

Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues

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Coping With the Impact of the Pension Protection Act

The Pension Protection Act of 2006 (PPA), which fundamentally changed the funding of defined benefit plans, was signed into law about three years ago. Guidance needed to interpret this new law has trickled in over these three years.

This newsletter summarizes the recent guidance that we have received regarding PPA as well as some potential strategies for addressing the increased costs for the 2009 year brought about by the adverse market conditions. Further, PPA has imposed additional requirements with respect to defined benefit plan documents and participant notices which will also be reviewed.

2009 Funding Requirements

PPA changed the interest rates used to determine plan costs and limited flexibility in determining the actuarial value of plan assets. Under PPA, interest rates used to determine a plan's funding requirement must be a function of corporate bond interest rates, and the actuarial value of plan assets may not

be less than 90% nor more than 110% of the market value of plan assets.

Typically, the 2008 actuarial valuation of a defined benefit plan determined the plan's funding requirement based on three interest rate segments (based on a 24-month average of corporate bond rates). The corporate bond rates used to determine the segmented interest rates steadily climbed during most of 2008. Simultaneously, many defined benefit plan sponsors suffered in light of current economic conditions and sought to limit their funding requirement for 2009.

One approach many practitioners consider is a switch in the basis for determining interest rates for funding purposes to what is known as the "yield curve." Unlike the above-mentioned segment rates, corporate bond rates are not averaged in determining the underlying interest rates of the yield curve. Therefore, switching to the yield curve would allow plan sponsors to take advantage of the funding reductions associated with the run up in the 2008 corporate bond rates.

However, PPA requires IRS approval to switch from the segmented interest rates used in 2008 to the yield curve in 2009. Recognizing this problem,

the IRS stated in March that final regulations will indicate that any change in the determination of interest rates used for 2009 funding purposes will be automatically approved.

The determination of the actuarial value of plan assets for funding purposes experienced similar issues. A typical defined benefit plan used the market value of plan assets to determine the 2008 funding requirements. Due to the severe declines in the financial markets during 2008, the use of the plan's market value of assets to determine 2009 funding requirements will lead to a significant cost increase.

For 2009 valuation dates, switching to an average asset value will often result in an actuarial value of plan assets that is 110% of the market value of the assets. Once again, PPA required IRS approval to switch from a market value of plan assets to an average asset value. However, relief found in IRS Notice 2009-22 stated that such a change in the determination of the actuarial value of plan assets will receive automatic approval.

Market declines have led to increased funding requirements in 2009 in an economic environment that requires employers to minimize expenditures wherever possible. In light of these economic times, defined benefit sponsors could look to take advantage of the relief that is available in changing the basis of their funding interest rates and the determination of the actuarial value of plan assets to help mitigate the impact of the difficult economic conditions.

PPA Plan Amendment

PPA changes many of the rules associated with the plan funding, plan operations and potential benefit restrictions due to a plan's funded status. A sponsor of a defined benefit plan has been required to operate in compliance with PPA rules but was not required to amend its plan document until the end of the 2009 plan year. As this deadline is rapidly

approaching, below is a description of many of the issues that need to be addressed in the PPA plan amendment.

Actuarial Assumptions for Lump Sum Distributions

Commencing with the 2008 plan year, lump sum distributions from defined benefit plans must be based on prevailing corporate bond rates. However, prior to PPA, lump sum benefits were determined based on 30-year Treasury rates. In order to ease the impact of the change in the basis for lump sum determination, there is a transition period from 2008 through 2011 where lump sum distributions are based on a combination of the prevailing corporate bond and 30-year Treasury rates.

Qualified Optional Survivor Annuity

Generally, defined benefit plans must offer plan benefits in the form of an annuity. If a participant is married, a joint and survivor annuity must be offered as a benefit option. Prior to PPA, a plan was only required to offer a single form of joint and survivor annuity (typically a joint and 50% survivor benefit). PPA requires an optional survivor annuity form in addition to the pre-PPA requirements.

Non-Spouse Beneficiary Rollovers

Commencing with distribution after December 31, 2006, PPA allows non-spouse beneficiaries of tax-qualified retirement plans to roll over distributions to an IRA. This was originally a voluntary feature that will become mandatory for distributions occurring after December 31, 2009.

