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## Treatment of Credit Balances for Single Employer Defined Benefit Plans Under the Pension Protection Act of 2006

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Prior to the Pension Protection Act of 2006 (PPA), credit balances were established, added to and used to offset minimum required contributions automatically. PPA has introduced complex rules regarding when and how credit balances can and must be used for various purposes. Under PPA, it is no longer automatic that a credit balance offsets the minimum required contribution or that the credit balance increases if contributions are made in excess of minimum required contributions.

**A** plan sponsor must now notify the enrolled actuary and plan administrator in writing of its election to use a credit balance in any way. Proposed regulations provide that these elections must be made by certain dates, must include the relevant details of the election (including the specific amounts involved with regard to the credit balance) and are irrevocable once made.

The new rules allow plan sponsors to voluntarily reduce credit balances, which may be advantageous in some situations. In certain circumstances, an involuntary reduction of the credit balance is mandated. PPA also distinguishes between credit balances that existed before PPA became effective (funding standard carryover balances; referred to as carryover balances in this article) and credit balances established after PPA became effective (prefunding balances), and treats these balances differently. When determining the amount of a credit balance to be used for any purpose, if the plan has a carryover balance in addition to a prefunding balance, the carryover balance must be used first and must be exhausted before any part of the prefunding balance can be used.



Note that due to the complexities of the new rules, limited space and lack of guidance with regard to end of year valuation date issues, the discussion in this article is generally limited to plans with beginning of year valuation dates, although most concepts and issues overlap. The discussion also relies on rules laid out in proposed regulations relating to credit balances under PPA, which may change under final regulations or other guidance as yet unpublished on the date this article was written.

*Another issue concerning quarterly contributions is the provision in the proposed regulations requiring the election to include the specific amount of the credit balance used for the offset.*

### Maintenance of Credit Balances

Under PPA, the carryover and prefunding balances must be maintained separately. The amount of the carryover balance on the first day of the PPA effective plan year<sup>1</sup> is the credit balance in the funding standard account on the last day of the pre-effective plan year<sup>2</sup> (if any). The prefunding balance is initially established as zero on the first day of the PPA effective plan year. The remaining amount of each balance on the first day of any subsequent plan year is the amount of the unused balance on the first day of the prior plan year, brought forward to the first day of the subsequent plan year using the actual rate of return on plan assets<sup>3</sup> for the prior plan year. The unused balance on the first day of the prior plan year, determined separately for each balance, is (a) the amount of the balance on the first day of the prior plan year, minus (b) any portion of the balance that was used to offset the minimum required contribution for the prior plan year, minus (c) any amount by which the balance was voluntarily or involuntarily reduced in the prior plan year.

Under the new rules, the carryover balance will eventually become zero. The prefunding balance, on the other hand, may be “added to” on the first day of a subsequent plan year, if excess contributions were made for the prior plan year; however, this addition is not automatic. The plan sponsor must make an election to add to the prefunding balance and the election must be made on or before the due date of the 5500 forms (including any extensions granted) for the prior plan year.

The amount available to add to the prefunding balance on the first day of the subsequent plan year is the amount of the interest adjusted excess contributions made for the prior plan year (if any). Excess contributions for the prior plan year are determined on the first day of the prior plan year according to the following formula:

- The excess (if any) of
- (a) contributions made for the prior plan year (other than contributions made to avoid or lift benefit restrictions under IRC §436), discounted to the first day of the prior plan year at the effective rate<sup>4</sup> for the prior plan year, over
  - (b) the minimum required contribution for the prior plan year, determined without regard to any election to use a carryover and/or prefunding balance to offset the minimum.

Interest adjusted excess contributions for the prior plan year are the excess contributions for the prior plan year (if any), brought forward from the first day of the prior plan year to the first day of

the subsequent plan year using the effective rate for the prior plan year.

Note that the law and regulations refer only to the effective rate for purposes of discounting contributions under (a) in the above excess contribution formula; however, it would seem appropriate to also apply any additional discounts required in connection with late quarterly contributions for this purpose, since these would be applied in determining whether minimum funding standards were satisfied.

