

August 29, 2007
News Flash

employee plans news

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Internal Revenue Service
Tax Exempt and Government
Entities Division

A Publication of Employee Plans

IRS Issues Proposed Rules on Benefit Restrictions for Underfunded Pension Plans

The IRS has released proposed rules implementing the 2006 Pension Protection Act's (PPA) restrictions on benefits in underfunded single-employer defined benefit retirement plans. The new restrictions are effective for most plans beginning in 2008. Plan sponsors may rely on the proposed rules for plan qualification purposes, provided that they do so on a consistent and reasonable basis.

The proposed rules are scheduled to be published in the August 31 *Federal Register* and apply to single-employer pension plans that are subject to the minimum funding standards. Accordingly, the new benefit restrictions do not apply to governmental plans (as defined in Internal Revenue Code §414(d)) or church plans (as defined in §414(e)) for which no election has been made under §410(d).

Overview of the PPA's Benefit Restrictions Provisions

The PPA requires underfunded plans to restrict the payment of certain benefits, restrict plan amendments increasing benefits, and restrict the accrual of benefits.

A plan is considered underfunded, and thus subject to the new benefit restrictions, if its funded level is less than 80%, with more restrictions applying if the funded percentage is less than 60%. A plan's funded level is generally determined by its "adjusted funding target attainment percentage" (AFTAP) – the ratio of the value of the plan's assets (minus "credit balances") to a "funding target" of 100% of the present value of all benefits accrued or earned under the plan.¹ The AFTAP for a current plan year is determined as of the plan's valuation date and must be certified by the enrolled actuary for the plan.

In general, the new restrictions on benefits are as follows:

- For a plan with an AFTAP less than 60%, a plan must provide that, unless the plan sponsor contributes the amount of the increase in plan liability resulting from the event, plant shutdown and other "unpredictable contingent event" benefits cannot be paid. Similarly, if the AFTAP would be less than 60% taking into account the liability for plant shutdown or other unpredictable contingent event benefits, a plan must provide that, unless the plan contributes an amount to bring the plan back to the 60% level, the benefits cannot be paid. (See IRC §436(b).)

• For a plan with an AFTAP below 80%, a plan must provide that, unless the plan sponsor contributes the amount of the increase in plan liability resulting from the plan amendment, an amendment that increases benefit liabilities (e.g., providing new benefits, changing the benefit accrual rate, or improving the vesting schedule) cannot take effect. In addition, if the AFTAP would fall below 80% taking into account the increase in liability because of a plan amendment, a plan must provide that, unless the plan sponsor contributes an amount to bring the plan back to the 80% level, the amendment cannot take effect. (See IRC §436(c).)

• For a plan with an AFTAP of less than 60%, the plan must provide that “prohibited payments” (generally, single-sum distributions and other payments that exceed a single-life annuity payment) cannot be paid; and, unless the plan sponsor contributes the amount needed to bring the plan to the 60% level, benefit accruals also must cease. (See IRC §§436(d) and 436(e).)

• If a plan is between 60% and 80% funded, it must provide that a participant may elect to receive part of the benefit as a prohibited payment (with the remaining amounts only payable in a nonaccelerated form).

A plan’s AFTAP is based on the actuarial valuation for the plan year under IRC §430. Because a valuation is typically not completed until some time after the beginning of the plan year, the enrolled actuary cannot certify the AFTAP for the plan year by the first day of the plan year. Accordingly, the law and the proposed regulations contain rules for applying the restrictions based upon the AFTAP for the prior year until the AFTAP for the current year has been certified by the enrolled actuary. Under these rules, a presumed AFTAP is determined based upon the AFTAP for the prior plan year.

The law and the proposed regulations provide incentives for plan sponsors and actuaries to identify which of their plans are close to having a benefit limitation apply and to determine the AFTAP for those plans first. For example, if a plan’s funding level for the prior plan year was less than 10 percentage points from the application of a limit, the limit will automatically apply on the first day of the fourth month of the year (e.g., April 1 for a calendar-year plan) unless the AFTAP for the year is certified by that date. In addition, if the enrolled actuary has not certified the AFTAP for the current plan year by the first day of the 10th month of the plan year (e.g., October 1 for a calendar-year plan), the AFTAP is deemed to be less than 60% for the remainder of the plan year.


Key Elements of the Proposed Rules

Of immediate and near-term interest to pension plan sponsors is the guidance in the proposed regulations for determining a plan’s AFTAP for 2007, which will be used for the 2008 plan year until the enrolled actuary certifies the AFTAP for 2008. In general, for the 2008 plan year, the proposed regulations (under IRC §§430(f) and 436) provide that:

• the plan’s 2007 “current liability” (under IRC §412(l)(7)) and actuarial value of assets are used in determining whether the plan’s “prior year funding ratio” is at least 80% and for purposes of applying the presumptions in 2008;

• expected future contributions for the 2006 and 2007 plan years that are timely made may be taken into account in calculating the plan’s 2007 and 2008 AFTAPs; and

• for purposes of determining the AFTAP for 2007, the credit balance in the funding standard account is reduced by the present value of a voluntary reduction in the 2008 funding standard carryover balance.



To avoid the restrictions on accelerated payments that could apply starting on April 1, 2008, the proposed rules give a calendar-year plan that is less than 80% funded several options. For example, it may:

- contribute more for the 2006 plan year by September 15, 2007 (thus increasing the 2007 funded percentage, which becomes the prior year funded ratio for 2008), or make a larger contribution by September 15, 2008, for the 2007 plan year (if the plan sponsor elects to reduce a funding standard carryover balance in 2008, the AFTAP for 2007 and 2008 will be higher); or
- obtain by April 1, 2008, an actuarial certification (or a “range” certification) attesting that the plan’s funded status for 2008 is more than 80%.

The proposed rules also provide guidance on: the timing of a plan sponsor’s election to apply a credit balance toward contribution requirements; the order in which minimum required contributions will be taken into account in computing carryover balances; the steps certain underfunded plans must follow to make partial lump-sum or other accelerated distributions; permitted transitional actuarial certifications and certifications for 2008 contributions for the 2007 plan year; presumptions about a plan’s AFTAP in the absence of an actuarial certification; and the application of the delayed effective date for plans covering both collectively bargained and noncollectively bargained employees.

(Footnotes)

¹ The Service intends to issue proposed regulations at a later date further defining the funding target. •

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