Benefit Insights

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A COMPANY THAT CREATES AND SERVICES EMPLOYEE BENEFIT PROGRAMS

A non-technical review of qualified retirement plan legislative and administrative issues **March 2008**

The Impact of the Pension Protection Act on Defined Benefit Plans

In August of 2006 President Bush signed the Pension Protection Act of 2006 (PPA) into law primarily to address the financial security of the defined benefit plan system. Generally, the changes to the funding requirements for defined benefit plans brought about by this new law are effective for plan years commencing in 2008.

PPA attempts to improve the financial security of the defined benefit system by focusing on the funding adequacy of a plan on a plan termination basis rather than addressing the funding sufficiency at the time a participant reaches retirement age. Generally, the pre-PPA funding requirements intended to create a level funding of a participant's benefit over their working lifetimes. The PPA rules attempt to ensure that benefits accrued to date are fully funded based on current market interest rates.

Further, as a result of PPA, a great deal of flexibility has been taken away from the enrolled actuary. The funding method as well as the mortality table and interest rates used to determine a plan's minimum funding requirement is now dictated by the Internal Revenue Code's minimum funding requirements.

As this article will address in detail, plans that are not adequately funded on a plan termination basis may be subject to restrictions on benefit accruals and distributions as well as limitations on the ability to amend the plan to improve benefits. In addition, as described below, PPA has significantly revised the method of calculating a participant's lump sum benefit.

Basic Funding Requirements

Prior to PPA, the actuary for a defined benefit plan was able to choose from a variety of different funding methods as well as choose the appropriate mortality table and interest rate in determining a plan's minimum funding requirement. PPA now mandates the single funding method as well as the mortality table and interest rates to be used for minimum funding purposes.

Generally, PPA's funding method determines the minimum funding requirement by adding the present value of the benefits accrued in the current year by all plan participants, called the normal cost, to the payment required to pay down the plan's underfunding over a seven year period called the shortfall amortization payment. The valuation liabilities,

known as the target liability, are determined by calculating the plan's termination liability based on current market interest rates. An underfunding exists to the extent that plan assets are less than the target liability.

In determining the plan liabilities for actuarial valuation purposes, the plan's actuary is required to use three different interest rates, known as segment rates, that are based on investment grade corporate bond rates. Applicable interest rates vary based on the length of time until a benefit is payable.

The above funding requirements will be subject to transitional rules that may eliminate the need to pay the shortfall amortization payment if the plan assets are close to the target liability. Further, plan assets and contribution requirements must be adjusted for the credit balance. The credit balance, which represents the accumulation of contributions exceeding minimum funding requirements, has become more complex under PPA. Credit balances based on contributions prior to the effective date of PPA are treated differently than post PPA contributions.

Basis for Limits and Restrictions

Each year a plan's funding ratio, known as the Adjusted Funding Target Attainment Percentage (AFTAP), must be certified by the plan actuary. Generally, the AFTAP is determined by dividing the plan assets by the plan's target liability. To the extent that these liabilities fall below ratios specified in the new law, limitations are imposed on:

- Benefit increases;
- Benefit accruals;
- Distributions in a form other than an annuity; or
- Shutdown benefits.

In determining the plan's AFTAP, plan assets must be adjusted for certain credit balances.

Limitation on Benefit Increases

A plan cannot be amended to increase benefits if the AFTAP is below 80% or would be under 80% if the amendment was adopted by the plan. An employer desiring to increase plan benefits with an AFTAP below 80% would be required to make a contribution (or provide security) which would bring the AFTAP up to 80%.

Plan amendments subject to this restriction include improvements to the benefit formula as well as any other amendment increasing the value of plan benefits, such as an improvement in the plan's vesting schedule. The funding based restriction on plan amendments is not applicable in the first five years of a newly established plan.

Restrictions on Benefit Accruals

A plan is required to cease benefit accruals if the AFTAP is less than 60%. The restriction on benefit accruals will continue until the plan's funding ratio improves and the AFTAP exceeds 60%.

Once the AFTAP exceeds 60%, the plan document does not need to be amended to restore lost benefit accruals if the accrual restrictions were in place for less than 12 months. However, if the accrual restrictions were in place for more than 12 months, an amendment will be required to restore the benefits that were lost during the time that the AFTAP was less than 60% and benefits were frozen. As detailed above, such an amendment restoring lost accruals could only be executed if the AFTAP increases to more than 80%.

Once again, the funding based restriction on benefit accruals is not applicable in the first five years of a newly established plan.

Restrictions on Benefit Distributions

If a plan's AFTAP is less than 60%, distributions may only be made in the form of a life annuity. Therefore, plans that permit distributions in the form of a lump sum or installment payments would be prohibited from offering these forms until their AFTAP reached the 60% level. Plans would be required to provide that participants affected by this

restriction have the ability to defer payment or elect another form of payment.

