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IRS Issues One Set of Final Regulations Regarding the New PPA Funding Rules for Defined Benefit Pension Plans

On October 7, 2009, the IRS released one set of final regulations under the new pension plan funding rules enacted as part of the Pension Protection Act of 2006 ("PPA"). However, a second set of final regulations must be issued before plan sponsors have all of the guidance they need to fully comply with the new rules. In this regard, the Service indicated that the second set of final regulations will be issued separately in the future. The new funding rules were first effective for plan years beginning on or after January 1, 2008. This set of final regulations is effective for plan years beginning on or after January 1, 2010, but plan sponsors can rely on the final regulations for prior plan years as well. The final regulations just issued are over 300 pages in length and are extremely complex, even by qualified plan guidance standards.

Pension Protection Background

The PPA made significant changes to the tax rules that apply to defined benefit pension plans, including the addition of Code section 430, which prescribes new funding rules for single employer defined benefit pension plans, and Code section 436, which imposes a series of limitations on the accrual and payment of benefits under pension plans that are underfunded by certain amounts. Before the issuance of these final regulations, the Service had issued the following three sets of proposed regulations:

1. Proposed regulations sections 1.430(f)-1 and 1.436-1 (August 31, 2007), which provided guidance regarding the determination and use of prefunding and funding standard carryover balances under the new rules (i.e., essentially carryovers attributable to contributions in prior plan years that were in excess of the minimum required contribution requirements), and guidance regarding the potential benefit limitations under Code section 436 for certain underfunded plans;
2. Proposed regulations sections 1.430(d)-1, 1.430(g)-1, 1.430(h)(2)-1 and 1.430(i)-1 (December 28, 2007), which provided guidance regarding the measurement of plan assets and liabilities under the new rules; and
3. Proposed regulations sections 1.430(a)-1, 1.430(j)-1 and 54.4971(c)-1 (April 11, 2008), which

provided guidance on how plan sponsors actually determine the amount, if any, of the minimum required contribution for each plan year and how such contribution requirements can be satisfied (see Bulletin No. 08-36).

The final regulations that were just issued, finalize the first and second sets of proposed regulations described above. The third set of proposed regulations described above represents the remaining funding regulations that still must be finalized before plan sponsors will have all of the guidance necessary to fully comply with the new funding rules.

Minimum Contribution Requirements (Code section 430)

Under the new funding rules, the minimum required contribution for a plan year generally is determined by comparing the actuarial value of the plan's assets and liabilities as of the beginning of the plan year. If the value of the plan's assets exceeds the value of the plan's liabilities, then the minimum required contribution essentially equals the amount of benefits that are expected to accrue during the plan year (the "normal cost"), reduced by the amount the assets exceed the liabilities. If the assets are less than the liabilities, the minimum required contribution equals the normal cost plus any funding shortfall (the extent to which the liabilities exceed the assets as of the beginning of the year) amortized over seven years.

As announced by the Service on its website in the IRS Employee Plan News, Special Edition, September 25,

2009, the final regulations just released allow plan sponsors to change the interest rate methodology they use to determine the plans' liabilities for the 2008, 2009 and 2010 plan years without obtaining the Service's approval. This is a significant development for many plan sponsors who applied a special rule announced by the Service earlier this year for determining the interest rate for the 2009 plan year.

Under the new rules, a plan sponsor generally must use one of two interest rates to determine the plan's liabilities - (1) segment rates, or (2) spot rates. The segment rates generally are less volatile over time because they reflect the average, for a 24-month period, of the yields on investment grade bonds that are of varying maturities. In contrast, the spot rates are generally based on a full yield curve as of a specific date. In addition, once an interest rate methodology is adopted by a plan, it generally cannot be changed without obtaining the Service's approval.

Many plan sponsors were facing significantly greater minimum required contributions for the 2009 plan year than they had expected because of the severe economic downturn in 2008. A plan's minimum required contribution is based, in part, on the value of a plan's assets as of the beginning of the plan year. As of January 1, 2009, many pension plans' assets had decreased in value significantly, some well over 40%. In addition, the segment rates were historically low. The lower the interest rate, the higher the liabilities. Thus, plan sponsors were determining their minimum required contributions for the 2009 plan year with dramatically lower asset values than they had expected and historically low interest rates. Many plans went from being overfunded for the 2008 plan year to significantly underfunded for the 2009 plan year.

To address this situation, the Service provided some relief for plan sponsors for the 2009 plan year. For that year, the Service is allowing plan sponsors to use the spot rates for 2009, regardless of whether they used those rates in 2008. This ability to use the spot rates in 2009 provided relief to many plan sponsors because of an unusual spike in the spot rates in October and November 2008, which caused the spot rates to significantly exceed the segment rates. The higher the interest rates used, the lower the liabilities. However, when the Service provided this relief, it did not indicate whether plan sponsors could switch back to the less volatile segment rates for the 2010 plan year. For this reason, many plan sponsors were reluctant to use the higher spot rates for the 2009 plan year. In the final regulations just released, the Service has nevertheless indicated that plan sponsors can switch back to the segment rates for 2010 without obtaining the Service's approval.

Benefit Restrictions for Certain Underfunded Plans (Code section 436)

Under new Code section 436, certain restrictions apply if a plan's funding level (i.e., percentage of plan assets to plan liabilities) falls below certain thresholds. If a plan is less than 80% funded, amendments providing benefit increases are prohibited unless the plan sponsor immediately funds the benefit increase or funds the plan sufficient to meet the 80% threshold. If the plan is between 60% and 80% funded, the plan can only provide partial lump sum distributions, which generally means lump sums equal to no more than 50% of a participant's accrued benefit. If a plan is less than 60% funded, the plan will have to be frozen, plant shutdown benefits cannot be paid and all lump sum distributions are prohibited. The final regulations just released provide guidance on when and how these restrictions apply.

Pension plans generally must be amended by the end of the 2009 plan year (December 31, 2009 for calendar year plans) to reflect these new benefit restrictions, regardless of whether they currently apply (i.e., a plan must provide that the restrictions apply if the plan's funding level falls below one of the applicable thresholds). Plan sponsors now have the guidance necessary to prepare these amendments. The Service indicated in the preamble to the final regulations that it is still deciding whether to issue model amendments for purposes of preparing these required amendments.

Potential Additional Funding Relief

Although the Service provided some funding relief by allowing plans sponsors to use the spot rates for the 2009 plan year, many plan sponsors are still facing significant minimum required contributions for 2009 and 2010. Congressmen Earl Pomeroy (D-ND) and John Boehner (R-OH) have proposed different

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