2007-7 provided guidance that plans were permitted, but not required, to offer these direct rollovers to non-spouse beneficiaries. However, the technical corrections in WRERA clarify that, effective for plan years beginning after December 31, 2009, plans must provide a direct rollover option for non-spouse beneficiaries and must provide a 402(f) notice.

For plan years beginning on or after January 1, 2009, if you have already adopted a plan amendment to allow non-spouse beneficiaries to make direct rollovers to an IRA, Prudential Retirement will permit non-spouse beneficiaries to make direct rollovers to an IRA. If you have not adopted an amendment to allow non-spouse beneficiaries to make direct rollovers to an IRA during the 2009 plan year, Prudential Retirement will not permit non-spouse beneficiaries to make direct rollovers this year. However, for plan years beginning on or after January 1, 2010, as directed by WRERA, Prudential will allow non-spouse beneficiaries to make direct rollovers to an IRA.

Combined plan deduction limit

A special combined plan contribution deduction limit applies when an employer sponsors both a defined contribution plan and a defined benefit plan covering one or more of the same employees. This limit is the greater of:
- 25% of compensation paid or accrued during the plan years to participants in the combined plans; or
- The contribution needed to meet the minimum funding requirements, but not less than the amount of the defined benefit plan's unfunded current liability.

Effective for contributions made for tax years beginning on or after January 1, 2006, PPA provided that this combined plan limit does not apply if the defined contribution plan contributions do not exceed 6% of compensation for beneficiaries under the plans. However, in 2007, the IRS took the position that even if defined contribution plan contributions do not exceed 6% of compensation, the combined plan limit would still apply to the defined benefit plan. WRERA clarifies that if contributions to a defined contribution plan are less than 6% of compensation, the defined benefit plan is not subject to the combined plan deduction limit. If contributions to a defined contribution plan exceed 6% of compensation, only contributions exceeding 6% of compensation are counted toward the combined limit. This provision is effective retroactively to contributions made for tax years beginning after December 31, 2005.

Extension of Pension Funding Equity Act amendment deadline

For plan years beginning in 2004 and 2005, the Pension Funding Equity Act (PFEA) replaced the Code section 417(e)(3) rate to be used for determining maximum annual benefits with a rate of 5.5%. PFEA also required plan sponsors to amend their plans by the end of the 2006 plan year to reflect this requirement.

PPA then required that distributions made in years beginning after December 31, 2005, use an interest rate assumption for adjusting a lump sum payment to comply with the benefit limitation rules, which is not less than the greater of:
- 5.5%;
- The rate that produces a benefit of not more than 105% of the benefit calculated using the minimum value lump sum interest rate; or
- The interest rate specified in the plan.

PPA also extended the PFEA amendment deadline to the last day of the 2008 plan year.

WRERA has now further extended the required amendment deadline to the last day of the 2009 plan year. In addition, plans with fewer than 100 participants in the preceding year are not subject to the 105% component of the benefit limit calculation.

Mortality tables for lump sum payments

PPA amended the interest rates and mortality tables used in calculating the minimum value of certain optional forms of benefit, such as lump sum payments. These are referred to as the "applicable interest rate" and the "applicable mortality table."

WRERA clarifies that the applicable mortality table that must be used to calculate the minimum value must also be used to adjust benefits to comply with the maximum annual benefit limits. This clarification is effective for plan years beginning after December 31, 2008. However, a plan may use the new mortality table for years or portions of years beginning after December 31, 2007, and before January 1, 2009.

Hybrid plan rules

PPA clarified the legal status of cash balance plans and other hybrid plan designs created after June 29, 2005, under ERISA, the Code and the Age Discrimination in Employment Act (ADEA), if they satisfy certain requirements. In 2008, the IRS issued proposed regulations on hybrid plan designs to reflect the changes required by PPA. The proposed rules incorporated the transitional guidance provided under Notice 2007-6 and offered guidance on a variety of issues regarding vesting, age discrimination, conversions, market rate of return and plan amendments.

