This article was printed in the *Journal of Deferred Compensation*, Volume 13, Number 3, Spring 2008, by Aspen Publishers, a Wolters Kluwer Company (1-800-638-8437, *www.aspenpublishers.com*).

PPA's Single-Employer Funding Rules—You Can't Leave Them to the Plan's Actuary

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Introduction

> There are three things of which you can be certain when legislation has a delayed effective date. First, as hard as they try (and they do try very hard), the government will not have published all the final guidance practitioners would like. Second, there will be pressure placed on Congress and/or the regulatory agencies to delay the effective date of the legislation (or some portions of it). Third, the effective date will arrive sooner or later and practitioners will have to do the best they can with the guidance that is published. That is the situation practitioners find themselves in now with respect to the new funding and benefit restriction rules under the Pension Protection Act of 2006 ("PPA"), which are generally effective for the 2008 plan year.

Notwithstanding justified concerns by practitioners about the lack of complete and final guidance on a totally new funding structure for single-employer defined benefit plans, the Treasury and IRS have done a yeoman's job of getting out workable guidance. Up to now, many practitioners have been able to avoid dealing with the new funding rules, leaving it to the plan's actuary to do projections of future funding obligations. But the time for relying solely on the plan actuary has run out.

The proposed Treasury regulations on benefit restrictions under section 436 of the Code (and the related regulations on funding standard carryover balances and prefunding balances under section 430(f) of the Code) impact the ability of participants to accrue benefits, of plans to pay accelerated payments such as lump sums ("lump sums") or unpredictable contingent event benefits such as shutdown benefits ("shutdown benefits"), and of employers to amend their plans to increase benefits. While the imposition of any restriction has broad implications for labor relations and corporate strategy, these new restrictions on benefits are of even more concern because some or all of the restrictions are deemed to go into effect if the actuary does not certify the funding percentage. Further, once the actuary has certified the plan's funding percentage as being below 80 percent or 60 percent, as applicable, the restriction applies immediately.

Practitioners will find it easier to understand the new rules if they understand the underlying concept of the single-employer plan funding legislation[1]—"the only 'good' defined benefit plan is one that is funded at a high percentage." The entire design is a "stick and carrot" approach. The stick is the benefit restrictions, which the designers hope will never have to be used or, at least, not for very long. The carrot is the greatly increased ability to deduct contributions up front.

Whether one can expect this approach to result in earlier funding than the old approach depends on assumptions about behavior, always a risky premise. The new rules will work if employers and their workers, especially in unionized industries, find the benefit restrictions so abhorrent that keeping the funding of the defined benefit pension plan high becomes a chief priority for use of limited resources, as opposed to paying for increased health benefits, improving wages, or the need for cash flow for business survival or expansion. Even then, if the money is not available for advance funding, the plan is not going to get funded.

Some analysts thought this bet was not worth making and short sighted[2] because it focused on protecting the government from having to bail out the PBGC rather than on preserving the defined benefit system[3]; the approach would lead to a further rush out of the defined benefit system. This consequence did not trouble many of those advocating the legislation. Their view was that an employer that could not afford its plan should indeed terminate it and, if they didn't, the plan should certainly be subject to benefit restrictions.

A Few Assumptions

As is usually the case when legislation makes major changes in law, PPA contains many transition and special rules. These rules apply mostly with respect to what happens in 2008; in some cases, the rules also affect 2009 and 2010. For the most part, the general body of this article ignores the transition and special rules; the article instead addresses them separately at the end.

This article assumes a calendar year plan for simplicity purposes. For the same reason, the article will assume a 2008 effective date for the new rules even though certain plans have delayed effective dates. All references in this article are to the Internal Revenue Code of 1986 ("Code"). In virtually all cases there are parallel provisions in the Employee Retirement Security Act of 1974 ("ERISA"); ERISA cites are not included except where there are no parallel Code provisions.

Overview of the Pre-PPA Rules[4]

Employers fund defined benefit pension plans as long-term obligations. Under pre-PPA law, the plan actuary tracks contributions, earnings, etc. in a funding standard account (FSA), and the actuary is allowed considerable discretion in choosing assumptions. Generally, employers must fund plans (other than small plans) that are not at least 90 percent funded on a more accelerated basis under the Deficit Reduction Contribution (DRC) requirements, using specified actuarial assumptions.

Employers must make "minimum contributions" each year. If the employer makes contributions in excess of the minimum, the actuary can treat the excess as a "credit balance" and use it as a credit against future years' minimum contributions (*i.e.*, in lieu of cash contributions). The actuary increases the credit balance each year by assumed earnings regardless of the plan's actual earnings. The actuary treats the difference between assumed and actual earnings as an experience gain or loss and amortizes it over five years.

Current law has limited restriction on amendments to increase benefits when plans are very poorly funded or the employer is in bankruptcy.[5] Current law also limits lump sums when the plan has a "liquidity shortfall."[6]

Overview of the PPA Rules[7]

PPA eliminates the two-tier structure of funding and much of the flexibility on assumptions provided to the actuary. There is no longer an FSA; instead the actuary must amortize each year's plan underfunding (*i.e.*, the shortfall between assets and liabilities) over a seven-year period. The following year, the actuary amortizes the new shortfall (taking into consideration the present value of scheduled future amortization payments from prior years) over a new seven-year period.

The pre-PPA "credit balance" is renamed the "funding standard carryover balance." The build up of

assets due to future excess contributions is titled the "prefunding balance." The actuary increases both balances by actual earnings, not, as under current law, assumed earnings. For most purposes in determining plan assets, the actuary must first subtract the amount of these balances from the asset figure. However, the employer can elect to "convert" part or all of these balances to assets so that the asset figure is not reduced as much or at all. In addition, in some cases related to avoiding benefit restrictions, the actuary must "convert" the balances to assets. An employer may use these balances (the funding standard carryover balance first) in lieu of cash to satisfy the minimum required contribution requirement but, unlike current law, only if the plan is at least 80 percent funded for the prior year.

Most plans must use the first day of the plan year as the valuation date. Plans with 100 or fewer participants (after aggregating all plans of the employer) may use any date as the valuation date.[8]

PPA greatly increases the number of situations in which benefit restrictions are imposed. In general terms, if the plan is less than 60 percent funded for a year, the plan must be frozen for any new accruals, may not pay out shutdown benefits, and may not pay lump sums. If the plan is at least 60 percent but not 80 percent funded, the plan generally may pay only 50 percent of the value of the lump sum. In addition, if the plan is below 80 percent funded, the employer may not amend the plan to increase benefits. In the case of collectively bargained plans, the plan is required to convert the funding standard carryover balance and the prefunding balance to assets if, and only if, the conversion of the balances would be sufficient to increase the funding level to a level that would avoid a restriction. This required conversion rule applies to the lump sum restriction regardless of whether the plan is collectively bargained.

Until the actuary certifies the funded status of the plan for the current year, the plan needs to operate as if its funded status were the following:

- If a restriction was in place for the prior year, from January 1 to April 1 the funding ratio for the current year is presumed to be the funding ratio for the prior year. Slightly different rules apply for the period between January 1 and April 1 if no restrictions were in place for the prior year.
- If the actuary has not certified the current year's funding ratio by April 1, the funding ratio for the current year is presumed to be the funding ratio for the prior year minus ten percentage points if the prior year's funding ratio was between 60 percent and 70 percent or 80 percent and 90 percent; otherwise (other than in 2008) it continues to be the funding ratio for the prior year (*i.e.*, without the reduction).
- If the actuary has not certified the current year's ratio by October 1, the funding ratio is conclusively presumed to be below 60 percent for the remainder of the year.

Funding Standard Carryover Balance and Prefunding Balance—Code Section 430(f)

Establishment[9]

Unlike prior law, PPA limits the situations in which the employer may use excess contributions (*i.e.*, contributions made in excess of the minimum required contribution) to satisfy future minimum cash contribution requirements. Because of this change, PPA treats excesses (*i.e.*, credit balances) accumulated before PPA's effective date somewhat more generously than it treats excesses contributed after that date.

PPA renames the pre-PPA credit balance the "funding standard carryover balance" and sets the funding standard carryover balance's value on January 1, 2008, as equal to the value of the credit balance on December 31, 2007. PPA designates any new contributions designated as excesses (*i.e.*, starting with excess contributions for the 2008 plan year) as the "prefunding balance" and sets the prefunding balance equal to zero on January 1, 2008. As is discussed below, excess contributions increase the prefunding balance only if the employer elects to treat the excess as an addition to the prefunding balance. In addition, employers may make special additional contributions to avoid the implementation of a benefit restriction.

These special additional contributions are not considered part of either the minimum contribution or the prefunding balance.

Maintenance[10]

PPA also changes how the actuary adjusts the values of the funding standard carryover balance and the prefunding balance from year to year. Each year, the actuary adjusts the beginning of the year funding standard carryover balance and prefunding balance to reflect the actual rate of return on plan assets. The adjustment is based on the fair market value of the assets and must take into consideration the timing of contributions, distributions, and other plan payments during the year. The actuary applies the rate of return adjustment after applying any adjustments to the balances resulting from the employer's election to use part or all of the balances to offset cash contributions for minimum funding and after applying any employer election or automatic action to convert part or all of the excess to assets.

