GRIST InDepth: Funding strategies for DB pension plans to avoid lump sum and accrual restrictions – revised

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In This Article
Summary | Now employers can finalize 2006-7 contribution strategies | Key findings | Overview of lump sum and benefit accrual restrictions | Practical implications of AFTAP certification timing rules | Strategies to avoid restrictions in 2008 | Strategies to avoid restrictions after 2008 | Special issues for plans with significant credit balances | More to come | Appendix – AFTAP and presumed AFTAP calculation rules

Summary

Many pension plan sponsors are committed to funding their plans sufficiently to avoid the Pension Protection Act's restrictions on lump sums, continued benefit accruals, plant shutdown benefits, and benefit enhancements. With the recent release of IRS proposed regulations, these employers can now decide on their final contributions for the 2006 plan year – due September 14 for calendar-year plans – and develop a 2007 funding strategy. This article describes strategies employers can use to avoid restrictions on lump sums (and other accelerated distributions) and benefit accruals in 2008 and beyond, including special issues for plans with significant credit balances. Future articles will cover plan operations under the lump sum and benefit accrual restrictions and analyze the different PPA restrictions on shutdown benefits and plan amendments improving benefits. *Note: This article has been revised to fix the first table.*

Now employers can finalize 2006-7 contribution strategies

Starting with the 2008 plan year (delayed for some collectively bargained plans), qualified single-employer and multiple employer defined benefit (DB) plans must meet specified funding thresholds in the current or prior year to pay lump sums or other accelerated distributions, provide continued benefit accruals, pay plant shutdown benefits, or implement amendments improving benefits. Employers committed to funding their plans sufficiently to avoid these Pension Protection Act (PPA) restrictions can rely on IRS proposed regulations, published August 31, to decide on their final contributions for the 2006 plan year – due September 14 for calendar-year plans – and develop a 2007 funding strategy. The proposed rules detail how the benefit restrictions will work in 2008 and later plan years and provide related rules for building and "burning" credit balances. Later this year, the IRS intends to propose additional rules addressing other aspects of the PPA.

This article offers strategies employers can use to avoid restrictions on accelerated distributions and benefit accruals in 2008 and beyond, including special issues for plans with significant credit

balances. It does not address lump sum restrictions that apply when the plan sponsor is in bankruptcy. Future articles will cover plan operations under the lump sum and benefit accrual restrictions and analyze PPA's restrictions on shutdown benefits and plan amendments improving benefits, which work differently from lump sum and accrual restrictions.

A note on terminology. PPA's restrictions on accelerated distribution restrictions apply to lump sums, annuity purchases, installment payments for a fixed period, Social Security level income options, and any other option that pays out faster than a single-life annuity. This article uses the term "lump sum" to describe all accelerated payment types, but readers should bear in mind that other payment options also may be restricted, depending on the plan design.

Key findings

Here, in a nutshell, are key findings on lump sum and benefit accrual restrictions under the proposed IRS regulations (the dates below should be adjusted for plans with delayed benefit restriction effective dates):

- All plans – regardless of funded status – can avoid these restrictions for the first three months of the 2008 plan year.

- By the start of the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans), all plans must obtain an actuary's certification of the 2007 lookback adjusted funding target attainment percentage (AFTAP) or the 2008 AFTAP to avoid a plan freeze and total cessation of lump sums.

- Assuming the plan obtains a timely 2007 lookback AFTAP certification, the certified percentage determines the benefit restriction consequences for the next six months (April 1 – September 30, 2008 for calendar-year plans). These consequences are counterintuitive due to an odd loophole in the proposed regulations (the IRS may not have intended these results and could plug the loophole in final regulations):

  - Plans can avoid restrictions for this six-month period if the 2007 lookback AFTAP is: (i) at least 90%, (ii) at least 70% but less than 80%, or (iii) less than 60%. But if final regulations plug the loophole in the proposed rules, plans in the last two categories might need a 2008 AFTAP certification by the start of the fourth month of the plan year, as described below.

  - A plan with 2007 lookback AFTAP of at least 80% but less than 90% (at least 70% but less than 90% if the IRS modifies the final regulations) will be subject to partial lump sum restrictions at the start of the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans) unless, on or before that date, an actuary certifies that the plan's 2008 AFTAP is at least 80%.

  - A plan with 2007 lookback AFTAP of at least 60% but less than 70% (or less than 70% if the IRS modifies the final regulations) must freeze benefits and stop paying lump sums at the start of the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans) unless, on or before that date, an actuary certifies that the plan's 2008 AFTAP is at least 80% (allowing continued accruals and unlimited lump sums) or at least 60% (allowing continued accruals but only partial lump sums).

