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End of Year Valuation Issues for Defined Benefit Plans

by Kevin J. Donovan, MSPA; G. Neff McGhie, III, MSPA; and Daveyne C. Totten, MSPA

Under the Pension Protection Act (PPA), the valuation date for single-employer defined benefit plans is generally the first day of the plan year; however, small plans may choose to use any other date during the year as the valuation date. There are many reasons why an end of year valuation date may make sense for small plans, such as better coordination of contributions with earned income for sole proprietor plans, funding based on actual data versus estimated data and simplification of general testing.

Unfortunately, because the rules under PPA have generally been written with beginning of year valuation dates in mind, guidance regarding end of year valuation dates is limited. This article provides a summary of issues that should be considered when using end of year valuation dates.

Valuation Date and Approval to Change the Valuation Date

In order to use a valuation date other than the first day of the plan year, a plan must have had 100 or fewer participants (including active and inactive participants, and any other individuals entitled to future benefits) on each day of the preceding plan year. In determining the number of participants, all single employer defined benefit plans maintained by the employer or members of the employer's controlled group are treated as one plan; however, only participants with respect to the employer are taken into account. For the first plan year of a plan, the determination is made based on the number of participants the plan is reasonably



expected to have on each day of the first plan year [§430(g)(2)(B)]. If a plan qualifies, the valuation date may be any day during the plan year.

Because the valuation date is considered part of the plan's funding method, a change in the valuation date generally requires specific approval; however, there are a couple of exceptions to this general rule [§1.430(g)-1(f)(3)]:

- Any change in the valuation date that is required by IRC Section 430 is automatically approved. For example, if a plan ceases to be eligible to use a valuation date other than the first day of the plan year due to the number of participants exceeding 100 in the prior plan year, a change to a beginning of year valuation date would be automatically approved.
- Any change in a plan's valuation date made for the first plan year beginning in 2008, 2009 or 2010 is automatically approved.

Valuation of Assets and Liabilities

Under PPA, the funding target, target normal cost and value of plan assets are all determined as of the valuation date [§430(g)(1); §1.430(g)-1(b)(1)]. If the value of plan assets is less than the funding target, the minimum required contribution equals the sum of the present value of benefits accruing during the plan year (the target normal cost) and an amortization installment payment for any shortfall (the shortfall amortization charge) [§430(a)(1)]. If the value of plan assets exceeds the funding target, the minimum required contribution is the target normal cost minus the excess, but not less than zero [§430(a)(2)]. These basics remain the same when using end of year valuation dates; however, there are some things to keep in mind.

If contributions for the current plan year are made prior to the valuation date for the year, the contributions (including interest at the effective rate between the deposit dates and the valuation date) must be subtracted from the value of plan assets. If the result of this subtraction is less than zero, the value of plan assets is set to zero [§1.430(g)-1(d)(2)].

The target normal cost for a plan using an end of year valuation date represents the cost of the benefits actually accruing during the plan year. The funding target represents the cost (determined on the valuation date) of benefits accrued as of the beginning of the plan year. It is important to note that benefits accruing during the year and benefits accrued at the beginning of the year that have been distributed during the year (and are therefore no longer included in the asset value at the end of the year) are not considered in determining the target normal cost and funding target when using an end of year valuation date.

Under PPA, the pre- and post-retirement interest rates previously selected by the actuary are replaced by prescribed rates. Most small plans use the prescribed three-tiered segment rates [§430(h)(2)(B)]. Final regulations specify that for plans with beginning of year valuation dates, the first segment rate applies to benefits expected to be paid during

the five-year period beginning on the valuation date, the second to benefits expected to be paid during the next 15 years, and the third to benefits expected to be paid thereafter [§1.430(h)(2)-1(b)]. While guidance with regard to the determination of the applicable segment rate for valuation dates other than the first day of the plan year is reserved in final regulations [§1.430(h)(2)-1(b)(2)(ii)], it is stated in the preamble that the Treasury Department continues to believe that the method included in proposed regulations is the most appropriate. Proposed regulations define the first five-year period as the five-year period beginning on the valuation date, regardless of when that occurs during the plan year.

The segment rate set used under PPA is generally the rate set in effect for the month that includes the valuation date. For example, a calendar year plan with a beginning of year valuation date would generally use the segment rate set for January, whereas a calendar year plan with an end of year valuation date would generally use the December segment rate set. A special rule allows plans to use the rate set for one of the four months preceding the valuation date as an alternative. Accordingly, for a plan using an end of year valuation date, the rate set for August, September, October or November could be used in lieu of the December rate set [§430(h)(2)(E)].