Offsetting the Minimum Required Cash Contributions

Under pre-PPA law, employers could use credit balances to offset required cash contributions even though the assets were not really in the plan.[11] In addition, under pre-PPA law, the employer could use the credit balance to reduce the amount of cash contributions needed to satisfy the minimum funding contributions regardless of the plan's funding.

PPA has changed this. In addition to the funding standard carryover balance and the prefunding balance being adjusted by real earnings, the employer may elect to use these balances[12] to offset required minimum cash contributions only if the plan's funding percentage, known as the "funding target attainment percentage (FTAP)," for the prior year was at least 80 percent.[13] The FTAP is equal to liabilities over assets. The liability is the plan's target liability for a year (without regard to any "at risk" liability),[14] and assets are adjusted as discussed below.[15]

Subtraction from Plan Assets

Generally, the actuary must subtract both the funding standard carryover balance and the prefunding balance from plan assets for purposes of determining the value of plan assets to use in determining the applicable FTAP. However, there are key exceptions to this rule.

The employer may use the funding standard carryover balance and prefunding balance in lieu of cash contributions if the FTAP is at least 80 percent for the prior year. For purposes of making this determination, the actuary must reduce the value of assets by the prefunding balance, if any, but does not have to reduce the value of assets by the funding standard carryover balance.[16] This measurement is purely to determine whether the plan may use the funding standard carryover balance and prefunding balance in lieu of cash contributions. The measurement by itself does not convert any of the prefunding balance into assets.

The reason for this variation from the general rule that assets are reduced by both balances for funding ratio purposes is that the funding standard carryover balance was accumulated before PPA (as the credit balance). Employers successfully argued that they had contributed the excess in the belief that they would always be able to use larger advanced contributions to offset future minimum required contributions, and it would be unfair to change that with respect to past contributions.

The second situation in which the actuary subtracts only the prefunding balance (and not the funding standard carryover balance) is when the actuary is determining whether the plan must establish a new shortfall amortization base for a year. And in this case, the actuary does not even subtract the prefunding balance unless the employer uses part of the prefunding balance to offset minimum contributions. Note that the employer can use any or all of the funding standard credit balance without triggering the offset by the prefunding balance; however, using $1 of the prefunding balance means the entire prefunding balance is offset.[17]

Elections[18]

Election to Use Balances to Satisfy Minimum Required Contribution

As discussed above, if the prior year's FTAP is at least 80 percent, the employer may elect to use the funding standard carryover balance and prefunding balance in lieu of required cash contributions to satisfy the minimum funding requirement. The employer must make the election to use part or all of the balances (funding standard carryover balance first) to offset cash contributions on or before the due date for filing (with extensions) the plan's annual report (Form 5500) for the plan year to which the election relates (*i.e.*, by September 15 of the following year). The hope of those designing PPA was that all plans would advance fund so as to have the option of using the balances—then the employer would not have to make cash contributions to satisfy minimum contributions if the employer had future cash flow issues or was in a bad economic situation, because the employer had made additional contributions in advance.

Election to Treat Excess Contribution as Addition to Prefunding Balance

When an employer makes a new contribution for a year in excess of the minimum required contribution, PPA treats that amount as an increase in the plan's assets unless the employer elects to treat it as an addition to the prefunding balance.[19] Note that a contribution in excess of the minimum required contribution is not an addition to the prefunding balance unless the employer makes the election to treat it as such. In most situations, the employer will want to make this election because it provides the employer with more flexibility with respect to future contributions than if the employer initially treats the excess contribution just as additional assets.

The employer must make the election by the filing time for the Form 5500 for the year to which the contribution relates. For example, an employer that wishes to treat an excess contribution for the 2009 plan year as a prefunding balance must make the election (in accordance with the election rules discussed below) by September 15, 2010 (the due date for the 2009 Form 5500), since the contribution relates to the 2009 plan year. However, the election is reported on the Schedule SB of the Form 5500 for the 2010 plan year (filed by September 15, 2011) because the addition to the prefunding balance takes place in 2010.[20]

Election to Convert Balances to Avoid Benefit Restrictions

Having a funding standard carryover balance or prefunding balance may allow the employer to avoid benefit restrictions without making additional cash contributions. As discussed below, in collectively bargained plans the actuary must automatically convert these balances to assets if the conversion will avoid a benefit restriction. In non-collectively bargained plans the actuary must convert only if converting would prevent the restriction on lump sums. With respect to the other restrictions in a non-collectively bargained plan, the employer may elect to convert some or all of the existing funding standard carryover balance and prefunding balance to assets in order to increase the FTAP for the year.[21]

Because this election affects the triggering of the benefit restrictions for the year, the employer must make this election by the end of the plan year to which the election applies and report it on the Schedule SB of the Form 5500 for the year.[22] As discussed further in the benefit restriction section of the article, many employers will want to make the election earlier so as to avoid the benefit restrictions going into place. Under the facts of the example in the earlier paragraph, the employer must make the election by December 31, 2009, and report it on the Schedule SB for the 2009 plan year (filed by September 15, 2010). However, the employer should make the election as early in 2009 as possible and definitely before October 1, 2009, to have it affect the 2009 AFTAP.

Election Procedures

The proposed regulations set forth a procedure for all elections. The employer makes the election by

providing timely written notification of the election to the plan's enrolled actuary and the plan administrator. The election is irrevocable when made, and must meet the timing rules discussed above and include relevant details such as the specific amounts involved.

Multiple Employer Plans[23]

Multiple employer plans[24] are generally non-collectively bargained plans sponsored by two or more employers who are not in the same controlled group. Multiple employer plans are treated under the funding rules as single-employer plans and are subject to the new funding rules.

The funding rules generally apply to multiple employer plans as if each employer maintains a separate plan unless the plan predated 1989 and did not elect employer-by-employer treatment. In the case of a non-electing plan, the rules would apply as if there were only one employer for the whole plan.

Effective Dates/Applicability of Code Section 430(f)[25]

Section 430(f) is generally effective for the first plan year beginning on or after January 1, 2008. Unlike certain other provisions of the PPA (such as the benefit restrictions of section 436 discussed below), there is no delay in the effective date of section 430 for collectively bargained plans. The only plans that have a delay are multiple employer plans of certain cooperatives, two "PBGC settlement plans," and plans of certain defense contractors. For these plans, references to 2008 and 2007 should be interpreted as meaning the first year the rules are effective for the plan and the preceding year. There are also special rules that impact certain interstate bus lines and certain commercial airlines.

Benefit Restrictions—Code Section 436

PPA takes a "stick and carrot" approach to trying to encourage employers to voluntarily fund defined benefit plans even more quickly than is required under PPA's seven-year amortization schedule. The carrot is in the form of an encouragement to employers—the ability to deduct contributions well in excess of what is deductible under pre-PPA law.[26] The stick is in the form of punishment for the employees—restrictions on the benefits the plan can pay or accrue—if the plan does not meet certain funding percentages. The idea is to give employees an incentive to push the employer to fund the plan even more rapidly than is required by the minimum funding rules.[27]

PPA includes four types of benefit restrictions[28]:

- A restriction on the plan paying shutdown benefits if the funding ratio at the time of the event is below 60 percent[29];
- A restriction on the employer amending the plan to increase benefits if the funding ratio is below 80 percent[30];
- A restriction on the plan paying lump sums if the plan funding ratio is below 60 percent and a partial restriction if the ratio is below 80 percent[31]; and
- A restriction on new benefit accruals if the plan's funding ratio is below 60 percent.[32]

The Code and the proposed regulations provide detailed rules on when the restrictions start and stop and what presumptions apply when the actuary has not certified the plan's funding by specific dates.

Even if plans limit contributions to the required contributions under the seven-year amortization schedule, few plans are likely to stay below 60 percent funded for very long after 2008—unless, of course, there is another perfect storm.[33] Therefore, the restrictions that apply when funding is in the 60 percent to 80 percent range are likely to have the biggest impact on employers and participants, and the restriction with the biggest impact on participants (and the most difficult restriction for plans to administer) will be the partial restriction on lump sum payments.

Section 436 Measurement Date and AFTAP

The plan's funding ratio drives the benefit restrictions. The proposed regulations introduce a new term—the "Section 436 Measurement Date"—as the measurement date for determining when restrictions start and stop. [34] Benefit restrictions run from the Section 436 Measurement Date and are not retroactive to earlier in the year.

For benefit restriction purposes, the relevant funding ratio is the plan's adjusted funding target attainment percentage (AFTAP), and the date the actuary certifies the AFTAP is a Section 436 Measurement Date if the actuary makes the certification within the first nine months of the plan year. If a presumed AFTAP applies, generally as of January 1, April 1, or October 1, than those dates are also Section 436 Measurement Dates.

If the actuary certifies the AFTAP for a year after October 1, that certification is not considered made as of a Section 436 Measurement Date for the year and thus has no impact on the applicable funding ratio for that year. Instead, the Code provides that the AFTAP is conclusively presumed to be less than 60 percent as of October 1. (The post-October 1 certified AFTAP does become relevant for purposes of the presumptions for the following year until that following year's AFTAP is certified.)

