

IRS Proposed Regulations on PPA Funding-Based Benefit Limitations: Buck's Reading of the Fine Print

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Internal Revenue Code Section 436, added by the Pension Protection Act of 2006 (PPA), limits the ability of underfunded single-employer and multiple-employer defined benefit plans to make benefit improvements, pay "accelerated" benefits (e.g., lump sums), accrue additional benefits, or pay unpredictable contingent event benefits. These provisions are generally effective in 2008 for non-collectively bargained plans.

The IRS has issued proposed regulations under Section 436. Plan sponsors may rely on these proposed regulations until final regulations are issued — which is not likely until 2008.

This *InsightOut* summarizes a [For Your Information](#) published October 4, 2007 entitled *IRS Proposed Regulations on Funding Balances and Benefit Restrictions Under PPA*, and elaborates on five aspects of the proposed regulations:

- The funding level calculation
- The limitations on benefit increases, accelerated benefit payments, benefit accruals, and unpredictable contingent event benefits
- How plan sponsors may avoid the limitations
- The dates during the plan year on which these limitations would apply
- What plan sponsors can expect in 2008

Importantly, legislation has recently been introduced in the House (H.R. 3868) that would delay the effective date of the PPA funding rules, including the benefit limitation provisions, for at least one year (i.e., until at least 2009 plan years). As of the date of this article, the likelihood of passage is uncertain. Unless and until such legislation passes, plan sponsors should prepare for complying with the PPA benefit limitation provisions.

FUNDING LEVEL CALCULATION DEFINED AND EXPLAINED

The funding level for purposes of applying the benefit limitations is the adjusted funding target attainment percentage (AFTAP). The proposed regulations require the AFTAP to be certified by the plan's enrolled actuary in writing to the plan administrator.

The AFTAP is generally the ratio of the value of plan assets (less prefunding and funding standard carryover balances created by contributions in excess of the minimum required amount) to the plan's PPA funding target at the beginning of the plan year.

The prior year's AFTAP is used to determine if any limitations apply until the plan's actuary has certified the current year's AFTAP. For the first year that the PPA funding rules apply (generally the 2008 plan year), the prior year AFTAP would be based on the plan's current liability determined under pre-PPA rules. In addition, the value of assets, before subtracting any credit balance, would be required to be within 10 percent of the market value and could include contributions made, or anticipated to be made, during the current plan year for the prior plan year.

THE LIMITATIONS EXPLAINED

Table 1 summarizes the limitations that apply at various funding levels. PPA provides that plan participants must generally be notified within 30 days after a benefit limitation applies.

Table 1 |

Funding Level	Applicable Limitations
Less than 80% but at least 60%	<ul style="list-style-type: none"> No plan amendments increasing benefits, except for increases in non-pay-related benefits reflecting actual pay increases Limited payment of lump sums and other accelerated forms of payment
Less than 60%	<ul style="list-style-type: none"> No plan amendments increasing benefits No lump sums or other accelerated forms of payment No further benefit accruals No unpredictable contingent event benefits

Limitations on Benefit Increases

PPA provides that a plan may not be amended to increase plan liabilities by increasing benefits, establishing new benefits, or changing the rate of vesting (unless required by changes in the Code or ERISA) if the AFTAP is less than 80 percent (taking into account the increased benefits). This limitation does not apply to benefit increases resulting from pay increases, or improvements to non-pay-related benefits as long as the improvements reflect the average pay increases of the plan's participants since the last benefit increase.

Limitations on Accelerated Benefit Payments

In general, accelerated benefit payments are benefits that exceed the monthly single life annuity amount (e.g., a lump sum or Social Security leveling option). PPA prohibits plans from making accelerated benefit payments if the plan's AFTAP

is less than 60 percent, and limits accelerated benefit payments if the plan's AFTAP is at least 60 percent but less than 80 percent. Bankrupt sponsors would not be permitted to pay any accelerated benefit payments unless the AFTAP is at least 100 percent.

- AFTAP less than 60 percent.* A plan may not make any accelerated benefit payments if the AFTAP is less than 60 percent. The proposed regulations provide that if a participant requests a prohibited distribution, the plan would have to permit the participant to elect another form of benefit or to defer payment to a later date.
- AFTAP at least 60 percent but less than 80 percent.* In this case, accelerated benefit payments would be restricted to one-half of the value of the accrued benefit, or the present value of the participant's PBGC maximum guaranteed benefit if less. Under the proposed regulations, a plan would have to permit the participant to elect to either defer payment to a later date, or split the benefit into restricted and unrestricted portions. If the participant elects to split the benefit, the plan would have to permit the participant to elect another form of benefit for the unrestricted portion. A plan may provide other options, such as permitting the unrestricted portion to be paid in an optional form while permitting the restricted portion to be deferred to a later date (if not in violation of other legal requirements).

Although not addressed in the proposed regulations, a PPA technical corrections bill currently in Congress provides an exception to this limitation for involuntary cash-outs (e.g., \$5,000 or less).

Limitations on Benefit Accruals

PPA provides that benefit accruals under a plan must cease if the AFTAP is less than 60 percent.

Limitations on Unpredictable Contingent Event Benefits

PPA prohibits a plan from paying any benefit or increasing benefits payable as a result of an unpredictable contingent event if the AFTAP for the plan year is less than 60 percent (taking into account the value of the unpredictable contingent

event benefits). Under the proposed regulations, an unpredictable contingent event would include a full or partial plant shutdown or similar event, or an event other than the attainment of age, performance of service, receipt of compensation, death or disability.

The proposed regulations provide that the limitation on unpredictable contingent event benefits depends on the AFTAP when the event occurs. So, if no limitation applies at the time of an unpredictable contingent event, benefits triggered by the event could still be paid in later years regardless of the plan's AFTAP at the time of payment. Conversely, if the limitation applies when an unpredictable contingent event occurs, payments triggered by the event would still not be permitted in later years, even if the limitation would no longer apply in those later years.