- To avoid lump sum and benefit accrual restrictions starting the first day of the 10th month of the 2008 plan year (October 1, 2008 for calendar-year plans), all plans must obtain, on or before that date, an actuary's certification that their 2008 AFTAP is at least 80% (allowing continued accruals and unlimited lump sums) or at least 60% (allowing continued accruals but only partial lump sums).

- After 2008, employers can use two different strategies to avoid lump sum and benefit accrual restrictions, representing a trade-off between lower versus more predictable contributions.

- Employers that want to preserve large credit balances in plans that pay lump sums or other accelerated distribution options will need to fund their plans to at least 92% in 2008, 94% in 2009, 96% in 2010, and 100% thereafter.

Overview of lump sum and benefit accrual restrictions

The PPA requires plans less than 60% funded to freeze benefits and stop paying lump sums. Plans at least 60% but less than 80% funded may continue accruing benefits, but may pay only partial lump sums. Additional lump sum restrictions – not covered in this article – apply if the sponsor is in bankruptcy. These restrictions generally apply starting in the 2008 plan year, with some exceptions:

- **Collectively bargained plans.** The effective date may be delayed as much as two years for collectively bargained plans, depending on when bargaining agreements expire (see *Collectively bargained plans* for details).

- **Certain defense contractor, rural cooperative, and PBGC settlement plans.** Delayed effective dates apply to plans sponsored by certain large defense contractors, multiple employer plans of some rural cooperatives, and PBGC settlement plans.

- **New plans.** Benefit accrual restrictions do not apply to new plans for the first five years (plans must be aggregated with any predecessor plans in applying this rule), although lump sum restrictions apply immediately.

- **Frozen plans.** Plans frozen by September 1, 2005 – with no accruals for any participants, including cost-of-living increases in the 415 limits – are not subject to lump sum restrictions.

To avoid lump sum and benefit accrual restrictions entirely, employers must contribute enough to keep their plans at least 80% funded, year in and year out. But employers willing to fund at this level must still navigate a labyrinth of complex rules. This section summarizes the proposed rules that dictate the action steps employers must take to avoid restrictions. Later sections discuss the practical implications of these rules and specific funding strategies for avoiding restrictions. The *Appendix* details the AFTAP calculation and the presumed AFTAP rules.

AFTAP. The *Appendix* describes in detail the calculation rules for this funded status measure, which determines whether benefit restrictions apply, but two rules are particularly important for employers' contribution strategies:

- **Credit balance.** Any credit balance is generally subtracted from plan assets in calculating the AFTAP, unless the AFTAP is at least 100% before such subtraction. The 100% funding threshold is phased in over four years – 92% in 2008, 94% in 2009, 96% in 2010, and 100% thereafter – but to take advantage of the phase-in threshold after 2008, the plan must have met the phase-in threshold in each prior year. When a plan falls short of these funding thresholds, the credit balance is deemed waived (and not subtracted from plan assets) if this would enable the plan to avoid lump sum restrictions (or to avoid benefit accrual restrictions if the plan is collectively bargained). Therefore, meeting these phase-in thresholds will be especially important for employers that want to preserve large existing credit balances for possible future use toward contribution requirements.

- **Contributions receivable.** After the 2008 plan year, the actuary's AFTAP certification may take prior-year contributions into account only if they've been paid to the trust by the certification date. This will require employers to accelerate or increase planned prior-year contributions in some situations.

Specific AFTAP certification. The plan's enrolled actuary must certify the plan's specific AFTAP each year. To avoid a plan freeze and complete cessation of lump sums, the plan administrator must receive this certification in writing by the first day of the 10th month of the plan year (October 1 for calendar-year plans). Employers that don't normally get valuation results by this time should work with their actuaries to devise the data collection or other procedures needed to complete certifications within the required timeframe. The final, specific AFTAP for the plan year is reported on Form 5500 Schedule SB, but AFTAP certifications are not otherwise filed with the IRS.

Range certification. During the first nine months of the plan year, plans can accrue and pay benefits according to an actuary's estimated *range certification* that the AFTAP is (i) at least 60% but less than 80%, (ii) at least 80%, or (iii) at least 100%. Plans using range certifications must still obtain certifications of the specific AFTAP by the 10th month of the plan year. But as long as the specific AFTAP is within the previously certified range – or exceeds the range only because the employer made additional contributions for the prior plan year or elected to waive a

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credit balance after the range certification was made – the plan won't have violated any qualification rules or failed to operate according to its terms.