The AFTAP is used only for Code Section 436 and differs from the FTAP, discussed earlier, in that the cost of annuity purchases in the previous two years for non-highly compensated employees is added back to the asset figure in the numerator and to the liability figure in the denominator of the AFTAP.[35]

The actuary determines the value of assets for purposes of the FTAP, and thus for purposes of the AFTAP, by reducing the value of the assets by the value of the funding standard carryover balance and the prefunding balance. However, if the FTAP (note, it is the FTAP, not the AFTAP, for this gateway) would be 100 percent or more without subtracting the balances, then the value of plan assets used in determining the FTAP and the AFTAP is determined without any subtraction of the balances.[36]

Except for pre-2009 years (which are discussed later in this article), the actuary may not treat any contribution for a prior year as assets for purposes of certifying the AFTAP until the contribution has actually been made. This rule applies both to required minimum contributions and to any additional contributions.[37]

Limitation on Unpredictable Contingent Event Benefits (Shutdown Benefits)[38]

Plans in certain industries have provisions that provide for increased benefits if a plant shuts down or there are large layoffs. These provisions, which are mostly found in collectively bargained plans, are aimed at protecting workers who intended to continue working until they became entitled to subsidized benefits (*e.g.*, a fully subsidized "30 and out" benefit) but who lost their jobs because of a change in the company's fortune. From the viewpoint of the pension plan, the difficulty with these provisions is that employers do not predict in advance that a plant will be closed down and these benefits triggered. As a result, the actuary cannot fund in anticipation of these benefits coming due and, if the plant closes down or there are large layoffs, the plan has to use assets intended for other benefits to pay these benefits.

Under pre-PPA law, these types of benefits, until the event occurs, are designated as "unpredictable contingent event benefits." Pre-PPA law defines an "unpredictable contingent event" as a "plant shutdown (whether full or partial) or similar event, or an event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability."[39] PPA borrows this definition for purposes of its definition of an unpredictable contingent event.

The general rule with respect to plant shutdowns is that if the AFTAP is less than 60 percent at the time of the event, the plan may not pay the shutdown benefit. In addition, if the AFTAP is 60 percent or greater but would be less than 60 percent taking into consideration the liabilities associated with the shutdown, the plan may not pay the part of the shutdown benefit that would not have been paid absent the

shutdown.

PPA provides for an exception if the employer makes additional contributions to the plan. If the AFTAP is less than 60 percent at the time of the shutdown, the employer must make an additional contribution equal to the increased liabilities created by the shutdown. If the AFTAP is 60 percent or greater at the time of the shutdown, but the cost of the shutdown benefits would move the AFTAP below 60 percent, the employer must make an additional contribution sufficient to bring the AFTAP back to 60 percent.

The restriction only applies to a plant shutdown that occurs during the time the AFTAP is below 60 percent. Benefits resulting from a shutdown that occurs earlier are not affected, and the plan must continue to pay those shutdown benefits even though the AFTAP has fallen below 60 percent. Conversely, if the shutdown occurs during a period when the AFTAP is, or would be if the shutdown liabilities were considered, below 60 percent, the increase of the plan's AFTAP in the future to 60 percent or greater does not mean that missed shutdown benefits commence. The benefits are gone permanently unless the plan provides otherwise.

Although it is not required, an employer could provide in a plan, or amend a plan to provide, that previously restricted shutdown benefits will commence once the actuary certifies that the AFTAP is at least 80 percent. A plan also could also provide, or be amended to provide, that the plan will make up lost benefits retroactively once the actuary certifies the AFTAP is at least 80 percent. The AFTAP must be 80 percent or greater (not just 60 percent or greater), because such a deemed or actual amendment would be an amendment retroactively increasing benefits (which, as discussed in the next section, is prohibited if the AFTAP is less than 80 percent).

Limitations on Plan Amendments Increasing Liability for Benefits[40]

Although PPA is cautious about restrictions that take away pre-existing rights, such as the right to shutdown benefits, lump sums, and future accruals, it is more aggressive in preventing plans from increasing benefits if the plan is not highly funded. Unlike the other restrictions, which are generally based on 60 percent,[41] PPA limits amendments increasing benefits if the AFTAP is below 80 percent. Pre-PPA law had a similar restriction under Code section 401(a)(29), but the restriction applied only when a somewhat different funding ratio was below 60 percent.

PPA restricts the employer from making amendments increasing benefits if the plan's AFTAP is less than 80 percent or would be less than 80 percent taking the amendment into consideration. This restriction affects amendments increasing the rate of benefit accruals as well as amendments accelerating vesting (unless the accelerated vesting is required by law).

PPA carves out an exception for benefit increases in "flat benefit" plans (*i.e.*, plans in which benefits are not based on compensation). The carve-out only applies if the rate of benefit increase does not exceed the contemporaneous rate of increase in average wages of participants covered by the amendment. Thus, for example, if union workers' average wages increase by three percent, the employer may amend the plan to increase the flat benefit by three percent or less without violating the restriction. In determining the average wage increase, the employer may separate active employees and non-active employees (who, of course, have no wage increases) but only if the amendment increasing the flat benefit applies only to active employees.

Limitations on Accelerated Benefit Distributions (Lump Sums)[42]

Some retirement experts believe defined benefit plans should not be permitted to make lump sum payments. They note that too often, especially with small payouts, once the distribution is in the hands of the participants, the participants spend the money rather than roll it to another retirement plan or IRA.

Current law addresses this by creating disincentives to discourage election of lump sums. For example, the Code waives withholding from the distribution if the money is paid directly to an IRA or another retirement plan (*i.e.*, a direct rollover),[43] and the Code requires a plan that wishes to make *de minimis* payouts (*i.e.*, payouts of $5,000 or less) to directly roll over that lump sum to an IRA or another plan if the value of the lump sum exceeds $1,000 and the participant does not instruct otherwise.[44]

Besides leakage of assets from retirement solution, lump sums create a problem for underfunded plans because they drain assets. This makes the plans even more poorly funded. [45] This is especially a problem if participants believe that the plan is likely to terminate and the PBGC will become the trustee because such a belief is likely to trigger a "run on the bank" of anyone eligible to retire or those who are willing to terminate employment to get the lump sum. When the PBGC trustees an underfunded plan, the PBGC does not pay lump sums (other than *de minimis* lump sums), and the PBGC cuts back most annuity benefits to guarantee levels.[46]

PPA limits lump sums to prevent lump sums from using up plan assets. The rules on payments of lump sums are the most complex of the restriction rules because both the 60 percent AFTAP and the 80 percent AFTAP apply. If the plan's AFTAP is less than 60 percent, then the plan may not pay a lump sum.[47] If the plan's ratio is 60 percent or greater but less than 80 percent, the plan may pay only 50 percent of the present value of the plan's lump sum (or, if less, 100 percent of the maximum PBGC guaranteed benefit that would apply to the participant at the time of the payment).

Unlike the restrictions on amendments increasing benefits and on paying shutdown benefits, PPA places no restriction on paying a lump sum simply because the liabilities associated with the lump sum payment would lower the ratio below the relevant 60 percent or 80 percent figure (*i.e.*, the plan does not look at the impact the lump sum payment would have on the AFTAP). In addition, as discussed below, while the employer may "buy" its way out of some of the restrictions by contributing enough to get the plan up to the 60 percent or 80 percent level, this way out is not available for accelerated payments. On the other hand, unlike the other restrictions, even non-collectively bargained plans have their funding standard carryover balance and prefunding balance automatically converted to assets if the conversion would allow the plan to pay a lump sum (or 50 percent of it).

The amount of the lump sum that is a "prohibited payment" is the amount in excess of the monthly payment under a single life annuity plus any Social Security supplement. Any payment for the purchase of an irrevocable commitment from an insurer and such other payments as the Commissioner may provide are treated the same as lump sums. The proposed regulations do not indicate other prohibited payments but reserve the Commissioner's authority to add prohibited payments by revenue ruling or other guidance.

The prohibition applies to all lump sums. Currently, there is no exception for *de minimis* lump sums (*i.e.*, those not in excess of $5,000). However, identical technical corrections are pending in the House and Senate to create such an exception. The proposed regulations do not anticipate the technical. [48]

AFTAP Less than 60 Percent

A plan may not pay a lump sum to any participant[49] whose annuity starting date occurs during the period after the actuary certifies the AFTAP to be less than 60 percent. The participant must be able to elect any other form of benefit available under the plan (as long as such form does not violate the prohibition) and must be able to elect to defer payment to a later date.[50] The plan may only pay an annuity no greater than the monthly payments under a straight life annuity (plus any Social Security supplement). The IRS has said that it considers a Social Security Leveling Option as an impermissible acceleration.[51]

AFTAP at Least 60 Percent but Less than 80 Percent

If the plan's AFTAP is at least 60 percent but below 80 percent, the plan may pay only 50 percent of the present value of the plan's lump sum (but not in excess of 100 percent of the present value of the PBGC's maximum guarantee) plus the amount of the straight life annuity under the plan (and any Social Security supplement payable under the plan). The first 50 percent is considered the unrestricted portion of

the lump sum. The remaining 50 percent is restricted, but the plan can pay the restricted 50 percent out in the form of a monthly straight life annuity (plus any monthly Social Security supplement).

