

CLIENT ACTION BULLETIN

January 25, 2008

CAB 08-03

IRS Proposes Rules for Measuring Defined Benefit Plan Assets and Liabilities

SUMMARY The IRS's recent proposed regulations on measuring single employer defined benefit plan assets and liabilities for funding purposes present plan sponsors a few narrowly constrained valuation options, and require that any elections made for the 2008 plan year be "irrevocable" for future plan years. The proposed rules, which implement provisions included in the Pension Protection Act (PPA), are generally effective for plan years beginning on or after January 1, 2009, but may be relied upon for the 2008 plan year. These rules apply to single employer pension plans that are subject to ERISA's minimum funding standards (i.e., they do not apply to plans sponsored by state/local governmental units or nonelecting churches).

The proposed rules are complex; this *Client Action Bulletin* covers only the specific areas that plan sponsors may wish to consider in light of the PPA's funding requirements.

DISCUSSION **Background**

The PPA established new funding standards that include prescribed assumptions for a defined benefit plan's annual actuarial valuation. The law's uniform funding method (unit credit) and mandated mortality and interest rate assumptions are used to calculate the employer contribution requirement and the plan's funded percentage, which in turn determine if a plan must restrict benefits (e.g., lump sums, shutdown, or accruals).

For plan valuation purposes, the PPA also introduced the concept of "target liability" to measure the plan's present value of benefits accrued to date. It is comparable to the "current liability" benchmark required prior to 2008. The target liability for funding purposes will gradually align more closely with the plan's termination liability over the next four years (as the lump-sum interest rate standard migrates from the 30-year Treasury standard to the corporate bond rate).

Limited Options, Long-Term Implications

The PPA's new funding methodology leaves little room for variance, but plan sponsors have some limited input, particularly about the interest rate used to measure liabilities. Decisions made may have relatively modest consequences for the 2008 plan year but will commit the plan to the chosen assumptions for future years, requiring IRS approval to alter those assumptions later.

Assumptions for Measuring Liabilities – In general, a plan's target liability for 2008 will resemble the 2007 "current liability" amount. However, for plans with subsidized lump-sum options, the target liability could be significantly higher because the plan must reflect the likelihood of paying lump sums and the inherent subsidy. Key issues for plan sponsors include:

- **Interest Rate Choices** – Plans will typically measure liabilities using the 24-month average of corporate bond rates as of the valuation date, condensed to three segment rates that match the applicable payout periods (i.e., the first five years, the next 15 years, and beyond 20 years). This default requirement phases in over three years. However, a plan sponsor instead can elect to ignore the transition from the pre-PPA interest rate standard and/or select a 24-month average from any of the four months prior to the valuation date ("lookback month"). Alternatively, a sponsor may use the full yield curve as of the valuation month to value liabilities (i.e., without the 24-month averaging and segmentation into three rates and without flexibility on the lookback month).

For calendar year plans, the 24-month average rates applicable for January 1, 2008, without transition or the full yield curve election, will generally minimize liabilities for most plan demographics. If the plan is underfunded, minimizing the 2008 target liability could help to avoid triggering benefit restrictions. But in selecting the interest rate assumption, plan

sponsors should weigh the long-term consequences of this choice: a standard that minimizes the target liability in 2008 may later result in increased future volatility.

- *Mortality Basis* – Most plans will use the IRS's prescribed mortality tables, which include some margin for future mortality improvements. Large plans with sufficient credible experience may employ a substitute mortality table that is based on their actual experience, but they must obtain IRS approval seven months prior to use.
- *Benefit Restrictions* – Plans confronting benefit restrictions must be funded as though the restrictions do not apply (e.g., if less than 60% funded – and thus required to freeze benefit accruals – the pending freeze must be ignored when funding the coming year's accrual).
- *Plan Provisions* – To reflect plan amendments adopted after the actuarial valuation date in the valuation of liabilities, a plan sponsor must elect to do so on the year's Form 5500 filing.
- *Salary Increases* – This assumption will have modest effects on valuing plan liabilities for funding purposes (although pension accounting disclosures remain greatly affected). The plan's target normal cost (which represents the value of expected benefit accruals during the year) must reflect projected salary increases during the year. This assumption, along with those about turnover and retirement, must take into account the plan's actual experience and a best estimate of expected future experience.
- *Form of Benefit Payment* – The plan's target liability must be adjusted to reflect the likelihood and increased value of electing any subsidized benefit options. For plans offering lump sums based on statutory interest rates and mortality tables, only minor adjustments – to reflect unisex mortality for the payout – are required. However, for plans that offer lump sums on a subsidized basis (e.g., 5% interest), the impact of the subsidy on target liability may be significant. (In the past, "current liability" did not reflect such lump-sum subsidies.)

Asset Valuation Method – Plan sponsors can value assets using either fair market value or an average of fair market value over not more than the past 25 months. The averaging option will be of little use to most plan sponsors, as it will understate the market value of assets when modest positive net returns are realized. A PPA "technical corrections" bill Congress is debating calls for allowing more favorable asset smoothing methods than currently permitted. The PPA also requires the discounting of contribution receivables for prior plan years, beginning with any 2008 plan year contributions made during the 2009 plan year. Thus, if a plan sponsor contributes \$1 million on September 1, 2009, for the 2008 plan year, the January 1, 2009 market value of assets may reflect only about \$960,000 of that total contribution.

Deadlines

Plan sponsors must determine the 2008 plan assumptions and asset valuation method by the due date (including extensions) for the year's Form 5500 filing. However, for calendar-year plans that were less than 90% funded in 2007, actuarial certifications of the 2008 funded ratio may be needed before April 1, 2008 to avoid benefit restrictions applying on a presumed basis. And all plans must be certified by the first day of the tenth month of the 2008 plan year to avoid being deemed less than 60% funded (which results in a cessation of accruals). The IRS guidance leaves open the question of whether assumptions used in the 2008 actuarial certifications for benefit restriction purposes are locked in for determining the final 2008 actuarial valuation referenced in the Form 5500 filing, especially if the assumption modification results in no material change in the plan's funded percentage.

ACTION

Plan sponsors should explore the short- and long-term effects of the new assumptions. Foremost for many plan sponsors is the 2008 funded ratio, which determines the application of any benefit restrictions during the plan year and which could have implications for the 2009 plan year for those plans modestly funded above a critical threshold in 2008. Plans with funded percentages on the cusp of a critical funding threshold may be helped by opting for one of the assumption variations that minimizes plan liabilities.

For additional information on the proposed regulations, please contact your Milliman consultant.