



CLIENT ACTION Bulletin

Employee Benefits

IRS Issues Final Rule on Pension Funding, Benefit Restrictions

SUMMARY

The IRS has published a final rule on measuring single-employer defined benefit plan assets and liabilities for funding purposes and on the use of funding balances, while also covering benefit restrictions applicable to underfunded pension plans. The agency in 2007 had issued separate proposed regulations on these subjects but integrated them more fully in the final rule due to their close interaction. The final rule, which generally adopts the provisions in the proposed regulations with some modifications, became effective upon its publication in the October 15, 2009, *Federal Register* and applies to plan years beginning in 2010, although reliance on the final rule is permitted for earlier plan years (as is reliance on previously proposed regulations).

The final rule is extensive and complex and will require further analysis; this *Client Action Bulletin* covers only a few key issues of concern to plan sponsors and their actuaries. The final rule does not address a number of significant related issues (e.g., benefit restriction notices to participants; quarterly contribution elections; mergers and spinoffs; and the definition of plan-related expenses that must be reflected in the annual funding requirements), although the IRS anticipates addressing them soon in upcoming proposed rules. Though the IRS also did not issue highly anticipated guidance related to cash balance and other hybrid plans, the agency is expected to do so in the coming weeks.

DISCUSSION

Pension Plan Funding Issues

The 2006 Pension Protection Act (PPA), among other things, established minimum funding requirements for pension plans. In implementing these requirements, the IRS's final rule specifies how to calculate a plan's liability ("Funding Target"), the cost of benefits accruing in the coming year ("Target Normal Cost"), and funding threshold (the adjusted funding target attainment percentage, or AFTAP). It also sets forth rules relating to a plan's valuation date and the value of plan assets, specifying the interest rates that must be used to determine "present value" and other calculations. In addition, the final rule expands the opportunities for plan sponsors to choose alternative interest rates and asset valuation methods, and provides guidance for determining the Funding Target and other special computations for plans deemed "at risk" due to their underfunded status.

Notably, the final rule provides:

- Automatic approval of a change in the interest rate basis and asset valuation methods – In its September 25 newsletter, the IRS had announced a preview of the final rule's automatic approval for changes in the interest rate used in calculating plan liabilities, in light of the September 30 deadline for actuarial certifications of a plan's AFTAP. The final rule extends automatic approval to changes in the asset valuation methods, thereby allowing plan sponsors for plan years beginning in 2009 or 2010 to again choose whether to use fair market value of assets, or an asset valuation method that smoothes asset gains and losses. Given the economic downturn over the past year, many plan sponsors chose to determine their 2009 funded status using the full corporate bond yield curve and a smoothed value of plan assets. The final rule allows plan sponsors at least one additional opportunity to select interest rate and asset valuation methods.
- More favorable treatment of credit balances than provided in the proposed regulations, which, in some cases, would have forced plan sponsors to use more of this cushion than necessary to meet minimum funding requirements. The final rule allows for the establishment and maintenance of funding standard carryover and prefunding balances, and sets up ordering rules for using and reducing the amounts from such accounts.

- Standing elections – The final rule permits plan sponsors to irrevocably and unconditionally direct the plan's actuary to use the funding balances to satisfy minimum contributions, or to add the maximum amount possible each year to the prefunding balance by the due date of the plan's Form 5500 filing.
- Additional time for AFTAP certifications where the plan's actuary prepares a "range certification" – If a plan sponsor elects to have the actuary provide a range certification by September 30 (for calendar-year plans), the final AFTAP certification may be issued as late as December 31, rather than September 30. The final regulations also expand the list of items required to be included in these certifications.
- For small plan sponsors, the final regulations contain a number of special provisions, including guidance on the use of a valuation date other than the first day of the plan year.

Benefit Restrictions and Administrative Issues

The IRS's final rule provides guidance on several administrative issues plan sponsors will need to address if their plan becomes subject to funding-based benefit restrictions. These provisions focus primarily on accelerated benefit payment forms, such as lump-sum distributions and plan options with a Social Security-leveling feature. When a plan becomes subject to benefit restrictions, no more than half of a participant's benefit can be paid in an accelerated payment form. Plan sponsors and administrators have been uncertain about how to calculate and to communicate these limitations.

The final rule offers three examples of retirement election forms for plans that either currently or expect to face restrictions. A plan sponsor may:

- provide an election form that does not reference the restrictions, providing additional communication only in the case that the participant elects an accelerated payment form;
- add "backup" options to the election form, allowing the participant to elect a primary payment form and contingent payment forms, should benefit restrictions apply at the time of payment; or
- offer separate elections for the restricted and unrestricted portions of the benefit, in the case that the restrictions apply at the time of election.

Clarifying prior ambiguity, the final rule includes a means for calculating a restricted Social Security-leveling income feature, providing an approach that will result in fewer level-income benefits being affected by benefit restrictions. The regulation also clarifies the annuity starting date to be used for calculating lump-sum distributions and certain annuities paid with a retroactive starting date. Further, ancillary lump-sum benefits are still problematic for plans facing benefit restrictions.

ACTION

Milliman actuaries have been working closely with those few clients needing to make last minute decisions and elections by October 15 in response to opportunities afforded by the final regulations. While this rush to consider new elections did not apply to most plan sponsors, decisions about certain elections that will affect the plan's funded status, plan administration, and benefits to participants will have to be made in the coming months. Plan sponsors and administrators should talk with their actuaries and other advisors to ensure that assumptions, methods, and procedures are accordingly adjusted to comply with the IRS's final rule. In addition, the PPA requires that plans be amended by December 31.

For additional information about the IRS's final rule, please contact your Milliman consultant.