Presumed AFTAP rules. Before the actuary certifies either the range or specific AFTAP, three presumed AFTAP rules may apply at various times in the plan year, depending on the plan's prior-year funded status and benefit restrictions (see *Presumed AFTAP* in the Appendix for details). The presumed AFTAP rules either continue benefit restrictions in effect at the end of the prior plan year or trigger more onerous restrictions starting the first day of the fourth month of the current plan year – or the first day of the tenth month if the plan fails to obtain a timely specific AFTAP certification. For employers committed to making sufficient contributions to avoid restrictions, the presumed AFTAP rules dictate when to obtain AFTAP certifications and when to make prior-year contributions that will be counted in the AFTAP. These deadlines are summarized in the table below (dates are for calendar-year plans):

Prior-year AFTAP	Certification deadline to avoid restriction	Prior-year contribution deadline to count in AFTAP
≥ 90%	By first day of 10th month (October 1) to avoid benefit freeze and total cessation of lump sums	End of 8½-month grace period (September 15) and before certification date
≥ 80% but < 90%	By first day of 4th month (April 1) to avoid partial lump sum restriction	Before certification date
≥ 70% but < 80%	By first day of 10th month (October 1) to avoid benefit freeze and total cessation of lump sums	End of 8½-month grace period (September 15) and before certification date
≥ 60% but < 70%	By first day of 4th month (April 1) to avoid benefit freeze and total cessation of lump sums	Before certification date

To apply the presumed AFTAP rules in 2008, employers must know their plans' 2007 lookback AFTAP. This is generally determined as the actuarial value of assets (but subject to a narrower 90% – 110% corridor around market value), minus the funding standard account credit balance, divided by current liability. But the credit balance is not subtracted from assets if the 2007 AFTAP would be at least 90% without such subtraction. Sponsors of plans that don't meet the 90% threshold can avoid the credit balance subtraction if they don't use the credit balance toward their 2007 contribution and waive it at the start of the 2008 plan year (see *2007 lookback AFTAP* in the Appendix for details). Further adjustments may be required for certain annuity purchases in the 2005 or 2006 plan years.

No AFTAP presumption or certification. Before an actuary certifies the AFTAP, lump sums and benefit accruals are not restricted, unless presumed AFTAP rules apply, Otherwise, a plan may not stop benefit accruals (except by prospective plan amendment), even if the employer is certain the restriction will apply after the AFTAP is certified. This rule has strange – and perhaps unintended – consequences for the 2008 plan year:

- First, because benefit restrictions were not in effect for the 2007 plan year, no plans have a presumed AFTAP at the start of 2008 plan year. This means no plans are subject to lump sum or accrual restrictions during the first three months of the 2008 plan year and before the actuary has certified the 2008 AFTAP.

- Second, if the plan has obtained a certification of the 2007 lookback AFTAP by the start of the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans), it has a presumed 2008 AFTAP on that date only if the 2007 lookback AFTAP was within one of two ranges specified in the regulations: at least 60% but less than 70%, or at least 80% but less than 90%. All other plans that obtained timely 2007 lookback AFTAP certifications – that is, plans with 2007 lookback AFTAP below 60%, at least 70% but less than 80%, or at least 90% – are not subject to lump sum or accrual restrictions during the first *nine* months of the plan year and before the actuary has certified the 2008 AFTAP. If the final regulations retain this rule, some well-funded plans could have restrictions triggered six months earlier than some poorly funded plans.

  Example. Before April 1, 2008, calendar-year pension Plan A obtains an actuary's certification that its 2007 lookback AFTAP is 83%. This is within one of the ranges (at least 80% but less than 90%) that triggers a presumption on April 1, 2008. Unless Plan A obtains by April 1, 2008 an actuary's certification that its 2008 AFTAP is at least 80%, its 2008 presumed AFTAP is 73% (prior year's 83% AFTAP minus 10%), triggering partial lump sum restrictions starting April 1.

  Example. Before April 1, 2008, calendar-year pension Plan B obtains an actuary's certification that its 2007 lookback AFTAP is 55%. Because Plan B's 2007 lookback AFTAP is outside of the ranges that trigger presumptions on April 1, Plan B may continue benefit accruals and unlimited lump sum payments through September 30, 2008. In fact, to stop paying lump sums before October 1, 2008, Plan B must obtain an actuary's certification that the plan's 2008 specific AFTAP is below 60% (because "less than 60%" isn't a permissible range certification).

IRS representatives have indicated informally that they did not intend to allow plans less than 90% funded to take advantage of this six-month extension. Therefore, sponsors of plans with 2007 lookback AFTAP below 60% or at least 70% but less than 80% should look for changes in the final regulations that may require them to obtain 2008 AFTAP certifications by the fourth month of 2008.

If a plan does not obtain either a 2007 lookback AFTAP certification or 2008 AFTAP certification by the first day of the fourth month of the 2008 plan year, benefits are frozen and lump sum payments must be stopped on that date.

