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IRS Proposes Updated Funding Rules for Single-Employer Defined Benefit Plans

The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) have issued proposed regulations under Internal Revenue Code Section (IRC Sec.) 430 which establishes minimum funding requirements for single-employer defined benefit plans, including rules for determining the funding target, target normal cost, and minimum required contribution. Those calculations also affect a plan sponsor's deductible contribution limit under IRC Sec. 404 for single-employer defined benefit plans.

Background

The proposal would implement statutory changes made by the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), and the SECURE 2.0 Act of 2022 (SECURE 2.0), while also addressing several technical and administrative issues.

Treatment of Plan-Related Expenses

The proposed regulations would clarify which expenses are included in the calculation of the target normal cost, which is used in determining a defined benefit plan's minimum funding requirements. The target normal cost generally would include expected non-investment plan expenses paid from plan assets, such as legal, actuarial, audit, administrative, and Pension Benefit Guaranty Corporation premium expenses. Benefit payments (including annuity contract purchases) and investment-related expenses would be excluded.

The proposal also addresses service providers that perform both investment and non-investment services.

- **Payments of $5,000 or more.** If total payments from plan assets to a service provider are expected to be $5,000 or more for the plan year, only amounts separately itemized as investment management fees or other expenses directly related to investing plan assets would be treated as investment-related expenses.
- **Payments of less than $5,000.** If total expected payments to the service provider for the plan year are less than $5,000, all payments to that provider would be treated as investment-related expenses without requiring itemization and excluded from the target normal cost.

Timing of Pension Plan Amendments

The proposal would expand the circumstances in which new plans and benefit-increasing amendments adopted after year-end may be reflected in an earlier plan year's funding calculations. At the same time, it would impose a more restrictive effective-date condition on other amendments adopted after the valuation date.

- **Amendments Adopted By the Valuation Date.** Amendments adopted by the valuation date generally would be reflected in that year's funding calculations if they take effect by the end of the plan year. A benefit-increasing amendment also must be permitted to take effect under applicable IRC Sec. 436(c) restrictions. An amendment that does not take effect until a later plan year would not be reflected until that later year.
- **Amendments Adopted After the Valuation Date.** An amendment adopted after the valuation date generally would not be reflected in that plan year's funding calculations. The principal exception is an IRC Sec. 412(d)(2)

election. If the plan administrator makes the election for an amendment adopted no later than 2½ months after the end of the plan year, the amendment generally would be reflected in that plan year's funding calculations, provided the amendment satisfies the statutory requirements for the election and takes effect no later than its adoption date. This proposed effective-date condition is more restrictive than the existing regulatory rule, where the amendment generally needs to only take effect by the end of the plan year. The change may create a timing issue for benefit-reducing amendments (e.g., plan freezes) that cannot take effect immediately because advance notice is required under ERISA Sec. 204(h).

- **Retroactive Plan Adoptions and Amendments Increasing Benefits.** Plan sponsors may be able to incorporate certain retroactively adopted plan provisions into funding calculations, but doing so requires careful attention to the applicable SECURE Act and SECURE 2.0 provisions, IRC requirements, and funding deadlines.
    - If the applicable requirements of the SECURE Act and IRC Sec. 401(b)(2) are satisfied, a new defined benefit plan adopted after the close of the employer's taxable year but before the employer's tax-return deadline, including extensions, may be treated as adopted on the last day of that taxable year, and its provisions may be reflected in funding calculations for the plan's first plan year.
    - Similarly, if the applicable requirements of SECURE 2.0 and IRC Sec. 401(b)(3) are satisfied, an amendment increasing benefits that was retroactively adopted after the end of the plan year may be reflected in the funding calculations for that plan year.
    - In either case, an IRC Sec. 412(d)(2) election would be required if the valuation date is before the date the plan is treated as adopted or amended.

  The proposal removes uncertainty for plans with beginning-of-year valuation dates by confirming that eligible retroactive plan provisions may be included in funding calculations under the deemed adoption rules of IRC Secs. 401(b)(2) and 401(b)(3). Sponsors seeking this relief should be aware that because the amendment deadline may fall after the minimum-funding contribution deadline, they would need to coordinate the amendment, elections, valuation date, and minimum required contribution timing very carefully.
- **Remedial Amendments.** The proposal addresses certain future remedial amendments involving a disqualifying plan provision designated by the IRS. If the remedial amendment period remains open and plan operations are changed in anticipation of the future required amendment, that amendment generally would be treated as adopted when the change actually occurs in the plan operations.

Anti-Abuse Rule for Mid-Year Amendments

Current regulations require certain liability-increasing amendments adopted after the valuation date to be reflected in current-year funding calculations even when they otherwise would not be taken into account. The rule applies if the amendment takes effect by the end of the plan year, increases plan liabilities through specified benefit changes, and would not be permitted to take effect under a modified IRC Sec. 436(c) test. Under that test, the increase in the target normal cost attributable to the amendment is treated as an increase in funding target.

The proposal would narrow this rule by adding a disproportionate-increase test. Under the new test, an amendment would have to satisfy the existing conditions and disproportionately increase target normal cost. That condition would be met if the percentage increase in target normal cost is more than twice the percentage increase in the funding target attributable to the amendment, taking into account only the benefits of participants currently employed by the employer.

Actuarial Assumptions and Funding Method Changes

Under current rules, actuarial assumptions and funding methods generally become established for a plan year when the Schedule SB is filed with the Form 5500. Changes are typically not allowed unless the IRS determines that the assumptions were unreasonable or the funding method was impermissible.

The proposal would allow an IRS-approved change to actuarial assumptions or a funding method to apply to a plan year as long as the request is submitted before the Schedule SB is filed for the plan year, even if IRS approval is not received until after the filing date. However, this relief would be limited to a timely submitted request that the IRS ultimately approves.

Next Steps

The regulations generally are proposed to apply to plan years beginning on or after the date that is six months after final regulations are published in the *Federal Register*. For earlier plan years, taxpayers could apply either the proposed rules or the existing regulations.

Treasury and IRS request comments on whether the proposed methodology for identifying a disproportionate increase in target normal cost is appropriate, other possible methods for making that determination, and the proposal's effect on small entities. Public comments are currently being considered.

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