### Elections to Use Credit Balances to Offset the Minimum Required Contribution

In general, the plan sponsor may elect to use all or a portion of a carryover and/or prefunding balance to offset the minimum required contribution for a plan year; however, this election is not available if the prior plan year funding ratio<sup>5</sup> is less than 80%. An election to use all or a portion of a credit balance to offset the minimum required contribution must be made on or before the due date of the 5500 forms (including any extensions granted) for the plan year to which the election relates; however, if the plan sponsor wants to use a credit balance to offset a quarterly contribution, proposed regulations provide that the election must be made on or before the due date of the quarterly contribution.

If preservation of the credit balance is of concern, the timing of an election to use a credit balance to offset the minimum required contribution could be critical. Excess contributions for purposes of determining the amount available to add to the prefunding balance are calculated based on a comparison of the discounted contributions to the minimum required contribution determined *without regard to any election to use a credit balance to offset the minimum*. If the plan sponsor elects to use a credit balance to offset the minimum required contribution and then later contributes more than the minimum after considering the offset, the amount available to add to the prefunding balance would not include the amount used as the offset.

As a numerical example, assume that the minimum required contribution before offset on the first day of the plan year is \$100,000 and the plan sponsor elects to use its \$25,000 carryover balance to offset the minimum, resulting in a minimum of \$75,000 after considering the offset. After making this election, the plan sponsor makes a contribution for the plan year, which has a discounted value of \$130,000 on the first day of the plan year. The excess contributions on the first

day of the plan year in this case would be \$30,000 (\$130,000 - \$100,000), and not \$55,000 (\$130,000 - \$75,000). By making the election to offset the minimum, and then contributing more than the minimum after considering the offset, the plan sponsor has lost a credit of \$25,000, which, when adjusted to the beginning of the subsequent plan year at the effective rate, would otherwise have been available to add to the prefunding balance.

In order to prevent a potential credit loss like that above, it may be prudent for the plan sponsor to wait until all contributions have been made for the plan year before making an election to use a credit balance to offset the minimum required contribution. This approach may not be possible, however, in the case of an election to offset a quarterly contribution, since proposed regulations require such an election to be made on or before the quarterly contribution due date.

Another issue concerning quarterly contributions is the provision in the proposed regulations requiring the election to include the specific amount of the credit balance used for the offset. If the actual amount of the quarterly contribution requirement and the effective rate for the plan year are unknown when a quarterly contribution comes due, it would be impossible to determine the specific amount of the credit balance necessary to offset the quarterly contribution at the time the election must be made. This requirement could force plan sponsors to overestimate the amount of the credit balance necessary to offset quarterly contributions, which could later force the loss of a credit that might otherwise have been available to add to the prefunding balance. It is hoped that final regulations will address this issue by allowing offset elections to include a formula that would ultimately lead to a specific amount, once all the facts are known. Many in the pension community have taken this approach in practice, and will likely continue to do so until final regulations are issued.

Note that the amount of the credit balance necessary to offset a quarterly contribution will not be equal to the amount of the quarterly contribution due. For this purpose, the amount of the credit balance necessary to offset the quarterly contribution is the amount of the quarterly contribution due, discounted to the first day of the plan year at the effective rate for the plan year.

### Voluntary and Involuntary Elections to Reduce Credit Balances

A plan sponsor may elect to voluntarily reduce any portion of a carryover and/or prefunding balance under PPA. Such an election would generally

result in higher funding ratios for purposes of funding and benefit restrictions, which may be advantageous in certain situations. An election to reduce a credit balance must be made by the end of the plan year to which the election relates.

