



ACI Advisors Corner

WHAT IF MY CLIENT DOES NOT WANT TO FUND THE DEFINED BENEFIT PLAN REQUIRED CONTRIBUTION FOR 2008?

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This material takes into account the Worker, Retiree and Employer Recovery Act of 2008 that was passed by the House on December 10, 2008 and by the Senate on December 11, 2008. The Bill will become effective when the President signs it. It is anticipated that he will do so shortly. In the industry this is known as the **Technical Corrections Bill**.

How did we get here?

For the last 10 years, entrepreneurs and professional organizations actively installed traditional and lately, cash balance defined benefit plans not just to benefit the owners and partners, but also to provide meaningful benefits for all levels of employees in companies. There has been great leverage in meeting the plan sponsor's goals when defined benefit plans have been combined with defined contribution plans for discrimination testing purposes. But as we all know, the world is changing. The purpose of this writing is to outline some of the issues with respect to funding a defined benefit plan when the plan sponsor chooses not to, or financially cannot afford to, fund the plan.

New Rules brought in by PPA

Major provisions of the Pension Protection Act of 2006 (PPA) became effective for defined benefit plans in 2008. Generally, the methodology, the terminology, the interest factors, and minimum funding requirements are all different than in prior years. The government has now mandated the funding method (known as unit credit), the mortality tables and the interest rates (often referred to as the segmented yield curve), and now requires that unfunded liabilities be funded evenly over a seven year period. So we have a new playing field.

When does a participant earn a benefit for the year?

Generally, participants in traditional and cash balance defined benefit plans accrue a benefit once they have completed 1,000 hours of service during the year. Thus, for most plans the 2008 accruals were most likely earned by May of 2008. So, now the big question—what can you do? There may be limited options for the 2008 contribution unless President-Elect Obama pushes some changes early in the year that would provide additional time to fund unfunded liabilities. Absent that, the actuary is tasked with developing the minimum required contribution based on the plan formula and new law provisions.

How is the minimum required contribution calculated

Generally, the minimum required contribution includes the cost to fund the current year's accrual of benefits plus an amortization of net gains and losses in the plan's assets and liabilities over a 7 year period. The measurement date (valuation date) for these calculations can be either the beginning of the plan year or the end of the plan year. Thus, for 2008, if the assets were \$1,000,000 as of January 1, 2008 and were \$700,000 as of December 31, 2008, with the decrease solely due to investment losses rather than benefit payments, the 2008 required minimum contribution would be significantly lower using a January 1, 2008 valuation date. The Plan's actuary, at his or her discretion, may still switch from an end of year valuation to a beginning of the year valuation.

The **Technical Corrections Bill** clarifies the allowable "asset smoothing" technique that actuaries may utilize when determining plan assets as of a given date. This means that the actual assets are not used for determining gains and losses in a given year, but rather the smoothing technique is applied so that the gains and losses are essentially spread over several years. These methodologies are rarely used in small plans.

When do required plan contributions need to be funded?

If the contribution for a calendar year 2008 plan is not made by September 15, 2009, the plan becomes deficient. This triggers a 10% excise tax and the IRS has the ability to impose a 100% excise tax immediately following a notice to the plan sponsor of the deficiency. This normally takes about a year to occur. Under PPA, these minimum required contributions must be paid to the plan before the plan is terminated. Employers will be faced with the issue of either coming up with the money through existing corporate assets, or borrowing, or paying the excise tax, which is assessed every year based on the unfunded minimum required contribution.

Does freezing the plan for 2009 make sense?

While this issue is playing out over the first three quarters of 2009, plan sponsors may consider freezing or possibly terminating their plans depending on their view of the desired objectives once the financial world heals. The easiest thing to do is to freeze the plan by providing a notice to the participants 15 days before any of the participants would have 1,000 hours of service for plans with less than 100 participants, and 45 days for plans that have in excess of 100 participants. Frozen plans that are not fully funded will have ongoing contributions, possibly resulting from asset loss, which fall into the category of unfunded liabilities requiring the seven year amortization plus interest as mentioned earlier, which at current interest level equals approximately 17% of the unfunded liability.