Plan Provisions

The present value of the benefit is determined by the plan provisions. Thus, if the plan provides for a lump sum greater than the value of the minimum lump sum determined using the assumptions of Code section 417(e), the rules apply to the greater lump sum.

PBGC Maximum

The PBGC has never had to determine the present value of the PBGC maximum guarantee at age 65 or at any other age because the PBGC applies its guarantees on a monthly basis. For purposes of the section 436 lump sum provision, the PBGC has now issued Technical Update 07-4, explaining the methodology it will use to calculate the present value of the maximum guarantee at each age.[52] The maximum is standard for all plans and differs by participant age, not plan provision. Each calendar year, the PBGC will provide a new table of the PBGC maximum lump sum at each age for lump sums payable in that year. The new table will reflect the annual increases in the PBGC maximum monthly guarantee and changes in the section 417(e) factors.

The PBGC guarantees are based on calendar years, so the table is based on calendar years, not plan years. The PBGC table is applied based on the participant's age at the time the present value is calculated. The PBGC has not specified how to determine the applicable age, leaving it to the plan to use a reasonable method consistent with what is used for other plan provisions. Thus, unlike the monthly guarantee tables, which are based on the participant's age on his or her last birthday, this table allows the plan to use the participant's actual age and months on the annuity starting date or, perhaps, age nearest the annuity starting date. The older the worker is treated, the higher the permissible maximum.

Receipt of Benefit

If the 50 percent restriction applies at the time of the participant's annuity starting date, the plan must offer a participant who wants a lump sum the option of either receiving the entire deferred payment when the restriction does not apply (if consistent with qualification requirements) or receiving a bifurcated payment—the unrestricted portion now and the restricted portion later.

The plan must allow the participant to receive the unrestricted portion in any form that the participant could otherwise have elected (*e.g.*, the lump sum). The plan must allow the participant to elect to receive the restricted portion in any form permitted in the plan other than a prohibited form (*i.e.*, any form with monthly payments not in excess of the monthly payments under a straight life annuity plus any Social Security supplement).

For example, assume Participant A had a benefit of $8,000 per month, translating to a present value of $1 million (and assume there is no issue with 50 percent of $1 million being in excess of the PBGC guarantee maximum). The plan could pay Participant A immediately a lump sum of $500,000 (the unrestricted part of the present value). The plan could also pay Participant A $4,000 a month based on the remaining 50 percent of the straight life annuity. Thus, Participant A's first payment could be the $500,000 lump sum plus the first annuity payment of $4,000. In the following months, Participant A could only receive the $4,000. (If there were a Social Security supplement, the plan could also pay that monthly amount.)

A plan may not pay a participant who elects to receive the restricted portion of the benefit immediately in the form of an annuity any amounts in excess of the monthly payments until the restricted period is over. Benefits provided to a participant and a beneficiary (*e.g.*, because of a QDRO) are aggregated. The regulations provide special rules for allocation in such cases.

Alternatively, a plan may (but is not required to) offer special optional forms (in a nondiscriminatory manner). For example, the plan could allow the participant to elect to receive the unrestricted portion as a

lump sum and allow delayed commencement of the entire restricted part (*i.e.*, elect not to receive the annuity)—subject to other qualification requirements such as spousal consent.

Resumption of Payments[53]

The benefit restrictions apply for a given period when the AFTAP is not equal to or greater than the relevant percentage (60 percent or 80 percent) as of a Section 436 Measurement Date. If the actuary certifies the AFTAP for a year (where there is a presumed AFTAP), the certification generally creates a new Section 436 Measurement Date. If the new AFTAP equals or exceeds the needed percentage to eliminate the restriction, the restriction stops applying as of the new Section 436 Measurement Date (*i.e.*, as of the new certification).

Once the restriction on lump sums (either the total restriction or the 50 percent restriction) ends, the plan must again make lump sums available for anyone with an annuity starting date occurring after the resumption.[54] However, the restriction is not retroactively removed for anyone with an annuity starting date during the restricted period (unless the plan provides, or is amended to provide, otherwise). The plan may provide, or the plan may be amended to provide, that the participant (with appropriate spousal consent) can modify an election made during a prohibited period. Any such amendment, whether automatic or added, is treated as allowing the participant to choose a new annuity starting date and is considered to be an amendment increasing benefits. Accordingly, the plan's AFTAP must be at least 80 percent for that amendment to be allowed.

100 Percent AFTAP Rule for Lump Sums During Bankruptcy[55]

Plans must provide that they will not pay any lump sums with respect to annuity starting dates that occur during a plan year in which the employer is a debtor in bankruptcy. This restriction does not apply if, and once, the enrolled actuary certifies that the plan's AFTAP is 100 percent or greater. For this purpose, the presumptions discussed below are not applicable.

Limitation on Benefit Accruals[56]

Plans must freeze all benefit accruals if the plan's AFTAP is less than 60 percent. However, unlike the restrictions on shutdown benefits and on amendments increasing benefits (but like the restriction on lump sums), the plan does not have to freeze accruals simply because the additional accruals would bring the plan's AFTAP below 60 percent.

The plan must restart accruals once the AFTAP is certified to be at least 60 percent (unless the plan provides otherwise), but the participants do not receive retroactive accruals (unless the plan provides otherwise). The plan may provide for, or be amended to provide for, retroactive accruals.

As with the other restrictions, amending a plan to provide retroactive accruals is treated as an amendment to increase benefits and is permissive only if the AFTAP is at least 80 percent (even though the freeze on accruals is lifted when the AFTAP is 60 percent). However, under a special rule applying only to benefit accruals, if the plan provides for the automatic restoration of benefit accruals for the restricted period under preexisting plan terms, the plan is treated as having adopted a plan amendment that increases liabilities under the plan only if the restricted period exceeded 12 months. Thus, a plan with an automatic retroactive accrual provision is not subject to the 80 percent AFTAP test unless the freeze on accruals exceeds 12 months; whereas, a plan that has to be amended to provide the retroactive accrual is subject to the 80 percent AFTAP test regardless of the length of the freeze.[57]

Requiring plans to stop accruing benefits if the AFTAP is below 60 percent is arguably inconsistent with the push for employers to provide their workers with retirement benefits. However, some of those designing PPA believed that plans that were poorly funded should "not continue to run up debt." They believed that any future contributions should be used to pay off the existing debt (*i.e.*, the unfunded liabilities).

Rules Relating to Contributions Required to Avoid Benefit Limitations[58]

PPA includes a series of actions that employers may want, or have, to take to avoid the triggering of benefit restrictions. There are five ways employers can avoid benefit restrictions under section 436. One of these is required:

- Conversion of the funding standard carryover balance and prefunding balance to assets if either the plan is collectively bargained or the restriction is on lump sums, and the conversion will eliminate the restriction.

There are four options that the employer may elect to use to avoid benefit restrictions under section 436.[59] They are:

- Elect to convert some or all of the funding standard carryover balance and prefunding balance to assets in situations in which such conversion is not required to occur[60];
- Make additional timely contributions for the prior plan year and do not elect to treat them as adding to the prefunding balance[61];
- Make specific contributions in an amount sufficient to remove the restriction in the case of the restrictions on shutdown benefits, benefit increases, and benefit accruals (this approach is not allowed as a way to eliminate lump sum restrictions)[62]; and
- Provide security to the plan.[63]

Required Conversion of the Funding Standard Carryover Balance and the Prefunding Balance[64]

In certain cases, if the amount of the funding standard carryover balance and prefunding balance is sufficient to increase the AFTAP so as to prevent a restriction from occurring, the employer is deemed to elect to convert these balances to assets (*i.e.*, to "burn" the balances) in order to prevent the benefit restrictions from being triggered.

In the case of the restriction on lump sums, this rule applies to both collectively bargained and non-collectively bargained plans. And it applies regardless of whether any participant is eligible to receive or elects to receive a lump sum during the plan year. It does not apply if the plan does not provide for any lump sums.[65]

In the case of the other restrictions (benefit increases, accruals, and shutdown benefits), this "burning" rule applies only if the plan is collectively bargained. For this purpose, a plan is considered collectively bargained if at least 25 percent of the participants are covered by collective bargaining agreements that cover benefit levels under the plan.[66]

If the "burning" rule applies, the employer is treated as making the election on the date that the restriction would otherwise have applied. Although the regulations are not clear, this rule probably does not apply if a plan is presumed to have an AFTAP less than 60 percent (see discussion of presumptions below) because the balances could not eliminate the restriction (even if they otherwise would be large enough).

Elect to Convert Balances[67]

Employers may elect to convert (or "burn") the balances (funding standard carryover balance first) to avoid the restrictions. The election permanently converts the designated balances into "assets" for all purposes, thereby increasing the plan's AFTAP. The method of making this election is discussed above in the discussion of section 430(f).

Elect to Make Additional Timely Contributions for the Prior Plan Year[68]

If the deadline for making contributions for the prior year has not passed, the employer may make additional contributions (in excess of the minimum required contribution) for the prior year. If the employer does not elect to treat these contributions as adding to the prefunding balance for the prior year, then the additional contributions become additional assets affecting the AFTAP for the current year. However, as with the required minimum contribution for the prior year, the actuary can only count these contributions for a certification of an AFTAP after the contributions are in the plan (other than for the pre-2009 transition years discussed below).[69]

For example, the employer would have to make a contribution for the 2010 plan year by September 15, 2011, for it to be timely. However, if the employer wants to avoid the prohibition entirely for the 2011 year (*i.e.*, for the period before the contribution is made), the employer needs to make the contribution before the AFTAP is determined (*e.g.*, April 1, 2011). If the employer does not make the contribution before April 1, 2011, the actuary can still certify as of April 1, 2011. The actuary may wish to do so if the actuary is otherwise ready and has reason to want to prevent the presumptions from applying.

