Part III. Administrative, Procedural, and Miscellaneous

Rev. Proc. 98-10

26 CFR 601.201: Rulings and determination letters.

Section 1. Purpose and Scope

This revenue procedure modifies Rev. Proc. 95-51, 1995-2 C.B. 431, which provides approval to change the funding method (actuarial cost method) used for a defined benefit pension plan. Specifically, this revenue procedure modifies § 3 of Rev. Proc. 95-51 to provide approval to change the asset valuation method to one of three additional methods and to provide approval for certain changes in valuation software. This revenue procedure also clarifies and modifies other provisions of Rev. Proc. 95-51.

Section 2. Background

.01 Section 412(c)(5)(A) of the Internal Revenue Code, as amended, and § 302(c)(5)(A) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, state that if the funding method of a plan is changed, the new funding method shall become effective only if the change is approved by the Secretary.

.02 Section 1.412(c)(2)-1 of the Income Tax Regulations generally provides that a change in the actuarial valuation method used to value the assets of a plan is a change in funding method that requires approval under § 412(c)(5) of the Code.

.03 Rev. Proc. 95-51 provides approval for certain changes in funding method. Section 3 of Rev. Proc. 95-51 provides approval for changes to 14 specific methods including three asset valuation methods. Section 4 of Rev. Proc. 95-51 provides four special approvals for changes. Section 5 of Rev. Proc. 95-51 provides rules relating to the establishment and maintenance of amortization bases upon changing methods. Section 6 of Rev. Proc. 95-51 provides restrictions under the revenue procedure.

Section 3. Additional Approvals under Rev. Proc. 95-51

.01 Section 3 of Rev. Proc. 95-51 (Approval for Specified Changes) is modified by adding the following:

.15 *Approval 15*. Approval is granted for a change in asset valuation method to the smoothed market value (without phase-in) described below, or to any alternative formulation that is algebraically equivalent to this smoothed value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c).

Under this method, the actuarial value of assets is equal to the market value of assets less a decreasing fraction (i.e., (n-1)/n, (n-2)/n, etc., where n equals the number of years in the smoothing period) of the gain or loss for each of the preceding n-1 years. The stated smoothing period may not exceed five (5) plan years.

Under this method, a gain or loss for a year is determined by calculating the difference between the expected value of the assets for the year and the market value of the assets at the valuation date. The expected value of the assets for the year is the market value of the assets at the valuation date for the prior year brought forward with interest at the valuation interest rate to the valuation date for the current year plus contributions minus benefit disbursements, all adjusted with interest at the valuation rate to the valuation date for the current year. If the expected value is less than the market value, the difference is a gain. Conversely, if the expected value is greater than the market value, the difference is a loss.

For example, if the smoothing period is five years, the actuarial value of the assets will be the market value of the plan's assets, with gains subtracted or losses added at the rates described as follows:

(i) 4/5 of the prior year's gain or loss
(ii) 3/5 of the second preceding year's gain or loss
(iii) 2/5 of the third preceding year's gain or loss
(iv) 1/5 of the fourth preceding year's gain or loss

.16 *Approval 16*. Approval is granted for a change in asset valuation method to the smoothed market value (with phase-in) described below, or to any alternative formulation that is algebraically equivalent to this smoothed value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c).

In the first year this method is used the actuarial value of assets is equal to the market value as of the valuation date. In each subsequent year, the smoothed value is calculated in the same manner as in Approval 15, except that the only gains or losses recognized are those occurring in the year of the change and in later years. The stated smoothing period may not exceed five (5) plan years.

.17 *Approval 17*. Approval is granted for a change in asset valuation method to the average value (as defined in § 1.412(c)(2)-1(b)(7)), modified to use the alternative phase-in as described below, or to any alternative formulation that is algebraically equivalent to this average. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c).

In the first year this method is used, the actuarial value of assets is equal to the market value. In the second year, the average value is calculated in the same manner as in Approval 11, except that the averaging period is two years. In the third year, the average value is calculated in the same manner as in Approval 11, except that the averaging period is three years. This process continues until the stated averaging period (not to exceed five years) is reached.

.02 Section 4 of Rev. Proc. 95-51 (Special Approvals) is modified to add a new § 4.05 as follows:

.05 Approval for Change in Valuation Software

(1) Approval is granted for a change in method that results from a change in valuation software where all the conditions set forth in paragraphs (2) through (8) are satisfied. Note that certain changes in valuation software may not constitute changes in funding method. For example, the update of the valuation software to incorporate the actual social security taxable wage base for the current year is not a change in funding method. Also, if all of the results of each specific computation are the same after the change in valuation software, there is no change in funding method.