Notice and Election Period Extended

Upon becoming eligible to receive plan benefits, a defined benefit plan was permitted to notify plan participants of their benefit options and elect their form of benefit up to 90 days prior to the benefit commencement date. Commencing with plan years after December 31, 2006, PPA allows a defined benefit plan to voluntarily extend the election period to 180 days.

Age 62 In-Service Distributions

Commencing for plan years after December 31, 2006, PPA allows a defined benefit plan to make distributions to participants that have reached age 62 even if they are still employed by the plan sponsor. Such a feature may be voluntarily elected by a defined benefit plan sponsor.

Benefit Restrictions

If a defined benefit plan's funded status falls below 80%, the plan may be subject to a funding-based benefit restriction. This restriction, which became effective for plan years beginning in 2008, must be detailed in the terms of the plan document.

Normal Retirement Age

In 2007, the IRS issued regulations and subsequent guidance regarding the definition of a reasonable normal retirement age. These rules have particular importance because a defined benefit plan is permitted to make a distribution to a participant who has reached the plan's normal retirement age even though such a participant remains actively employed.

In order to take advantage of this rule, plans were established using a very low normal retirement age so that participants could take out a lump sum benefit (determined based on plan defined actuarial assumptions). Upon receipt of the lump sum, the benefit was then rolled over to an IRA or 401(k) plan that allowed the participant to direct how the lump sum benefit was invested.

In order to prevent such arrangements, the final regulations and subsequent guidance basically state that, if a plan uses a normal retirement age prior to age 65, it must be reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

A normal retirement age between the age of 62 and 65 is deemed to be reasonable. According to the guidance, deference is given to a plan using a retirement age between 55 and 62 assuming it is reason-

able under the facts and circumstances. In practice, the IRS has not necessarily been showing deference to plans using a normal retirement age between ages 55 and 62. In these cases, they have been asking for data substantiating the plan's defined normal retirement age. Such data is very difficult to provide for a small retirement plan that has limited data regarding the age of the employer's typical retiree.

Generally, a defined benefit plan can be amended to comply with the 2007 normal retirement age regulations. Such an amendment must be adopted by the later of the end of the first plan year beginning after June 30, 2008 or the due date for filing the employer's tax return for the employer's taxable year that includes the first day of the plan year beginning after June 30, 2008.

The IRS is closely scrutinizing plans that use a normal retirement age between the ages of 55 and 62. Without obtaining a determination letter that approves the use of such retirement age, a plan's qualified status could be jeopardized.

Reporting Requirements

Missed Quarterly Contributions

Generally, the Pension Benefit Guaranty Corporation (PBGC) must be informed whenever a minimum funding obligation is not met. A failure to make a plan's required quarterly contribution on a timely basis is considered to be such a failure. Historically, the PBGC waived this requirement for a plan with less than 100 participants. However, the PBGC eliminated this waiver for plan years commencing in 2009.

After an outcry from practitioners and plan sponsors, the PBGC issued limited relief from the requirement that they must be notified each time a plan sponsor fails to make a required quarterly contribution. This relief is only provided if the plan sponsor paid the PBGC flat rate premium in 2008 and the financial inability of the plan sponsor

to make the contribution is not the reason for the missed quarterly contribution.

The relief also applies to plans with 25 to 99 participants. Such plans only have to inform the PBGC of their first failure to make the required quarterly contribution on a timely basis.

Annual Funding Notice

Defined benefit plans that are covered by the PBGC's insurance program have a new notice requirement commencing with the 2008 year. The new notice brought about by PPA is known as the Annual Funding Notice and replaces the Summary Annual Report. The purpose of this new notice is to provide plan participants with additional information regarding a defined benefit plan's funded status. The new notice must provide information regarding:

- The plan's funding policy;
- The plan's asset allocation;
- A general description of benefits eligible to be guaranteed by PBGC;

- Statement of right to obtain copy of Form 5500 on request;
- Impact of plan amendments;
- Specific information regarding the plan's funded status; and
- Summary of rules regarding a plan termination.

The notice must be provided no later than 120 days after the end of a plan year if the plan has at least 100 participants. For plans with less than 100 participants, the notice must be provided no later than the date the plan sponsor files its Form 5500.

Conclusion

PPA has changed life significantly for sponsors of defined benefit plans. There have been dramatic changes to the funding requirements which can create burdens on plan sponsors during difficult economic conditions. Plan sponsors need to work closely with their advisors to ensure that appropriate funding techniques are being utilized, the plan is timely amended and new notice requirements are being satisfied.

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