Certifying by April 1, 2011, does not prevent the employer from making the contribution by September 15, 2011, and the actuary certifying a revised AFTAP before October 1, 2011. The new certification date would generally be a new Section 436 Measurement Date and eliminate any restrictions in 2011 as of that date. Contributions after September 15, 2011, would not be deductible in 2010 nor help the AFTAP in 2011, although they would be deductible 2011 contributions that would help the 2012 AFTAP.

The inability to make contributions for the prior year after September 15 of the current year, combined with the inability of a plan to make specific contributions so as to eliminate the lump sum payment restrictions (discussed in the next section), may pose problems for plans that are trying to terminate late in the year. An employer that makes additional contributions after September 15 (so as to have sufficient assets to terminate a plan) may not be able to make full lump sum payments on plan termination if the certified AFTAP for the year is below 80 percent. (The additional contributions after September 15 would not increase the AFTAP.)

The IRS is aware of this issue, and it is likely that there will be additional guidance addressing it in the future. The issue is somewhat complicated by the interaction of the PBGC standard termination provisions that allow majority owners to agree to have their benefits ignored for purposes of determining whether a standard termination can occur and the IRS rules that prohibit participants (including majority owners) from waiving benefits (ignoring benefits for purposes of determining whether a standard termination can occur is not treated as a waiver). Another difficulty arises in the frequent situation in which the employer agrees to make whatever additional contributions are necessary to terminate the plan once calculations are complete. If the AFTAP is below 80 percent those contributions late in the year would not change the AFTAP so as to allow 100 percent termination lump sum payments. [70]

Elect to Make Specific Contributions[71]

An employer may make specific contributions in order to avoid any of the restrictions other than the restriction on lump sums. The amount of contribution the employer needs to make depends on whether the restriction occurred because the AFTAP was too low to start (in which case the contribution must result in the AFTAP reaching the desired level after the benefit increase, accrual, or shutdown benefit) or, in the case of amendments providing benefit increases or shutdown benefits, because the benefit increase or shutdown benefit would otherwise result in the AFTAP being too low (in which case only the employer must contribute only the full cost of the benefit increase or shutdown benefit).

The employer makes this election, like other elections, by providing the election in writing to the plan's enrolled actuary and plan administrator. The election, once made, is irrevocable. The payment must include appropriate interest, does not count for the minimum required contribution, and is not added to the

prefunding balance. It also appears that it does not create a new AFTAP for the year. It simply buys the way out of the restriction for the year. The regulations do not appear to address what this means. The regulations also do not address how quickly these contributions have to be made, whether they are considered made retroactively, and whether they can be made after October 1.

Elect to Provide Security[72]

PPA allows an employer to provide security to the plan solely for purposes of determining the AFTAP for benefit restrictions. The security is not considered as a contribution or asset for any other purpose (including the minimum funding requirements). The only permitted security is a bond issued by a corporate surety company or an escrow of cash or U.S. securities that mature in three years or less.

The employer must provide the security by the valuation date. While the valuation date must be the first date of the plan year (other than in small plans), the presumption rules treat the Section 436 Measurement Date as the valuation date for purposes of the lump sum and benefit accrual restrictions. (Because of different language, that does not appear to be the case for shutdowns and amendments increasing benefits.) The regulations simply provide that the employer must provide the security by the valuation date without addressing these distinctions.[73]

If the security is turned over to the plan, the amount of the security is treated as a contribution for all purposes when it is turned over to the plan. If the security is turned over to the plan through an enforcement mechanism, the contribution of the security is not treated as a specific contribution that would end the restrictions on shutdowns, amendments increasing benefits, or accruals.

Presumptions[74]

The AFTAP is a current year calculation by the plan's actuary. However, the actuary is unlikely to be able to make that certification on the first day of the plan year. PPA addresses this problem by setting up a series of presumptions as to what the AFTAP is prior to certification for the year.[75] For the most part, Congress left to the Treasury the job of making the presumptions work, and the proposed regulations try to make the PPA's general rules fit diverse situations.

January 1 of Year X[76]

The proposed regulations provide that the first day of the plan year (January 1) is a Section 436 Measurement Date. As of that date, the AFTAP for the current plan year (year X) is presumed to equal the certified AFTAP for the prior year (year X-1).[77] If the actuary has not certified an AFTAP for year X-1 as of January 1 of year X, the plan must treat the year X AFTAP as being less than 60 percent.

April 1 of Year X[78]

If the actuary still has not certified the year X-1 AFTAP on April 1 of year X, then the below 60 percent assumption continues until the actuary certifies the year X-1 AFTAP or the year X AFTAP. If the actuary has certified the year X-1 AFTAP, then that AFTAP (or that AFTAP minus 10 percentage points) is presumed to be the year X AFTAP. The 10 percentage point reduction applies if the year X-1 AFTAP was at least 60 percent but not 70 percent or at least 80 percent but not 90 percent. If the presumed year X-1 AFTAP is at least 70 percent but not 80 percent or is 90 percent or greater, the presumed AFTAP remains the year X-1 AFTAP (without subtraction of the 10 percentage points) until the earlier of when the actuary certifies the year X AFTAP or October 1 of year X.[79]

The plan must treat April 1 (or, if later, the date the actuary certifies the year X-1 AFTAP) as a Section 436 Measurement Date and must apply new restrictions if the 10 percentage point reduction lowers the presumed year X AFTAP sufficiently to trigger new restrictions (which will usually be the case).

October 1of Year X[80]

If the enrolled actuary does not certify the AFTAP for year X before October 1 of year X, October 1 becomes a Section 436 Measurement Date and, as of that date, year X's AFTAP is "conclusively

presumed" to be less than 60 percent.[81] In such a case, the presumption of less than 60 percent continues for the remainder of year X, even if the actuary certifies year X's AFTAP before the end of year X. It also continues to apply for the next year ("year X+1") if the actuary has not certified the AFTAP by December 31 of year X. Once the actuary certifies year X's AFTAP, whether before or after December 31 of year X, that AFTAP becomes the presumed AFTAP for year X+1.

Special Rules Where Presumptions Apply[82]

A plan must treat a presumed AFTAP the same as an actual AFTAP. Thus, the rules require the plan to automatically convert ("burn") the funding standard carryover balance and prefunding balance to assets if the conversion would be sufficient to increase the presumed AFTAP so that a restriction does not apply.[83] If the presumption that the AFTAP is below 60 percent results from the actuary not yet certifying the year X-1 AFTAP, no conversion takes place because the presumed year X AFTAP will continue to remain under 60 percent.

If the presumed year X AFTAP changes, the actuary must determine again whether conversion of balances would eliminate a restriction. For example, if the presumed year X AFTAP becomes 10 percentage points lower on April 1, the actuary must see if there is sufficient additional funding standard carryover balance or prefunding balance to avoid a restriction. If the plan must convert additional available balances to assets to avoid a restriction, the conversion must take place. If, when the actual AFTAP is determined (creating a new Section 436 Measurement Date), it turns out that actual AFTAP is lower than the presumed AFTAP and the plan has insufficient further balances to convert to prevent the restrictions, there is no "reclassification" of the amounts already converted to assets back to balances (*i.e.*, the adjustment is only in one direction).

Rules Where No Restrictions Apply at the End of Prior Year[84]

Lump Sums and Benefit Accruals

If there were no restrictions of any kind in place at the end of year X-1, the plan may not apply the restrictions on lump sums or benefit accruals as of January 1 of year X even if the plan anticipates that once the actuary actually certifies the AFTAP for the year there will be future restrictions. There is a special exception to this rule that provides that the plan may not pay lump sums during a period if the employer is in bankruptcy and the actuary has not certified the AFTAP for the year to be at least 100 percent. Once April 1 of year X occurs, the same rules apply in this situation as apply when there had been a restriction in place in year X-1.

Shutdown Benefits and Amendments Increasing Benefits[85]

If no restrictions were in place in year X-1 and a shutdown occurs on or after January 1 of year X, or the employer makes an amendment increasing benefits on or after such January 1, the year X-1 AFTAP is treated similar to a presumed AFTAP. If the increased liabilities from the occurrence of the event or the amendment lowers the presumed year X AFTAP enough (*i.e.*, below 60 percent or 80 percent, respectively), the plan must apply the restriction.

The employer may make specific contributions to pay for the shutdown benefit or amendment increasing benefits. If after the actual certification of the year X AFTAP, it turns out that the specific contributions were not all necessary, the actuary can classify the excess over what was necessary as contributions for the current year for purposes of the minimum required contribution.