If the plan's AFTAP is between 60% and 80%, payments in a form other than a life annuity will be restricted. Plans within this funding range may only make payments to the extent that their value does not exceed:

- One-half of the payment that could be made absent any restrictions, or
- The present value of the maximum benefit guaranteed by the Pension Benefit Guaranty Corporation which is currently $4,312 per month.

In other words, a plan which permits lump sum distributions would be restricted to paying out one-half of the lump sum if the plan's AFTAP was between 60% and 80%. In this situation, the plan would be required to defer payment or elect another form of payment. Although not required by law, the plan could permit the payment of one-half of the lump sum and allow the participant to defer payment of the remaining lump sum until such time as there is no funding based restriction.

How is the Plan's AFTAP Certified?

The plan's enrolled actuary is required to certify the plan's AFTAP in writing. The timing of such certification is critical in determining the applicable AFTAP. Generally, the AFTAP should be certified by the first day of the fourth month of the plan year. If the actuary is unable to certify the AFTAP by this deadline, the AFTAP is the prior year's AFTAP less 10%.

For example, let's assume that the plan year is the calendar year and the AFTAP for 2007 was 85%. The applicable AFTAP for 2008 must be determined by April 1, 2008. If the AFTAP is not determined by that date, as of April 1, 2008 the AFTAP becomes the 2007 AFTAP less 10% or 75%. As the AFTAP is now less than 80%, the plan may not be amended to improve benefits, and plans permitting lump sum distributions may only pay one-half of the lump sum otherwise payable to a terminated participant.

Further, let's assume that on July 1, 2008 the actuary certifies the 2008 AFTAP to be 88%. As of July 1, 2008 the above restrictions are no longer applicable. If the actuary was able to complete the certification by April 1, 2008, these restrictions would not have been applicable at any point during the year.

If the actuary is unable to certify the AFTAP by the first day of the tenth month of the plan year, the AFTAP is automatically deemed to be 60% and all of the restrictions addressed in this article will become applicable. These restrictions will remain in place for the remainder of the year regardless of when the actuary ultimately certifies the AFTAP.

Let's go back to our example above. However, let's now assume that the actuary does not complete the AFTAP certification until October 15, 2008. Under this scenario, the applicable AFTAP for 2008 would be as follows:

- January 1, 2008 through March 31, 2008 the AFTAP will be equal to the 2007 AFTAP which was 85%, and there would be no applicable limitations or restrictions.
- From April 1, 2008 through September 30, 2008 the applicable AFTAP would be 75%, which is the 2007 AFTAP less 10%.
- From October 1, 2008 through December 31, 2008 the applicable AFTAP would be 60%.

The above highlights the importance of the timing of the actuary's certification of the plan's AFTAP for a particular year. The actual AFTAP determined by the actuary was 88% which would not have imposed any limitations or restrictions if it was certified by April 1. However, since the certification was not completed until October 15, the adjusted 2007 AFTAP resulted in the application of certain restrictions as of April 1 and all restrictions and limitations as of October 1.

In order to avoid the unnecessary imposition of any restrictions or limitations, it is imperative that the sponsor of a defined benefit plan provide the plan actuary with the necessary census and asset information as soon as possible so that the actuary has the opportunity to calculate the plan's AFTAP within the first three months of a plan year.

Lump Sum Distributions

Effective for plan years commencing in 2008, PPA has significantly changed the interest rate and mortality table used to determine the lump sum distribution payable to plan participants. Prior to PPA, the applicable 30-year Treasury rate was used to determine a participant's lump sum benefit. This rate is replaced by what PPA calls a three-segment rate approach, which varies based on the length of time until the benefit is payable or expected to be paid. These segment rates are based on a yield curve using investment-grade corporate bonds, which typically carry higher yields than treasuries and will ultimately result in lower lump sum payments.

To mitigate the immediate impact on plan participants, the segment rates are phased in over the next four years. During this transition period, lump sums will be determined using a blend of the 30-year Treasury rate and the new segment rates.

Conclusion

PPA has made dramatic changes to the funding rules and the determination of lump sum benefits for defined benefit plans. Further guidance is forthcoming to deal with the many nuances in the law that may impact the application of the new rules to a specific plan.

The sponsor of a defined benefit plan needs to work closely with the plan's actuary to monitor the plan's funded status in order to avoid the imposition of unintended restrictions or limitations on the plan. To facilitate this process, which requires the actuary to determine the funded status on a timely basis, the plan sponsor must diligently respond to any requests for census data and plan investment information.

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