AMERICAN BENEFITS COUNCIL

October 15, 2009

SHORT SUMMARY OF THE TREASURY/IRS FINAL REGULATIONS ON DEFINED BENEFIT PLAN FUNDING AND BENEFIT RESTRICTIONS

Final regulations governing defined benefit plan funding and benefit restrictions were published in the Federal Register on October 15. These new regulations allow plan sponsors to modify certain funding elections with respect to their 2008 plan year (the first plan year which began in 2008) but only if the election is made in writing by the due date (including extensions) of the Schedule SB "Single-Employer Defined Benefit Plan Actuarial Information" of Form 5500 (October 15 for calendar year plans).

The regulations, which become effective October 15, apply to sections 430 and 436 of the Internal Revenue Code (as added by the Pension Protection Act of 2006 (PPA)), governing minimum defined benefit plan funding standards and limitations on pension benefits for single-employer defined benefit plans. The regulatory requirements will generally apply to plan years starting in 2010 but certain rules (including the credit balance election described below) apply earlier.

Plan sponsors that elected to apply more of their "credit balance" than necessary to cover the 2008 minimum required contribution can revoke the excess election by providing written notification of the revocation to the plan's enrolled actuary and the plan administrator by the Schedule SB due date. This is a special transition rule because such revocations would normally be required by the end of that plan year. However, plan sponsors should check with their actuaries before making an election because revocation after the enrolled actuary has certified the plan's funding percentage for the year could result in a change in the certification.

The excess elections could have been made prior to enactment of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), which clarified the averaging/ smoothing issue and other IRS guidance providing flexibility in selecting the applicable interest rate to be used to determine funding obligations for 2009 and 2010 (see the discussion of interest rate elections below). The final regulations provide some additional transition relief which could affect funding for the 2008 plan year (for example, contributions made for the 2008 plan year can be taken into account at full value without a present value discount, provided they were made by the deadline for contributions (September 15 for calendar year plans).

The final regulations modify the rules for adding contributions to the plan's funding balance but plan sponsors need to elect the amount to be added, or make a standing election to add the maximum amount, by the due date of the 2008 Schedule SB. The regulations also allow the plan sponsor to provide a standing election in writing to the plan's enrolled actuary to use the plan's "credit balance" (now known as the prefunding balance or funding standard carryover balance) to the extent needed to avoid an unpaid minimum required contribution. However, both of these standing elections are automatically revoked if the plan sponsor changes enrolled actuaries (the plan sponsor may reinstate the revoked standing election by providing a replacement notice to the new enrolled actuary by the due date of the Schedule SB).

A number of issues were reserved for future proposed regulations (mostly related to WRERA changes), including (1) definition of plan related expenses, (2) determining the prefunding balance with respect to plan mergers and spinoffs, and (3) adjustment for expected earnings that are applied in determining average plan assets (but the final regulations permit use of assumed earnings rate of zero for plan years beginning in 2008 – despite probable plan losses – as described in Notice 2009-22).

The final regulations state that any change in any interest rate election that is made for the first plan year beginning in 2009 or 2010 is automatically approved. This treatment formalizes the guidance on interest rate flexibility as provided in the September 25 IRS Employee Plans News Special Edition: Upcoming Funding Regulations and Guidance and the March 31 "IRS Employee Plans News: Plans May Use Reasonable Interpretation in Selecting a Yield Curve." In addition, any change in a plan's valuation date or asset valuation method that is made for the first plan year beginning in 2008, 2009 or 2010 is automatically approved.

Plan sponsors are permitted to rely on the final regulations prior to the 2010 plan year and can also rely on the relevant proposed regulations for certain statutory sections. The IRS acknowledged that the remedial amendment period for the PPA (the time period in which plans must be amended to comply with PPA) ends with the last day of the plan year beginning in 2009 (December 31 for calendar year plans). The IRS states that it is reviewing whether sample plan amendments should be issued for Code sections 430 and 436.

Although Treasury and IRS have not yet released regulations for hybrid plans, the new funding regulations may provide a preview of the administration's views on some cash balance plan issues – particularly the so-called "whipsaw" issue (an anomaly under which the plan is required to pay out distributions that are greater than the account balance). The regulation states that the account balance in a cash balance plan must be brought forward to normal retirement age using the plan's interest crediting rate and discounted back using the statutory rate. If these rates do not match, the calculation may become subject to "whipsaw" under which the participant is entitled to an amount in excess of the account balance. Under prior law, the 30-year Treasury rate was used, but PPA requires using a changing yield curve and segmented rate. The Council understands that the IRS takes the position that either a fixed interest crediting rate or a variable rate, such as an equity rate, could result in "funding whipsaw."