Unlike the situation that applies when there is a restriction for year X-1 (so the presumptions apply on January 1 of the current year), a special rule applies when the benefit restrictions were not in place at the end of year X-1. If the year X-1 AFTAP restricts the payment of the shutdown benefit or the implementation of an amendment increasing benefits during year X,[86] the plan generally must reinstate the

applicable shutdown benefit or benefit increase retroactively if, when the actuary calculates the actual AFTAP for year X, it is at least 60 percent (for the shutdown benefit) or at least 80 percent (for the amendment increasing benefits).

If the plan is providing benefits with respect to one or more shutdown benefits or one or more amendments, the rules are applied to subsequent shutdowns or amendments by including the cost attributable to the earlier shutdown or amendment that would have increased benefits.

Actuarial Certifications

The certification of the AFTAP must be by an enrolled actuary. The actuary must make the certification in writing and provide it to the plan administrator. In doing the certification, the actuary may only take into consideration contributions already made by the time of the certification. The actuary may not anticipate contributions except for pre-2009 years (as discussed later in this article).[87]

The actuarial certification poses many dilemmas for the actuary because the restrictions go into place the day the actuary certifies the AFTAP. The only way the structure can administratively work is for the actuary to be talking with the plan administrator and employer with respect to the actuary's preliminary findings as to the AFTAP prior to the actual certification. Implementing a restriction such as a limit on lump sums takes time. In addition, there are certain elections that the employer can make (discussed earlier) with respect to using the balances or making additional contributions that would change the AFTAP or prevent a restriction from being applied.

It is unrealistic to assume that after the actuary tells the plan administrator and employer that there will have to be a restriction on lump sums the news would not leak. This could lead retirement eligible workers and those willing to separate from service accelerating their retirement or separation to try to get the lump sum before the restriction becomes effective.[88]

On the other side of the equation, what if the employer wants the actuary to delay a certification of a higher AFTAP so as to have an excuse to continue to restrict benefits? It remains unclear what obligations the actuary has under fiduciary law (most likely none) or under actuarial best practices to provide the certification as soon as possible. The employer has the ability to continue to avoid paying lump sums and to continue freezing accruals by delaying a certification showing the AFTAP had increased from the prior year. If an actuary refuses to cooperate, will the employer just find another actuary?

With time, these problems will no doubt get resolved, but 2008 promises some interesting issues.

Range Certifications[89]

The proposed regulations introduce a new concept that is not included in the statute. The regulations allow the actuary to certify at any time before October 1 that the AFTAP for the year will be in a specified range. The three ranges are: (i) at least 60 percent and less than 80 percent, (ii) 80 percent or higher, and (3) 100 percent or higher.[90]

Once the actuary certifies the range, it is as if the actuary had determined the year's AFTAP. This avoids the application of the presumptions (including the reduction of the prior year's AFTAP by 10 percentage points). As long as the actual AFTAP that the actuary certifies following the range certification is in the same range, the plan is fine. However, if the actual AFTAP is lower, the plan may find itself treated as retroactively violating the benefit restrictions. And if it is higher then the range-certified AFTAP, the plan may find that it improperly restricted benefits.

If the actuary makes a range certification, the plan is treated as having a certified AFTAP at the smallest value within the applicable range. For example, if the range certification is "60 percent to 80 percent," the plan is treated as having an AFTAP of 60 percent until the actuary makes the actual specific certification of the AFTAP. If during a range certification a shutdown occurs or the employer wants to amend the plan to increase benefits, the amount the employer must contribute to "pay" for the benefit would be based on the 60 percent. (In the case of an amendment, this would require contributions to get up

to 80 percent.) If when the actuary makes the certification of the specific AFTAP, part or all of the specific contribution would not have been needed, the plan may reclassify the extra contribution as a regular contribution.

As with the specific AFTAP certification, the actuary may not take into consideration for the range certification any contributions (including minimum required contributions) receivable for the year but not yet made.[91] In addition, if the certified specific AFTAP is not within the range, the plan faces difficulties if the difference causes a "material change."

There is a "material change" if plan operations with respect to benefits, taking into account any actual contributions and elections based on the range certification, would have been different based on the subsequent certified specific AFTAP. A material change results in the prior year's presumptions coming back into effect retroactively. It is as if the range certification was never made.

In the case of an immaterial change (*i.e.*, a change that is not a material change), the restrictions would only apply prospectively. The regulations treat as an immaterial change (and thus not retroactive) any change between the range certification and the specific certification that results from the employer making additional contributions or electing to convert balances to assets. Thus, the employer could make contributions for the prior plan year by September 15 of the current year to increase the specific AFTAP to bring it back into the certified range and avoid having a material change.

The range certification is useful only if the actuary is very certain of the range (generally, if the actuary is certain that the AFTAP will turn out to be in the higher part of the range). If there is any doubt, the actuary should not be making a range certification because the consequences to the plan are severe.

For example, if the actuary certifies a range of 60 percent to 80 percent, the plan has to make available 50 percent of the lump sum. If it later turns out that the actual certification is below 60 percent (out of the range), the plan would have violated the restrictions (and therefore the qualification rules of the Code and the requirements of ERISA) by paying 50 percent of the lump sum (payment of any part should have been prohibited).[92]

Special Situations—New Plans and Multiple Employer Plans[93]

Most of the benefit restrictions do not apply to plans in their first five years of existence (counting predecessor plans). The one exception is the restriction on lump sums, which does apply in the first five years.

The benefit restrictions generally apply to multiple employer plans as if each employer maintains a separate plan unless the plan predated 1989 and the plan did not elect employer-by-employer treatment. Thus, the benefit restrictions could apply differently to employees of different employers participating in the multiple employer plan. In the case of a non-electing plan, the rules would apply as if there were only one employer for the whole plan.

Notices

The proposed regulations do not address notices and thus are outside the scope of this article. However, plans are required to provide notice pursuant to new section 101(j) of ERISA. Even though the provision is in ERISA, the Secretary of the Treasury has the authority to issue guidance on when the plan must give the notice. Section 101(j) requires a notice to participants within 30 days after the plan becomes subject to a restriction on shutdown benefits or lump sums. In the case of freezing of accruals, the section provides that the notice must be given within 30 days after the valuation date for the year in which the AFTAP is less than 60 percent or, if earlier, deemed to be less than 60 percent. In the absence of regulations, it is not entirely clear how the timing of these two provisions differ.

While notices are not required until after the restriction, some employers for labor relations purposes

may find it useful to provide notices to participants ahead of time. In the case of lump sum restrictions, employers must weight the benefits of early notice against a concern that the notice could trigger retirements and separations by employees wanting a lump sum.

Effective Dates and Applicability[94]

The section 436 regulations are generally effective for plan years beginning on or after January 1, 2008. Although the regulations are not effective until at least the 2009 plan year, the regulations may be relied on in the interim.

Section 436 has a delayed effective date for collectively bargained plans until plan years beginning after the earlier of the termination of the collective bargaining agreement (if it is in effect before August 17, 2006—PPA's enactment date) or January 1, 2010. PPA also delays the new funding rules, including section 436, for multiemployer plans of rural electric cooperatives, rural telephone cooperatives, and rural agricultural cooperatives until plan years beginning after January 1, 2017; for "PBGC settlement plans" (essentially two specific plans that, because of how prior possible plan terminations were handled in negotiations with the PBGC, were able to get special consideration in the legislation), until plan years beginning after January 1, 2014; for large government defense contractors, until the earliest of the plan year beginning after they no longer meet the definition of eligible government contractor, the Cost Accounting Standards Pension Harmonization Rule is adopted by the Cost Accounting Standard Board (which PPA instructs CASA to adopt by January 1, 2010) or January 1, 2011. Certain airline plans and urban bus company plans have special rules.

Transition Rules

Special Rules for the 2007 AFTAP[95]

PPA is not effective until plan years beginning on or after January 1, 2008. However, the 2007 AFTAP can have a significant impact on what benefit restrictions apply in 2008. PPA left to the Treasury the determination of how the actuary must calculate the 2007 AFTAP. The proposed regulations contain special rules for this determination.

The actuary determines the 2007 AFTAP based on calculations the actuary is already making for 2007. The actuary uses the plan's 2007 "current liability" under the pre-PPA funding rules to determine liability for the 2007 AFTAP. The actuary uses the plan's 2007 actuarial value of assets under the pre-PPA funding rules (increased or reduced as appropriate so the value is not less than 90 percent or more than 110 percent of the market value of assets) to determine assets for the 2007 AFTAP. The actuary must reduce the value of assets by the plan's "credit balance" as of the beginning of 2007.[96]

Special Rules for the 2008–2010 AFTAP[97]

As discussed earlier, for purposes of determining the AFTAP, the actuary need not subtract from assets the funding standard carryover balance and prefunding balance if the FTAP (note that it is FTAP, not AFTAP, even though the rule only applies to benefit restrictions) for the year would be 100 percent without the subtraction. There is a special rule for 2008–2010. Under this rule, 92 percent, 94 percent, and 96 percent, respectively, are substituted for the 100 percent target percentage in the calculation of the FTAP. The rule is only available in 2009 if it was satisfied in 2008, and only available in 2010 if it was satisfied in both 2008 and 2009.