AVOIDING THE LIMITATIONS

The proposed regulations outline four methods that plan sponsors can use to avoid a benefit limitation:

- *Surrender prefunding and/or funding standard carryover balances.* Funding balances are created when a plan sponsor makes contributions in excess of the minimum required amount and normally can be used to reduce future required contributions. Giving up the ability to use funding balances to reduce future contributions will increase the assets taken into account in determining the AFTAP, which may increase the AFTAP sufficiently to avoid the application of a limit.

Importantly, PPA requires that funding balances be surrendered if doing so would avoid the limitation on accelerated benefits. Collectively bargained plans are further required to surrender funding balances to avoid any of the other benefit limitations.

- *Make additional contributions for a prior plan year.* Contributions made before the deadline for making prior year contributions will increase the assets taken into account in determining the AFTAP if the plan sponsor elects not to use these contributions to increase the prefunding balance. This method may be used to raise the

AFTAP to 60 percent or 80 percent and avoid a limitation.

In determining the AFTAP, the value of assets would not be reduced by prefunding and funding standard carryover balances if the unadjusted funded ratio (without reducing assets by funding balances or adjusting for annuity purchases) is at least 100 percent (phased in from 90 percent in 2007 to 100 percent in 2011). It may be possible that contributions necessary to bring the AFTAP to this phased-in percentage — which would avoid all limitations — may be less than the amount necessary to raise the AFTAP to either 60 percent or 80 percent.

- *Provide security.* Instead of making plan contributions, the plan sponsor may provide security that could be treated as a plan asset for determining the plan's AFTAP. The security must be either (i) cash or U.S. government securities held in escrow by a bank or insurance company and maturing in three years or less, or (ii) a bond issued by a surety company.
- *Make additional contributions for the current plan year that are specifically designated to avoid a limitation.* Contributions can be irrevocably designated for the purpose of avoiding a benefit limitation, other than the limitation on making accelerated benefit payments, as follows:
 - A plan with an AFTAP less than 80 percent can avoid the limitation on plan improvements by making a designated contribution equal to the cost of the improvements.

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- Similarly, a plan with an AFTAP less than 60 percent could pay unpredictable contingent event benefits after making a designated contribution equal to the cost of those benefits.
- If a plan improvement would reduce the AFTAP from 80 percent or more to below 80 percent, a designated contribution sufficient to increase the post-amendment AFTAP to 80 percent will avoid the limitation on plan improvements.
- Likewise, if an unpredictable contingent event benefit would reduce the AFTAP from 60 percent or more to below 60 percent, a designated contribution sufficient to increase the AFTAP (adjusted for the value of the additional benefits) to 60 percent will avoid the limitation on these benefits.
- Finally, a plan with an AFTAP less than 60 percent can continue benefit accruals by making a designated contribution sufficient to increase the AFTAP to 60 percent.

These designated contributions would not count toward satisfying current or future minimum required contributions.

There is an important exception to these rules for the 2008 plan year: during the first three months of the plan year, there are no limitations on accelerated payments or benefit accruals, regardless of the 2007 AFTAP.

WHEN THE LIMITS APPLY

If the current year's AFTAP is certified by the first day of the tenth month of the plan year, any resulting limitations take effect on the date of certification. Until then, the AFTAP is presumed to be as shown in Table 2, with any resulting limitations becoming effective as shown.

Table 2 |

Effective Date	Presumed AFTAP
First day of plan year	Prior year AFTAP if certified, otherwise less than 60%
First day of fourth month of plan year	Prior year AFTAP minus 10% if certified, otherwise less than 60%
First day of tenth month of plan year	Less than 60% for remainder of plan year, even if current year AFTAP is later certified

There is an important exception to these rules for the 2008 plan year: during the first three months of the plan year, there are no limitations on accelerated payments or benefit accruals, regardless of the 2007 AFTAP. Furthermore, plans may not apply these limitations during this time based on an expectation that the limits will apply when the 2008 AFTAP is certified.

WHAT PLAN SPONSORS CAN EXPECT IN 2008

The proposed rules are very complex and may have some unanticipated effects, especially during the period before the 2008 AFTAP has been certified. For example, the situations outlined in Table 3 may require additional employer contributions and/or surrender of funding balances to avoid potential limitations during this time. Note that a funding balance that is surrendered based on the 2007 AFTAP cannot be recovered even if the actual 2008 AFTAP would not have required surrender.

Table 3 |

2007 AFTAP*	Potential Limitation	Effective
Less than 90%	Lump sums (partial limitation) and plan improvements	Fourth month of plan year
Less than 80%	Plan improvements	First day of plan year
Less than 70%	Plant shutdown benefits, lump sums, and additional accruals	Fourth month of plan year
Less than 60%	Plant shutdown benefits	First day of plan year

*Adjusted for any plan improvements or shutdown benefits

CONCLUSION

Clearly, the new rules will require plan sponsors to coordinate closely with the plan actuary and administrator to avoid unforeseen problems. For example, for calendar year plans:

- A plan that offers lump sums and has a 2007 AFTAP of less than 90 percent may be required to irrevocably surrender a funding balance on April 1, 2008, even if the 2008 AFTAP is later certified to be over 80 percent.
- A plan that has a 2007 AFTAP of less than 70 percent will need to make additional 2007 contributions and/or surrender a funding balance before April 1, 2008 in order to avoid a benefit freeze, unless the 2008 AFTAP has been certified to be over 60 percent before then.

The proposed rules have far-reaching effects on plan administration. Now is the time to determine the potential problems that may lie ahead and develop strategies for possible outcomes.

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