WRERA provides additional guidance that clarifies that:

- A failure to comply with the preservation of capital rule (i.e., a participant's account balance cannot be less than the contribution credits) violates ADEA, ERISA and the Code;
- The new vesting rules apply to participants who have an hour of service after December 31, 2007;
- The interest crediting rules for hybrid plans in existence on June 29, 2005, apply to plan years beginning after December 31, 2007, unless the plan sponsor elects to apply the rules earlier; and
- The vesting and interest crediting rules for hybrid plans that apply to collectively bargained plans do not apply to plan years beginning before the earlier of:
    - The later of the termination of the collective bargaining agreement or January 1, 2008; or
    - January 1, 2010.

DB(k) plans

Effective for plan years beginning in 2010, PPA allows certain employers to establish "eligible combined plans," more commonly known as "DB(k) plans." This plan design will only be available to employers with fewer than 500 employees when the plan is established and will provide both a defined benefit portion and a 401(k) automatic enrollment portion. The plan will be funded through a single trust with a single plan document and will file only one Form 5500. However, the rules of ERISA must be applied to the defined benefit component and the 401(k) component as if each component were a free-standing plan.

Although the IRS has not provided any regulatory guidance with respect to DB(k) plans, WRERA clarifies that in the case of a termination of a DB(k) plan, the 401(k) component and the defined benefit component must be terminated separately. As a result, the defined benefit component will need to comply with Pension Benefit Guaranty Corporation plan termination requirements.

Retiree health care

PPA permitted a plan with assets exceeding 120% of the plan's current liability (or funding target) to transfer two but not more than ten years of estimated retiree medical costs to a health care account under the plan. For all years for which a transfer has been made, the employer must make contributions sufficient to maintain the plan's 120% funding level (or transfer assets back from the health account to the pension plan). This provision applied to transfers made after August 17, 2006.

The new law provides that asset transfers from health accounts to maintain the plan's funded status are not subject to the excise tax on reversions. This change applies retroactively to transfers made after August 17, 2006.

Provisions relating to the economic crisis

WRERA also includes provisions that offer funding relief to plan sponsors in response to the current economic situation and market volatility.

Funding target transition relief

PPA provided that if a plan's assets are less than the funding target, the minimum required contribution is the plan's normal cost plus an amortization of the plan's funding shortfall. This new PPA funding target is phased-in over three years. Plans with a funding target at or below the set phase-in level for the year (e.g., 92% for 2008, 94% for 2009 and 96% for 2010) only need to fund up to that percentage. If the plan does not meet those phased-in funding target percentages, the plan would no longer be eligible for the phase-in period, and the employer must fund the plan based on the 100% funding target. The transition rule does not apply to a plan that was:

- Not in effect for 2007; or
- Subject to certain deficit reduction contribution rules.

WRERA provides funding relief and revises the phase-in rules to permit plans that miss the phase-in funding target for a specific year to continue to fund up to the specified funding target for the remainder of the three phase-in years, rather than 100%. This may reduce the required contributions for some plans. This provision is effective retroactively to 2008.

Temporary relief on frozen benefit accruals

For plan years beginning after December 31, 2007, PPA imposed benefit restrictions on certain underfunded plans. For example, a plan sponsor must freeze all future benefit accruals under any plan that is less than 60% funded for the current plan year.

WRERA temporarily allows underfunded plans to look back to the plan's funding status during the previous plan year to determine whether the plan was at least 60% funded solely for the purpose of determining whether benefit accruals must be frozen. However, all other benefit restrictions continue to apply to the plan. This provision applies to plan years beginning during the period beginning on October 1, 2008, and ending on September 30, 2009.

Next steps

Prudential Retirement will continue to monitor the IRS published guidance regarding these new rules. We will keep you informed as additional guidance is made available that clarifies the WRERA provisions discussed in this *Pension Analyst.*

If you have questions about the technical corrections or the new provisions regarding funding requirements, asset and liability determinations, benefit restrictions or deduction rules, you should contact the plan's enrolled actuary. If you have questions about how the revisions to the distribution rules affect your plan and the need for plan amendments, you should contact your document provider or your Prudential Retirement representative.

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