Restrictions in 2008

There is no prohibition in effect in 2007, so the rules that apply from January 1, 2008, to April 1, 2008, are the rules discussed earlier that apply to plans that have no restrictions in effect for the prior year. Thus, if the employer amends the plan to increase benefits or a shutdown occurs on or after January 1, 2008, the employer must use the prior year's AFTAP to determine whether the restrictions would apply. Further, if

when the 2008 AFTAP is certified, the AFTAP is sufficiently high to avoid a restriction, the plan must retroactively pay the shutdown benefit or implement the amendment increasing benefits. The rule, as discussed earlier, is different for the restrictions on lump sums and future accruals. These rules do not apply until April 1, 2008, and once applied have no automatic retroactive application.

Under the general rule, if the actuary does not certify the 2008 AFTAP before April 1, 2008, then the presumed AFTAP as of April 1, 2008, is the 2007 AFTAP minus 10 percentage points if the 2007 AFTAP is between 60 percent and 70 percent or 80 percent and 90 percent. Under a correction to the original proposed regulations, the 10 percentage point reduction also applies in 2008 if the 2007 AFTAP is between 70 percent and 80 percent.[98]

Contributions for 2006 and 2007

For purposes of determining a plan's 2007 AFTAP, the actuary may take into consideration anticipated contributions for the 2006 plan year made after the end of the 2006 plan year but within the permissible 8-1/2 month post-plan-year period for funding. The 2006 rule only has current applicability for some fiscal year plans. However, a similar rule applies for purposes of calculating the 2008 FTAP and AFTAP with respect to contributions made or reasonably expected to be made timely after the end of the 2007 plan year.[99]

Employers that make additional contributions for 2006 and 2007 that result in increased credit balances may elect to "convert" those balances (and any other credit balances that would otherwise be treated in 2008 as funding standard carryover balances) to assets. Without the election, the contributions would be part of the funding standard carryover balance as of 2008. If such an election is made, the conversion also applies for purposes of calculating the 2007 ratios (which are applicable to 2008 until the 2008 ratio is certified).[100]

Conclusion

The proposed regulations are very complex, reflecting a very complex statutory structure. The rules are only proposed, with a lot of open questions. However, the proposed regulations are what we have for the beginning of 2008 and, although only proposed, the IRS allows taxpayers to rely on them.

PPA made dramatic changes for those sponsoring or advising on defined benefit plans. The funding rules have significant implications for what benefits plans can pay and what accruals can take place. They also limit the employer's ability to increase benefits. These are issues that affect the plan's qualification and the plan's risk to lawsuit under Title I of ERISA. These are not issues that can be left solely to the plan's actuary.

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[1] PPA also includes new rules for multiemployer plans. The new multiemployer funding rules, in essence, give financially troubled multiemployer plans more time than under prior law to get funded. This article does not address the multiemployer plan rules.

[2] There is a natural ebb and flow to plan funding over the long term because the funding percentage is so dependent on the interest rate and the equity markets. This ebb and flow also applies to the PBGC's deficit, which is expressed in present value terms. The PBGC's deficit for the 2007 fiscal year (ending September 30, 2007) was just over $13 billion, down from just over $23 billion at its maximum. The improvement almost entirely reflects higher interest rates and equity values (since the new PPA's rules were not yet effective).

[3] The PBGC maintains private trust funds funded by premiums from plan sponsors, the assets of the plans that the PBGC trustees, and investment income. The full faith and credit of the government does not stand behind the PBGC's obligations. However, most analysts believe that if the PBGC could not pay benefits, Congress would pass legislation giving the PBGC federal assets.

[4] Code § 412, as in effect pre-PPA.

[5] Code §§ 401(a)(29) and (33).

[6] Code § 401(a)(32).

[7] Code §§ 430 and 436.

[8] The Treasury has reserved how the benefit restrictions apply to small plans that are allowed to use non-first day of the year valuation dates until Congress passes a pending technical correction providing the Treasury with more flexibility.

[9] Code § 430(f)(1) and Prop. Treas. Reg. § 1.430(f)-1(b)(1) and (2).

[10] Code § 430(f)(8) and Prop. Treas. Reg. § 1.430(f)-1(b)(3).

[11] The credit balance was based on assumed earnings, and in years when the plan had negative or low earnings—as happened during the early years of this century—the value of the credit balance substantially differed from the value of the actual assets in the plan.

[12] The funding standard carryover balance, which is the old credit balance and thus an artificial number because it had grown before 2008 using assumed interest, must be used up first before the prefunding balance can be used. *See* Prop. Treas. Reg. § 1.430(f)-1(e)(2).

[13] Code § 430(f)(3) and Prop. Treas. Reg. § 1.430(f)-1(d)(3).

[14] Code § 430(i).

[15] Code § 430(d)(2).

[16] Code § 430(f)(4) and Prop. Treas. Reg. § 1.430(f)-1(d)(2).

[17] *See* Code § 430(f)(4)(C) and Prop. Treas. Reg. § 1.430(f)-1(c)(2). There is a third exception that allows the actuary to avoid subtracting either balance in the few situations where the plan has a binding written agreement with the PBGC not to use credit balances to pay minimum contributions. These agreements generally resulted from the PBGC negotiating with the employer that the employer would make additional contributions to a poorly funded plan and agree not to use those contributions (which became credit balances) in lieu of cash contributions to meet future minimum funding requirements (at least for a set number of years). *See* Code § 430(f)(4)(B)(ii) and Prop. Treas. Reg. § 1-430(f)-1(c)(3).

[18] Code § 430(f)(5) and (6) and Prop. Treas. Reg. § 1.430(f)-1(f).

[19] Once a balance is treated as part of the assets, it is not available (even if the plan's FTAP is over 80 percent) to offset future minimum required contribution obligations, but it does go to increasing the assets for the FTAP calculation and for determining the shortfall between target liabilities and assets.

[20] It will generally be best for the employer to elect prefunding balance treatment unless the employer needs the assets in 2009 to reach an 80 percent FTAP for 2009.

[21] The plan must use the funding standard carryover balance first. The funding standard carryover balance is the old credit balance. It was accumulated under the old rules (assumed earnings) and is not subtracted from assets in certain cases, so the goal is to use it up first. *See* Code § 430(f)(3) and Prop. Treas. Reg. § 1.430(f)-1(e)(2).

[22] Note that the plan sponsor must make this election earlier than the election to treat additional contributions as adding to the prefunding balance.

[23] Prop. Treas. Reg. § 1.430(f)-1(a)(2).

[24] A multiple employer plan differs from a multiemployer plan. Both involve two or more employers, but the multiple employer plan is treated as a single employer plan for the funding rules. A multiemployer plan, which in addition to the two or more employers also involves a union and generally joint trusteeship, has its own funding rules. The very different funding rules for multiemployer plans are not discussed in this article.

[25] PPA § 102(c) and Prop. Treas. Reg. § 1.430(f)-1(h).

[26] Under PPA, employers may deduct an amount equal to the amount needed to reach the funding target for the year plus the target normal cost for the year plus a cushion amount. The cushion amount equals 50 percent of the funding target for the year plus the increase in the target based on projected future increases in compensation. In the case of PBGC-covered plans, in including compensation increases, the actuary may ignore the considered compensation limit of section 401(a)(17) and the benefit limit of section 415(b). *See* Code § 404(a)(1) and (o). In addition, contributions to PBGC-covered plans are ignored for purposes of the combined limit. *See* Code § 404(a)(7).

[27] Under prior law employers and unions had an incentive to allocate more of the negotiated increase to wages and health care costs than to pension contributions because pensions were a long-term cost and the PBGC guarantee was there as a backstop. PPA was intended to change that equation.

[28] PPA includes an additional restriction, but it is under Code § 409A. If any plan of any member of a controlled group is in "at risk" status under Code § 430(i), no member of the controlled group can fund any rabbi trust for, or restrict any assets to pay nonqualified deferred compensation to, employees subject to

Code § 162(m) or § 16(a) of the Securities Act of 1934. The provision also applies to situations where the plan sponsor is in bankruptcy and to the six-month periods before and after the date of plan termination of a plan terminating with insufficient assets under Title IV of ERISA *(i.e.*, in a distress or involuntary termination). *See* Code § 409A(b)(3).

[29] Code § 436(b) and Prop. Treas. Reg. § 1.436-1(b).

[30] Code § 436(c) and Prop. Treas. Reg. § 1.436-1(c).

[31] Code § 436(d) and Prop. Treas. Reg. § 1.436-1(d).

[32] Code § 436(e) and Prop. Treas. Reg. § 1.436-1(e).

[33] Many have called the period in the early years of this century when interest rates dropped (increasing liabilities) and the stock market fell (decreasing the value of assets in plans heavily invested in equities) the "perfect storm" in that the two situations were the worse possible scenario for defined benefit plans.

[34] Prop. Treas. Reg. § 1.436-1(j)(4).

[35] Prop. Treas. Reg. § 1-436-1(j)(2) and (3).

[36] Prop. Treas. Reg. § 1.436-1(j)(2)(ii). There is also a special transition rule for 2008–2010, which is discussed in the transition section. Under this rule, a plan may substitute 92 percent of the target liability for 100 percent for 2008, and substitute 94 percent in 2009 and 96 percent in 2010.

[37] Prop. Treas. Reg. § 1.436-1(h)(4)(i)(B).

[38] Code § 436(b) and Prop. Treas. Reg. § 1.436-1(b).

[39] Code § 412(l).

[40] Code § 436(c) and Prop. Treas. Reg. § 1.436-1(c).