(2) There has been a modification to the computations in the valuation software or a different valuation software system has been used. Examples of modifications to the computations in the valuation software include a change from commutation functions to direct calculation of actuarial values, changes in the rounding conventions or changes to correct errors or inefficiencies in the computations. Examples of using a different valuation software system include a change in the spreadsheet software (e.g., Lotus 1-2-3 to Excel) or a change in the actuarial software vendor.

(3) The underlying method is unchanged and is consistent with the information contained in the prior actuarial valuation

reports and prior Schedules B of Form 5500.

(4) The modification to the computations in the valuation software or the use of a different valuation software system is designed to produce results that are no less accurate than the results produced prior to the modification or change.

(5) The net charge to the funding standard account for the year does not differ from the net charge that would result if the valuation software had not been changed (all other factors being held constant) by more than two percent (2%).

(6) A change in valuation software requiring approval was not made for the prior plan year.

(7) Section 4.04 (Approval for Takeover Plans) of this revenue procedure is not applicable to the change.

(8) The effect of the change in method is treated in the same manner as an experience gain or loss, unless the actuarial assumptions are being changed, in which case the effect of the change in method is treated as part of the effect of the change in assumptions.

Section 4. Clarifications and Modifications of Rev. Proc. 95-51

.01 Section 3.11 of Rev. Proc. 95-51 is clarified to read as follows:

.11 *Approval 11*. Approval is granted for a change in asset valuation method to the average value as defined in § 1.412(c)(2)-1(b)(7) (which does not have a phase-in), or to any alternative formulation that is algebraically equivalent to this average value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c).

For example, under § 1.412(c)(2)-1(b)(7), if the averaging period is five years, the average value is based on the fair market value of assets in the current year and the adjusted values of assets for the prior four years as provided in § 1.412(c)(2)-1(b)(8). An alternative formulation which is algebraically equivalent to this method is one in which the average value of assets is equal to the fair market value on the valuation date, minus decreasing fractions (4/5, 3/5, 2/5 and 1/5, in this example) of the appreciation and depreciation of the assets in each of the four preceding years. The stated averaging period may not exceed five (5) plan years.

.02 Section 3.11 of Rev. Proc. 95-51 is clarified to read as follows:

.12 *Approval 12*. Approval is granted for a change in asset valuation method to the average value (as defined in § 1.412(c)(2)-1(b)(7)), modified to use the phase-in described below, or to any alternative formulation that is algebraically equivalent to this average value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c).

In the first year this method is used, the average value is calculated as in Approval 11, except that the adjusted values for all but the most recent prior year are replaced by the adjusted value for the most recent prior year. In the second year, the average is calculated as in Approval 11, except that the values for all but the most recent two prior years are replaced by the adjusted value for the second most recent prior year. This process is continued until values for all prior years in the averaging period are phased in. The stated averaging period may not exceed five (5) plan years.

.03 Section 4.02(1) of Rev. Proc. 95-51 is modified to read as follows:

(1) If a plan uses an individual aggregate funding method and an individual normal cost becomes negative for a participant, approval is granted to re-allocate excess assets to other participants in proportion to the present value of accrued benefits, or in proportion to the accrued liability determined under the immediate gain funding method described in § 3.01, § 3.08 (only if the normal cost for a participant is determined as a level percent of compensation under the plan's method), or § 3.09 (only if the normal cost for a participant is determined as a level dollar amount under the plan's method) or in proportion to the allocated adjusted assets prior to the reallocation. For this purpose, excess assets are defined as the excess, if any, of the assets currently allocated to the participant over the present value of the participant's future benefits.

.04 Section 4.04(3) of Rev. Proc. 95-51 is modified to read as follows:

(3) The method used by the new actuary is substantially the same as the method used by the prior actuary, and is consistent with the information contained in the prior actuarial valuation reports or prior Schedules B of Form 5500. Also, the method used by the new actuary must be applied to the prior year (using the assumptions of the

prior actuary) and the absolute value of each resulting difference in normal cost, accrued liability (if directly computed under the method) and actuarial value of assets, that is attributable to the change in cost method, does not exceed five percent (5%) of the respective amounts calculated by the prior actuary for that year.