PPA provides that the carryover and/or prefunding balances must be involuntarily reduced under certain circumstances. If the restriction on accelerated benefit payments under IRC §436 would otherwise apply, and reducing the amount of a carryover and/or prefunding balance would bring the Adjusted Funding Target Attainment Percentage (AFTAP) up to the threshold necessary to avoid the restriction (60%, 80% or 100%, as applicable), the plan sponsor is treated as having made an election to reduce the balances to the extent necessary to avoid the restriction, effective on the date the restriction would otherwise have applied.<sup>2</sup> For collectively bargained plans,<sup>7</sup> if the restrictions on shutdown (or other unpredictable contingent) benefits, plan amendments or benefit accruals would otherwise apply, and reducing the amount of a carryover and/or prefunding balance would bring the AFTAP up to the threshold necessary to avoid the restriction (60%, 80% and 60%, respectively), the plan sponsor is treated as having made an election to reduce the balances to the extent necessary to avoid the restriction, effective on the date the restriction would otherwise have applied.

Note that these deemed election rules are generally applied based on presumed AFTAPs, as well as actual AFTAP certifications; however, they do not apply to plans with a presumed AFTAP below 60%. The deemed election rules are also not applied if the combined carryover and prefunding balances are not sufficient to avoid the applicable restriction, even if both are reduced to zero.


Note also that it is not entirely clear at this time whether an involuntary reduction in a credit balance trumps an earlier election to use that credit balance to offset the minimum required contribution. For example, this situation would arise if an election is made to use a credit balance to offset a quarterly contribution for the current plan year before the AFTAP is certified for the year, or before a presumed AFTAP becomes effective, and the AFTAP as later certified or presumed would have required a reduction in the credit balance for the year if that election had not been made.

### Effect of Credit Balances on the Value of Plan Assets

PPA also applies new rules regarding when carryover and prefunding balances are used to reduce



the value of plan assets. In general, the amount of any carryover or prefunding balance must be subtracted from the value of plan assets; however, there are some exceptions to this general rule.

For purposes of determining whether a plan is exempt from the requirement to establish a shortfall amortization base under the IRC §430 transition rules, the prefunding balance is subtracted only if an election to use the prefunding balance to offset the minimum required contribution is made, and the carryover balance is not subtracted under any circumstance. For purposes of determining a plan's AFTAP under IRC §436, if the IRC §430 FTAP determined without subtracting the credit balances is 90% for plan years beginning in 2007, 92% for plan years beginning in 2008, 94% for plan years beginning in 2009, 96% for plan years beginning in 2010, or 100% for plan years beginning in and after 2011, the balances are not subtracted in determining the AFTAP. For purposes of calculating the plan's prior year funding ratio (used to determine whether a credit balance can be used to offset the minimum required contribution for the current plan year), the prefunding balance, but not the carryover balance, is subtracted. Finally, if a binding agreement with the PBGC exists restricting the use of any amount of the balances to offset minimum required contributions, the amount of the balances so restricted are not subtracted for purposes of determining the funding shortfall. 

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- 1 The PPA effective plan year is the first plan year to which PPA applies.
- 2 The pre-effective plan year is the plan year immediately preceding the PPA effective plan year.
- 3 The actual rate of return on plan assets is determined on a fair market basis, and must take into account the amount and timing of all contributions, distributions and other plan payments made during that period.
- 4 The effective rate is the effective interest rate determined for minimum funding purposes under PPA.
- 5 The prior year funding ratio is (a) the actuarial value of plan assets on the valuation date for the prior year reduced by any prefunding balance (but not by any carryover balance), divided by (b) the funding target for the prior plan year (determined without regard to the at-risk rules). For purposes of determining the prior year funding ratio in the PPA effective plan year, the actuarial value of plan assets on the prior valuation date is the actuarial value of plan assets on the prior valuation date, except that if an asset smoothing method was used, the value cannot be less than 90% or more than 110% of the fair market value of assets, and the funding target for the prior plan year is the plan's current liability on the prior valuation date.
- 6 The date the restriction would otherwise have applied is generally the date an AFTAP certification is made (or a presumed AFTAP becomes effective) that would result in the application of the restriction if the balances were not reduced.
- 7 If a plan covers both collectively bargained employees and non-collectively bargained employees, the plan is considered to be a collectively bargained plan for this purpose if at least 25% of plan participants are collectively bargained employees.