

CLIENT ACTION BULLETIN

October 17, 2007

CAB 07-11

Proposed IRS regulations on PPA benefit restrictions

SUMMARY The IRS issued proposed regulations on August 28, 2007, under the Pension Protection Act of 2006 (PPA), that provide detailed guidance on benefit restrictions applicable to underfunded defined benefit (DB) plans. The regulations spell out what plan sponsors must look for in their 2007 plan valuation results to determine whether they have until October 1, 2008 to complete their 2008 valuation, or must complete their valuation much sooner in an effort to avoid triggering benefit restrictions as early as April 1, 2008 (for calendar year plans). Potential benefit restrictions are particularly important for plans less than 90% funded that pay lump sums or possess other optional forms that accelerate benefit payments relative to a straight life annuity.

Background

The proposed IRS regulations detail certain procedures and methods actuaries must use when certifying the plan's key funded ratio, as well as the consequences of making or missing specific certification deadlines.

In accordance with the rules, DB plan sponsors must make an annual determination of their plan's funding percentage, which determines if they are subject to specific benefit restrictions. Because of timing needs for the assessment of the plan's funded ratio, plan sponsors may need to rely upon the prior year's funded ratio when determining if benefit restrictions apply in the current year—at least until the current year's certification can be completed. Restrictions vary with the level of plan underfunding. Plans less than 80% funded are restricted when paying lump sums (generally to only 50% of the value), and prevented from improving plan benefits. Plans less than 60% funded must suspend the accrual of plan benefits, are precluded from paying lump sums (at least when more than \$5,000), and cannot pay emerging plant shutdown claims. Once restrictions apply, plan sponsors must notify participants within 30 days.

DISCUSSION **Key dates**

The proposed regulations are generally effective for plan years beginning on or after January 1, 2008 (collectively bargained plans have a delayed effective date), though the earliest application for benefit restrictions will be the first day in the fourth month of the 2008 plan year. In any given plan year, specific restrictions may be triggered depending on whether the actuarial valuation is completed by the fourth or 10th month of the current plan year (restrictions would apply sooner when the current year's funded status is certified earlier to be below the critical threshold). The government will assume the worst when a plan certification is delayed. When a plan is within 10% of one of the critical funded ratios during the prior year, missing the month four certification deadline means a plan's funding will be presumed to be less than the critical threshold in the current year—until the current year's certification proves otherwise. Missing the month 10 certification deadline means a plan will be presumed to be less than 60% funded. If benefit restrictions were in place at the end of the prior year, they are presumed to apply in the current year until a certification shows the funded ratio rose above the critical threshold.

Handling credit balances

Plans with credit balances may have important choices to make about whether and how they can use them. Underfunded plans may be forced to waive credit balances as early as April 1, 2008. If the plan's funding percentage is at least 90% for 2007, without reducing assets by credit balances, the plan sponsor does not have to worry about any benefit restrictions applying until the 2008 actuarial valuation is completed. Plan sponsors have the first nine months of the 2008 plan year to complete the valuation. With a large credit balance, even an improvement in funded status from just over 90% in 2007 to just under 92% in 2008 will require an action plan.

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Brief outline of proposed benefit restrictions

In theory, a plan's funded percentage is the ratio of its assets to liabilities; however, the proposed regulations spell out in much greater technical detail how these are to be calculated. Generally, fully funded plans are exempt from benefit restrictions and are defined as 92% funded in 2008, 94% in 2009, 96% in 2010, and 100% thereafter. Credit balances are not deducted from plan assets in making this calculation. Until the 2008 year's actuarial valuation is completed, plans must look to 2007's funded ratio to determine if benefit restrictions apply. If benefit restrictions apply at the end of the 2008 plan year, the plan is presumed to be underfunded on the first day of the 2009 plan year, until and unless the actuary certifies the plan's funded ratio in fact exceeds the critical funding percentage.

Plans below 60%: Plans whose funded ratio is (or is presumed to be) below 60% must cease benefit accruals and any accelerated payments, such as lump sums and Social Security leveling options. Emerging plant shutdown benefits also are disallowed any year a plan's funded ratio is below 60% or would drop below 60% after reflecting the increase in liabilities due to the shutdown. If the plan's funded ratio is below 60%, then the plan sponsor would need to fund the full amount of any liability increase due to a shutdown (or commit the amount with certain qualifying securities). A plan that is slightly above 60% funded but would drop below 60% with the shutdown event must contribute an amount to retain at least a 60% funded ratio. If the benefit restrictions due to a funding ratio below 60% remain in place for more than 12 months, any suspended past accruals will not be automatically restored once the funded ratio rises above 60%. The rules include possible remedies for this situation.

Plans below 80%: Plans with funded ratios of at least 60% but less than 80% are prevented from improving plan benefits, unless the plan sponsor fully funds the increased liabilities. Such plans also are constrained from paying accelerated payments. Plans funded **slightly above 80%** may also be prevented from improving benefits, if making the amendment drops the plan's funding ratio below 80%, unless the plan sponsor makes additional contributions to keep the funded ratio above 80%. In all cases, the plan actuary must calculate the funding effect of any proposed plan amendment before it can be adopted.

Plans frozen before Sept. 1, 2005: Plans that froze their formulas prior to September 1, 2005 are exempt from the prohibitions on accelerated forms of payment mentioned above.

Plans with less than a 10% cushion above a critical threshold: The government presumes that plans funded less than 10% above a critical threshold one year are below that critical percentage on day one of the fourth plan month the next year. To avoid this, the plan's actuary must provide either (i) a formal certification by month four that the plan stayed above the critical threshold; or (ii) a range certification (an estimate using current assets and an adjusted roll-forward of the prior year's liability) that shows the plan stayed above the critical threshold. Using a range certification is problematic, however. If the actual funding level is later shown to have fallen below the critical threshold, restrictions will commence with the revised certification, unless the plan sponsor makes the necessary additional contribution. Otherwise, such a "material change" to the initial range certification could actually disqualify the plan.

ACTION The actions plan sponsors take will depend on the plan's funding level, certification timing, size of credit balance, and importance of benefit restrictions to the plan. Underfunded plans can avoid complications by keeping the funding ratio at least 10% above critical thresholds. Or, if they can calculate the funded ratio early in the plan year, they can increase funding to the extent necessary. Plan sponsors must consider how to use existing credit balances, whether to do an initial valuation using a range estimate, and whether to defer making a contribution payment temporarily. In 2008, the actuary's valuation may reflect contribution receivables that will be deposited in trust after the certification. These proposed regulations are quite expansive, and we cannot treat them in detail here. If you need more complete information on these proposed IRS regulations, please feel free to contact your Milliman consultant.