Satisfying Minimum Funding Standards

In determining whether minimum funding standards are satisfied, contributions are adjusted from the deposit dates to the valuation date using the effective rate for the plan year [§430(j)(2); Proposed §1.430(j)-1(b)(3)]. For plans using a beginning of year valuation date, the adjustment is always downward (a discount); however, for plans using an end of year valuation date, the adjustment can be either downward or upward, depending on when the contribution is deposited. When using an end of year valuation date, a contribution deposited during the plan year would be adjusted upward between the deposit date and the valuation date; whereas a contribution deposited after the end of the plan year would be adjusted downward.

Credit Balances and Schedule SB

Credit balances by definition are determined as of the first day of the plan year and must be adjusted when using an end of year valuation date. Generally, the credit balance (determined on the first day of the plan year) is accumulated from the beginning to the end of the plan year using the effective rate for the year in order to determine the amount available for use on the valuation date.

Any unused portion of the accumulated credit balance at the end of the year is discounted back to the first day of the plan year using the effective rate, then accumulated forward to the first day of the following plan year at the actual rate of return in order to determine the remaining credit balance on that date [§1.430(f)-1(b)(3); §1.430(f)-1(b)(4)].

Lines 7 through 13 of Schedule SB bring the credit balances forward from the beginning of the prior year (after voluntary or deemed reductions, if any) to the beginning of the current year (after reductions, if any). The balances reported on these lines are the balances at the beginning of the applicable plan year, regardless of the valuation date, and some lines must be adjusted for end of year valuation dates:

- Line 8, which reports the portion of the credit balance used to offset the prior year funding requirement, should be the amount shown on line 35 from the prior Schedule SB, *discounted* from the end of the prior year to the beginning of the prior year using the prior year effective rate.
- The dollar amount entered on Line 11b, which represents interest applied to excess contributions made for the prior year, will always be zero if an end of year valuation date was used in the prior year, since the excess contributions entered on line 11a (line 38 from prior year) would be the excess contributions determined at the end of the prior year in this case.
- The amounts entered on Line 12, which represent reductions in the balances due to elections or deemed elections for the current year, if any, should be the reduction amounts as of the valuation date for the current year, *discounted* from the last day of the current year to the first day of the current year using the current year effective rate.

The amounts entered on Line 35 of the SB, which represent the balances used to offset the current year funding requirement, should be the amounts determined as of the end of the current plan year, since the entries in Lines 31 through 39 (relating to the minimum required contribution and satisfaction of minimum funding standards for the current year) are all determined as of the valuation date for the current year.

FTAPs and AFTAPs

According to the 2010 Schedule SB instructions, the FTAP (line 14) for a plan using an end of year valuation date is determined as follows:

- The actuarial value of assets at the end of the year (Line 2b), *minus*
- The credit balances entered on Line 13 increased to the end of the year with interest at the effective rate, *divided by*

- The funding target at the end of the year [Line 3d(2)].

For purposes of the AFTAP reported on line 15 of Schedule SB for a plan with an end of year valuation date, the FTAP is adjusted as follows:

- Both the assets and funding target are increased by the aggregate amount of annuity purchases for non-highly compensated employees for the two prior plan years;
- The assets are increased to include contributions for the current plan year, adjusted for interest using the effective rate between deposit dates and the valuation date (including receivable contributions);
- The credit balances used are the balances at the end of the current year, adjusted (if applicable) for any interest adjusted excess contributions (for the current year) added to the prefunding balance; and
- The funding target is increased by the amount of the target normal cost for the current year.

This “final” AFTAP is reported on the SB for the current plan year, even though it is not used to determine the applicability of section 436 benefit restrictions until the following year.

Questions remain with regard to how the AFTAP is determined if the valuation date is changed. For example, assume the valuation date is changed from the end of year in 2009 to the beginning of the year in 2010. What is the AFTAP used to determine the applicability of section 436 benefit restrictions for 2010? Is it the AFTAP reported on Schedule SB for 2009 (as described above), or is a new AFTAP determined based on the 2010 beginning of year valuation results? Informal verbal IRS guidance indicates that restrictions should be based on a new beginning of year AFTAP using the 2010 valuation results in this case, but there is no formal guidance.