[41] There is a partial restriction on lump sum payments if the plan is funded between 60 percent and 80 percent.

[42] Code § 436(d) and Prop. Treas. Reg. § 1.436-1(d).

[43] Code § 3405(c)(2).

[44] Code § 401(a)(31).

[45] When a plan is less than 100 percent funded, decreasing the numerator (assets) and the denominator (liabilities) of the funding ratio by the same amount decreases the funding ratio. For example, assume assets were $700 and liabilities were $1,000. If the plan pays a lump sum of $500, the funding ratio would go from 70 percent to 40 percent.

[46] ERISA § 4022 and PBGC Reg. § 4022.7. The PBGC guarantee varies with the participant's age at the later of the date of plan termination and the date the participant commences benefits.

[47] There is a special exception that allows a plan that was frozen for accruals as of September 1, 2005, to pay lump sums.

[48] 72 Fed. Reg. 50555 (Aug. 31, 2007).

[49] A similar prohibition applies to payments to the beneficiary, such as payments for a qualified preretirement survivor annuity ("QPSA").

[50] This is the case if such a deferral would not violate a qualification requirement such as the Code § 415(b) 100 percent of compensation limit or the Code § 411 forfeiture prohibitions.

[51] A Social Security supplement is an additional payment that the plan makes until the participant is eligible for Social Security. A Social Security Leveling Option is not an additional payment. It accelerates part of the accrued benefit to the earlier years so that the participant will receive the same combined monthly payment both before and after starting Social Security payments.

[52] TU 07-4 states that the PBGC will calculate the maximum present value by applying Code § 417(e) to the monthly guarantee limit. The PBGC will use the applicable interest rate for the previous August so it can publish the table before the end of the year. The PBGC will calculate the maximum present value as the greater of the present value (using section 417(e)) of the monthly guarantee commencing immediately or commencing at age 65. Because the PBGC does not reduce its monthly benefit guarantees in accordance with section 417(e), in some cases the present value of the immediate maximum annuity will be greater, and in some cases the present value of the age 65 maximum annuity will be greater. Whichever is greater will depend on the participant's age and the interest rate that applies under section 417(e) for that year.

[53] Code § 436(i) and Prop. Treas. Reg. § 1.436-1(a)(4).

[54] Of course, if the plan did not provide for lump sums before the restriction, or the plan only provided for *de minimis* lump sums before the restriction, nothing in PPA requires the plan to change its lump sum provision to offer additional lump sums.

[55] Code § 436(d)(2) and Prop. Treas. Reg. § 1.436-1(d)(2).

[56] Code § 436(e) and Prop. Treas. Reg. § 1.436-1(e).

[57] Treas. Reg. § 1.436-1(a)(4)(ii)(B).

[58] It is not totally clear from the regulations whether the methods below result in a new certified AFTAP (and new Section 436 Measurement Date) or just remove a restriction. It appears that the conversions, both required and voluntary, should be done before the AFTAP is certified. If so, the issue is moot. It also appears that making specific contributions is after the AFTAP is certified (otherwise you could wind up with two AFTAPs when lump sums are involved, because specific contributions cannot be used to eliminate lump sum restrictions).

[59] *See* the discussion on "elections" above, under the Code § 430 discussion, for rules on what is a "timely" election.

[60] Code § 430(f)(5) and Prop. Treas. Reg. §§ 1.430(f)-1(e) and 1.436-1(f)(1).

[61] Code § 436(f)(6) and Prop. Treas. Reg. §§ 1.430(f)-1(e) and (f) and 1.436-1(f)(2).

[62] Code §§ 436(b)(2), (c)(2), and (e)(2) and Prop. Treas. Reg. § 1.436-1(f)(2).

[63] Code § 436(f)(1) and Prop. Treas. Reg. § 1.436-1(f)(3).

[64] Code § 436(f)(3) and Prop. Treas. Reg. § 1.436-1(a)(5)(i).

[65] It is likely that if the technical discussed earlier making an exception from the lump sum restriction for *de minimis* lump sums is enacted, this provision would be applied by treating a plan that makes only non-*de minimis* lump sums as not providing for lump sums.

[66] This is the same definition of "collectively bargained" that is used for the effective date provision.

[67] Code § 430(f)(5) and Prop. Treas. Reg. §§ 1.430(f)-1(e) and 436-1(f)(1).

[68] Code § 436(f)(6) and Prop. Treas. Reg. §§ 1.430(f)-1(e) and (f) and 1.436-1(f)(2).

[69] Prop. Treas. Reg. § 1.436-1(h)(4)(i)(B).

[70] PBGC Reg. § 4021.21(b) and Prop. Treas. Reg. § 1.411(a)-4(a). The inability to waive benefits or to count unpaid contributions other than to determine whether a standard termination can occur under ERISA Title IV would seem to mean that those benefits may not be disregarded and those assets not included for purposes of certifying the AFTAP in the year of plan termination. In the case of contributions, any contribution actually made after September 15 is not going to be treated as a contribution for the prior year. Thus, contributions made after September 15 of the current year will not affect the current year AFTAP with respect to the plan's ability to pay lump sums (because no specific contributions are allowed to eliminate a lump sum restriction).

[71] Code § 436(b)(2), (c)(2), and (e)(2) and Prop. Treas. Reg. § 1.436-1(f)(2).

[72] Code § 436(f)(1) and Prop. Treas. Reg. § 1.436-1(f)(3).

[73] The preamble is not much more help. *See* 72 Fed. Reg. 50551–50552.

[74] Code § 436(h) and Prop. Treas. Reg. § 1.436-1(h).

[75] The presumptions do not apply for purposes of prohibited payments in a year when the employer is in bankruptcy. In that case the plan may not make any prohibited payments until the actuary certifies that the AFTAP is at least 100 percent.

[76] Prop. Treas. Reg. § 1.436-1(h)(1).

[77] Technically, this presumption only applies where the plan was subject to a benefit restriction on the last day of the prior year. Where there was no benefit restriction for the prior year, the result for the January 1 to April 1 period (or earlier if the actuary certifies for the current year earlier) is slightly different. This is discussed below.

[78] Prop. Treas. Reg. § 1.436-1(h)(2).

[79] With a very minor exception, a reduction of 10 percent in the presumed funding ratio has no impact when the ratio is below 70 percent and 80 percent or when it is over 90 percent after 2008. As will be discussed below, it does have an impact in the 70 percent to 80 percent range in 2008. As a result, the Treasury has issued a correction to the proposed regulation. The correction applies the 10 percentage point reduction to the presumed AFTAP in 2008 if the 2007 AFTAP was in the 70 percent to 80 percent range.

[80] Prop. Treas. Reg. § 1.436-1(h)(3).

[81] Note that the presumption is not that the AFTAP continues to be the prior year's AFTAP, but rather that the AFTAP is treated as being less than 60 percent.

[82] Prop. Treas. Reg. § 1.436-1(g)(2).

[83] As discussed above, this is the case for all restrictions in collectively bargained plans and the rule for lump sums in all plans.

[84] Prop. Treas. Reg. § 1.436-1(g)(3) and (5).

[85] Prop. Treas. Reg. § 1.436-1(g)(3), (4), and (5).

[86] This seemingly would apply only after April 1 if there is a 10 percentage point reduction.

[87] Prop. Treas. Reg. § 1.436-1(h)(4)(i).

[88] The employee's annuity starting date would have to be before the AFTAP was certified. Whether this is easily accomplished depends on the language of the plan. For example, if plans pay as of the first day of the month following retirement or separation, that first day is the annuity starting date. Thus, anyone who retires or separates during a month would not be able to receive a lump sum if the actuary certified before the end of the month.

[89] Prop. Treas. Reg. § 1.436-1(h)(4)(ii).

[90] It does not appear that the regulations allow the actuary to do a range certification that the AFTAP is below 60 percent in order to start the restrictions early.

[91] There is an exception to this for 2007 and 2008 AFTAPs.

[92] Currently, there is no indication as to how the IRS will apply its correction program to failures to pay benefits or the payment of impermissible benefits because of mistaken AFTAPs. There is also the continuing concern of participant suits under Title I of ERISA.

[93] Code § 436(g) and Prop. Treas. Reg. § 1.436-1(a)(3).

[94] PPA § 113 and Prop. Treas. Reg. § 1.436-1(k).

[95] Code § 436(k) and Prop. Treas. Reg. § 1.436-1(j)(2)(iii).

[96] Achieving a 90 percent 2007 funding ratio (under the pre-PPA rules) has the advantage of keeping the plan out of the DRC funding requirements for 2007, which makes the plan eligible for the reduced (from 100 percent) target liability percentage used to determine whether a shortfall amortization base must be established for the 2008 (92 percent of target liability), 2009 (94 percent), and 2010 (96 percent) years. *See* Code § 430(c)(5).

[97] Code § 436(j)(3) and Prop. Treas. Reg. § 1.436-1(j)(ii)(2).

[98] The regulations published on August 31, 2007, did not include this rule. The IRS published a correction on November 9, 2007 (72 Fed. Reg. 63528).

[99] Prop. Treas. Reg. § 1.436-(h)(4).

[100] Prop. Treas. Reg. § 1.436-1(j)(2)(iii)(3).