Note that if a plan has carved out a certain number of employees to participate in the defined benefit plan (required by law to be at least 40% of those that would otherwise be eligible); complexities may occur even in a frozen defined benefit plan that is **fully**

funded. This may require additional accruals to pass the 40% test. The matter is complex and prior to the freezing of any defined benefit plan should be appropriately vetted with the client so that surprises do not occur.

Plan restrictions if the plan is not funded to certain levels

The PPA also brought in a new potential restriction on a defined benefit plan if the plan does not have a certain minimum level of funded status. This is called “the adjusted funding target attainment percentage” (AFTAP). If an AFTAP Certification is not done by an Enrolled Actuary by April 1st for a calendar year, the current year’s AFTAP is deemed to be the prior year’s percentage reduced by 10 percentage points. When an AFTAP falls below 80%, only partial lump-sum distributions can be made to participants by operation of the law. If an AFTAP is not certified by October 1st for a calendar year plan, it is deemed that the AFTAP is less than 60%, causing the freezing of the plan, the inability to amend benefits up, and no lump-sum distributions are allowed at all.

Note: Based on the **Technical Corrections Bill**, the above AFTAP restrictions for plan years beginning after October 1, 2008 will be based on the prior year’s AFTAP. The Bill also allows for the \$5,000 mandatory cash-out (if the plan has been amended to incorporate this element) even if the plan is otherwise restricted with regard to lump sum distributions. Finally, for plans that use an end of year valuation date, a plan could, for example, use the December 31, 2007 AFTAP results for both 2008 and 2009. This may postpone the recognition of the 2008 asset decline for AFTAP purposes (but not for minimum required funding purposes) to 2010!

Even if the AFTAP is greater than 80%, lump sum distributions to the top 25 most Highly Compensated Employees may be restricted if the plan is not funded at a high enough level which is still calculated at 110% of the pre-PPA current liability using government imposed interest rates and mortality table. If the HCEs who are restricted wish to receive distributions, this can be accomplished by entering into an escrow agreement or purchasing a surety bond that secures repayment to the Plan of the lump sum distribution in the event that the Plan is terminated with insufficient assets.

Should a plan be terminated after it has been frozen?

If the plan is covered by the Pension Benefit Guaranty Corporation, it must have sufficient assets to satisfy all the liabilities in the plan before it can be terminated. From an IRS perspective, a defined benefit plan cannot be terminated while an outstanding minimum required contribution is in existence. An underfunded defined benefit plan could be terminated through the PBGC if the minimum contributions have been made and a majority owner waives a portion of his or her benefits. This would require approval by the PBGC. What cannot be done is for a reversion to be created through the waiver of benefits. Since there is a 50% excise tax on reversions anyway, this is not a highly attractive solution.

If the plan is not covered by the PBGC it can be terminated once the minimum required contribution is made for the current year. If the assets are less than the plan liabilities, non

highly compensated participants are normally made whole and the balance of the assets are allocated to the owners and other highly compensated employees to the extent that assets permit.

If the defined benefit plan is paired with a defined contribution plan for compliance purposes, freezing the defined benefit plan may not always cease the contribution requirement for the defined contribution plan. The defined contribution plan will continue to be subject to compliance testing which may impose a required minimum contribution. For example, employee deferrals for a highly compensated employee may trigger a required minimum contribution (QNEC) to satisfy the ADP/ACP nondiscrimination tests. In addition, plans that are top heavy will require a minimum contribution if a key employee continues to make employee deferrals.

Decreasing the plan formula instead of freezing the plan

Some clients may choose to decrease the benefit formula to a very low level but maintain the plan as an active plan until such time as economic conditions change and then prospectively reinstate higher formulas. There is an advantage to this, if the desire is to fund significant amounts of contributions by maintaining the plan at low levels for several years, then fund for significantly higher deductions once the economy turns around.

The real question to ask in making the decision to either maintain the defined benefit plan at its current formula, reduce the formula, freeze it or terminate it, depends greatly on the plan sponsor's view of the purpose of the plan in the future. In all settings where a defined benefit plan continues to exist, even in frozen state, actuarial calculations, minimum required contributions, and 5500 filing forms all need to continue.

If you have any questions concerning any defined benefit plan that we can assist you with, we would be happy to answer your questions.

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