Quarterly Contributions

Final regulations provide no guidance with regard to the application of additional charges when late quarterly contributions are made to plans with end of year valuation dates. Absent guidance, one reasonable approach is to discount late installments from the deposit date to the quarterly due date using the effective rate plus 5%, then adjust the result from the quarterly due date to the end of the year using the effective rate only. Note that the adjustment of the result from the quarterly due date to the end of the year will be upward for quarterly contribution due dates during the plan year, and downward for quarterly contribution due dates after the end of the year, as illustrated by the following examples:

Final regulations provide no guidance with regard to the application of additional charges when late quarterly contributions are made to plans with end of year valuation dates.

The PBGC has made it clear that the benefits to be valued as of the valuation date are those accrued as of the beginning of the year, regardless of when the valuation date occurs during the year.

- \$50,000 quarterly due April 15, 2010 for 2010 calendar year deposited April 15, 2011 (6% effective rate):

$$\$50,000 / 1.11^{(365/365)} \times 1.06^{(260/365)} = \$46,954$$
- \$50,000 quarterly due January 15, 2011 for 2010 calendar year deposited April 15, 2011 (6% effective rate):

$$\$50,000 / 1.11^{(90/365)} \times 1.06^{(-15/365)} = \$48,613$$

Shortfall Amortization Bases

Under PPA, the shortfall amortization payment is determined on the valuation date in the year the base is established, and the balance of the base in subsequent years is determined as the present value of the remaining amortization payments on the current valuation date, using the segment rates applicable to the current valuation date [§430(c)]. There is no formal guidance with regard to determining the balance of a base established in a prior year when the valuation date is changed. Informal guidance indicates that if the valuation date is changed, the amortization payment used to determine the present value of the payments on the current valuation date stays the same.

Maximum Deductible Contribution

There is no substantive difference in the determination of the maximum deductible contribution under section 404(o) between end of year and beginning of year valuation dates; however, there would be a difference if regulations (or technical amendments) do not provide for an interest adjustment to the amount determined under 404(o) from the valuation date to the end of the year. As currently written, the maximum deductible contribution for a plan with an end of year valuation date would be higher than for a plan with a beginning of year valuation date, even if all assumptions were realized during the plan year, simply by virtue of the fact that it is determined at the end of the year, and the interest adjustment is automatically included.

PBGC Issues

The determination of unfunded vested benefits (UVBs) for purposes of the PBGC variable rate premium is based on the funding target and market value of assets on the valuation date. The participant count for PBGC premium purposes is determined on the last day of the prior plan year, regardless of the valuation date. The PBGC filing due date for small plans is generally four months after the end of the plan year, regardless of the valuation date. Since the valuation must be completed in order to determine the UVBs, this timing could be problematic if using an end of year valuation date.

The PBGC has made it clear that the benefits to be valued as of the valuation date are those accrued as of the beginning of the year, regardless of when the valuation date occurs during the year. It is unclear whether vesting is determined at the beginning or the end of the year when an end of year valuation date is used (end of year vesting is recommended).

Note that the standard premium funding target on the valuation date is determined using the spot segment rates for the month preceding the first day of the plan year, regardless of the valuation date. If the alternative premium funding target is elected, the vested portion of the actual funding target on the valuation date would be used to determine the UVBs. ↗

Kevin J. Donovan, MSPA, EA, CPA, is managing member of Pinnacle Plan Design, LLC. He is a CPA and an Enrolled



Actuary. Kevin is former member of the ASPPA Board of Directors and a former Vice President of ACOPA. He is a frequent lecturer in the retirement plan area. He has spoken at numerous ASPPA conferences as well as conferences sponsored by NIPA, Sungard, the CCA, etc. Kevin has also

authored several articles regarding retirement plan design. (kdonovan@pinnacle-plan.com)

G. Neff McGhie, III, MSPA, EA, is an Enrolled Actuary, on the Board of Directors for ACOPA and author of the Defined Benefit Answer Book, a Panel Publication. He is owner and operator of Sierra Pension Services, Inc., an actuarial consulting and pension administration company specializing in creative plan design work. Neff also provides actuarial consulting and valuation services for other pension administration firms. He is a frequent speaker on pension issues locally and in national conferences. (sierrapension@mindspring.com)

Daveyne C. Totten, MSPA, MAAA, EA, is a senior actuary for Actuarial Pension Analysts, Inc., a consulting firm with primary offices located in Fayetteville, NY. Daveyne worked in the New York metropolitan area as a consultant and manager for ten years before joining APA in 1989, and she currently manages APA's Middlebury, VT office. She is also president of the Vermont Enrolled Actuaries Club and an ACOPA volunteer, serving on the ASPPA CPE Subcommittee and coordinating ACOPA articles for The ASPPA Journal. (totten@sover.net)

