

CLIENT ACTION Bulletin

Employee Benefits

Certifying a Pension Plan's Funded Status

SUMMARY

With the sharp decline in pension asset values during 2008, many tax-qualified single-employer defined benefit plans face the prospect of triggering benefit restrictions as required by the Pension Protection Act (PPA). As part of the process of avoiding such restrictions, most plan sponsors are obtaining an actuarial certification about their plans' funded status. Plan sponsors confronting PPA restrictions should carefully consider possible actions with respect to the actuarial certifications, because the decisions can have major implications for plan benefits. Plan sponsors or their delegates (such as a pension committee) should seek advice from legal counsel about any fiduciary issues that might be raised by the actuarial certification process.

DISCUSSION

Overview of Benefit Restrictions

In general, the PPA imposes limitations on benefits provided under a pension plan unless the plan's funded status, as certified by its actuary, meets certain thresholds:

1. A plan determined to be less than 60% funded must freeze benefits and discontinue accelerated forms of distributions (such as large lump sums) that pay out faster than a single-life annuity.
2. A plan that is at least 60% but less than 80% funded may continue to provide benefit accruals but must partially restrict accelerated forms of distributions and is prohibited from increasing benefits.
3. A plan with an 80% or higher funded status generally will avoid benefit restrictions for the plan year.
4. A plan that has been frozen since September 1, 2005, is exempt from the restriction on accelerated forms of distribution.

Timing of Certifications

The plan's funded status is determined by an enrolled actuary, who calculates the ratio of the value of the plan's assets to the actuarial present value of accrued benefits and certifies the resulting percentage – technically, the “adjusted funding target attainment percentage” (AFTAP). The date the actuary certifies the AFTAP plays a key role in prompting benefit restrictions: they are applied based on the AFTAP for the prior plan year without adjustment until the first day of the fourth month of the plan year (e.g., April 1 for calendar-year plans) or until the AFTAP for the current year is certified, if earlier.

If the plan actuary does not provide an AFTAP certification by the first day of the fourth month of the plan year (April 1, for calendar-year plans), the AFTAP is deemed 10 percentage points lower than in the preceding year, and thus can trigger benefit restrictions. If the AFTAP certification is not provided by the first day of the tenth month of the plan year (October 1, for calendar-year plans), the AFTAP is presumed to be less than 60%, thus restricting benefit accruals and distributions for the remainder of the plan year.

However, the “Worker, Retiree, and Employer Recovery Act of 2008” (WRERA), which was enacted at the end of 2008, provides temporary relief for plan years beginning between October 1, 2008, and September 30, 2009. The law allows the plan sponsor to look back to the prior plan year to avoid freezing benefit accruals (but provides no escape from restrictions on accelerated forms of distribution or other benefit limitations).

Thus, because the certification date affects participants' benefits and sponsors' ability to implement options to “fund out” of otherwise applicable restrictions, plan sponsors should pay particular attention to the timing of the AFTAP certifications.

Illustrative Examples

A plan's actuary will seek instructions from a plan sponsor about the timing of the AFTAP certification. The effects of this discretionary decision can be illustrated by the following examples (based on calendar-year plans):

Hypothetical 1

Plan X has an AFTAP certification of 80% in 2008 and 55% in 2009. Because the 2009 AFTAP is below 60%, benefit restrictions would normally apply. However, the WRERA allows the plan sponsor to look back to the prior year and avoid freezing benefit accruals in 2009. Whether to utilize or decline the look-back is a decision directly affecting participants' benefits and thus, the plan sponsor should document its determination.

Hypothetical 2

Plan Y has an AFTAP certification of 68% for 2010. Under the rules that presume the plan's AFTAP, benefit accruals will cease as of April 1, 2011, if no AFTAP certification is made for 2011. The plan sponsor knows that contributions have significantly increased the asset values in the trust and has reason to know a current AFTAP certification would be above 60%.

If the sponsor does not instruct the actuary to certify an AFTAP prior to April 1, benefit accruals will be restricted for several months. If AFTAP certifications have consistently been made in September, then continuing to do so – with benefit accrual restrictions for several months – may be a reasonable approach. At a minimum, the plan sponsor should understand the impact of the delay on participants and their benefits.

ACTION

With April 1 quickly approaching, calendar-year plan sponsors that have not yet done so should carefully consider their options for the timing of the certifications, if not for this year, then for future years. A comprehensive review of the issues might entail: current and future economic conditions; plan investments; projections of assets and liabilities; the impact of accounting rules; marketplace competition; legislative and regulatory issues; employee communications; and administrative processes and costs. Plan sponsors also should discuss concerns with their legal counsel.

In general, plan sponsors may wish to follow precedent, and by so doing, may avoid charges of abusing discretionary authority. For example, a pension committee that has consistently instructed the actuary to prepare an AFTAP certification prior to April 1 is not likely to be faulted for continuing that schedule, even in a year when benefit restrictions will be triggered as a result. Seeking additional information from the plan's actuary can help plan sponsors understand the consequences of decisions on plan benefits and participants. And finally, plan sponsors should document any discretionary actions they take with respect to the plan's funded status and AFTAP certification.

For additional information about the AFTAP certifications, including the certification timing process, please contact your Milliman consultant.