.05 Section 5.01(2) (Creation of a Funding Method Change Base) of Rev. Proc. 95-51 is modified to read as follows:

> Except in the case of a change to a funding method described in § 3.02, § 3.03, § 3.04, or § 3.05, all existing bases shall be maintained and an amortization base shall be established equal to the difference between the unfunded accrued liability under the new method and an amount equal to (A) the net sum of the outstanding balances of all amortization bases (including, when the preceding method was an immediate gain method, the gain or loss base for the immediately preceding period), treating credit bases as negative bases, less (B) the credit balance (or plus the funding deficiency), if any, in the funding standard account, less (C) the sum of (i) any existing accumulation of additional funding charges for prior plan years due to § 412(l), (ii) any existing accumulation of additional interest charges due to late or unpaid quarterly installments for prior plan years and (iii) any existing accumulation of additional interest charges due to the amortization of prior funding waivers (which sum can be found on the Schedule B, for example, in 1997 on Line 9q(4)), all adjusted for interest at the valuation rate to the valuation date in the plan year for which the change is made. If this difference is a positive or negative number, the resulting base will be a charge base or a credit base, respectively. In the case of a change to a funding method described in § 3.02, § 3.03, § 3.04, or § 3.05, (a) the bases described in paragraph (1) must be maintained, and (b) all amortization bases other than those described in paragraph (1) shall be considered fully amortized.

.06 Section 5.01 of Rev. Proc. 95-51 is modified by adding the following:

(5) If the funding method is being changed in accordance with the approval provided in § 4.01 (Approval to Anticipate Scheduled Benefit Increases), no base is established due solely to the change in method. The entire increase in unfunded liability resulting from anticipation of benefit increases scheduled to take effect during the term of the collective bargaining agreement currently applicable to the plan is treated as resulting

from a plan amendment and the base established in the funding standard account is amortized over a 30- year period.

.07 Section 6.01(2) of Rev. Proc. 95-51 (Administrator Approval) is modified to read as follows:

(2) This revenue procedure does not apply unless the plan administrator (within the meaning of § 414(g)) or an authorized representative of the plan sponsor indicates as part of the series Form 5500 for the plan year for which the change is effective that the plan administrator or plan sponsor agrees to the change in funding method. However, in the case of a change in funding method described in § 4.01 (Approval to Anticipate Scheduled Benefit Increases), the plan administrator or authorized representative does not need to agree to the request.

.08 Section 6.02(3)(c) of Rev. Proc. 95-51 (Four-year limitation on changes) is clarified and modified to read as follows:

(c) The funding method is being changed in a way not described in (a) or (b), and a funding method change (other than a change for which approval is provided by § 4 of this revenue procedure, or a change described in (a) or (b)) was made in any of the four (4) preceding plan years.

Section 5. Effective Date

.01 In general, this revenue procedure is effective for plan years commencing on or after January 1, 1997.

.02 For plan years beginning in 1997, § 4.04(3) of Rev. Proc. 95-51 may be applied as originally issued or as modified by § 4.04 of this revenue procedure.

.03 The modification made by § 4.05 of this revenue procedure to § 5.01(2) of Rev. Proc. 95-51 (Creation of a funding method change base) is effective only for plan years commencing on or after January 1, 1998.

.04 If the funding method for the plan was changed in accordance with § 4.01 of Rev. Proc. 95-51 (Approval to anticipate scheduled benefit increases) as originally issued and the amortization period for the amortization base established as a result of the method change was 10 years, the plan sponsor may either, (1) retain the 10 year period, or (2) file an amended Schedule B for the year of the change and for any subsequent years reflecting a 30 year amortization period for such base.

Section 6. Effect on Other Revenue Procedures

Rev. Proc. 95-51 is clarified and modified.

Section 7. Comments Requested Concerning Mergers

The Service requests written comments concerning potential standard procedures that can be used for a change in funding method in connection with a plan spin-off or merger. Comments and information should be sent to: Commissioner of the Internal Revenue Service, Attention: CP:E:EP:A:1, Washington, DC 20224.

Drafting Information

The principal author of this revenue procedure is Todd Newman of the Employee Plans Division. For further information regarding this revenue procedure, call (202) 622-6076 between 2:30 and 3:30 Eastern time (not a toll free number) Monday through Thursday. Mr. Newman's number is (202) 622-6262 (also not a toll free number).