Collectively bargained plans. Two special benefit restriction rules apply to collectively bargained plans:

- The effective date of PPA benefit restrictions is the first plan year beginning on or after the earlier of (i) January 1, 2010 or (ii) expiration of the last bargaining agreement ratified before 2008 (ignoring any extension agreed to after August 17, 2006). Sponsors of bargained plans with large credit balances should bear in mind that the phase-in thresholds to avoid subtracting the credit balance from plan assets are *not* delayed for those plans. If the PPA benefit restrictions first apply to the plan's 2010 plan year, the plan's 2010 AFTAP must be at least 96% to avoid subtracting the credit balance.

- While all plans – whether bargained or not – are deemed to waive credit balances if doing so avoids lump sum restrictions, collectively bargained plans are also deemed to waive credit balances if necessary to avoid freezing benefits. The special rule for bargained plans isn't meaningful for those that pay lump sums because the total cessation of lump sums will be triggered at the same time as the benefit freeze. But this rule does have implications for bargained plans that don't pay lump sums and would have AFTAP below 60% when the credit balance is subtracted from assets.

Under the proposed regulations, plans that cover both bargained and nonbargained employees are considered collectively bargained if at least 25% of participants are members of bargaining units that negotiate plan benefit levels.

Multiple employer plans. The benefit restriction rules apply to multiple employer plans in the same way as minimum funding rules. If each employer is treated as maintaining a separate plan for funding purposes, then each employer is also treated as maintaining a separate plan for benefit restriction purposes. In this case, participants employed by one employer could have their accruals and lump sums restricted, while those employed by another do not. If the multiple employer plan existed before 1989 and elected to be treated as one plan for funding purposes, then benefit restrictions are also applied as if it is one plan – all participants, regardless of their employer, are subject to the same restrictions.

Practical implications of AFTAP certification timing rules

The proposed regulations don't restrict the participant census data or asset data used in making either specific or range AFTAP certifications. However, IRS representatives have informally indicated future guidance may require specific AFTAP certifications to use participant census data and asset data as of the valuation date, while range certifications may use estimated data. But such a requirement may not have much practical effect because AFTAP certifications (whether range or specific) apparently may be revised at any time. As long as the AFTAP ultimately reported on Form 5500 Schedule SB for the plan year is not materially different from any previously certified AFTAP, multiple certifications cause no problems for the plan. But if the change is material, the plan risks disqualification for either violating the benefit restriction rules or failing to operate according to its terms. A change is material if both of the following conditions apply:

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- the subsequent certification changes the application of lump sum and benefit accrual restrictions to the plan, and
- the change did *not* result from the employer making additional prior-year contributions or electing to waive a credit balance after the prior certification date.

A material AFTAP change is most likely to arise when the plan needs an AFTAP certification by the fourth month of the plan year to avoid restrictions. The actuary may need to estimate the AFTAP using participant census data rolled forward from an earlier valuation date and unaudited assets – and the specific AFTAP using census data as of the current valuation date and audited assets data could be materially different. Material changes might also occur if the employer has participant data collection problems and an initial valuation using inadequate data is later revised.

The following examples illustrate the problems that can result from certifications using estimated data. All the examples deal with calendar-year pension Plan G, which had a 2008 AFTAP of 84%, allowing it to pay unlimited lump sums though March 31, 2009. To continue paying unlimited lump sums throughout 2009, G needs a certification by April 1, 2009 that its 2009 AFTAP is at least 80%. On January 1, 2009, G's adjusted assets (before any additional contribution described in an example) are $81 million and G has no credit balance. The examples differ in the adjusted funding target values determined using roll-forward and final census data, and in the valuation timing.

Example 1. In March 2009, the actuary estimates that G's adjusted funding target for 2009 is $100 million using roll-forward participant data from 2008. On April 1, 2009, the actuary makes a range certification that G's 2009 AFTAP is at least 80%. The plan continues paying unlimited lump sums. In July 2009, the actuary finalizes the 2009 valuation results using 2009 participant data and determines that the 2009 adjusted funding target is actually $101 million. On July 28, 2009, the actuary certifies that the 2009 specific AFTAP is 80.2%. This is not a material change because the plan's operations would not have been any different if this AFTAP had been certified on April 1 – that is, the plan still would have paid unlimited lump sums.

Example 2. The facts are the same as in Example 1, except that the actuary determines that the final 2009 adjusted funding target is $103 million, resulting in a 2009 specific AFTAP of 78.6% unless additional 2008 contributions are made. If the actuary had certified on April 1 that the plan's 2009 AFTAP was 78.6%, partial lump sum restrictions would have been triggered on that date. Therefore, certifying that the 2009 AFTAP is 78.6% would be a material change, causing G to violate the benefit restriction rules. To avoid this, G's sponsor must contribute an additional $1.4 million for the 2008 plan year (adjusted for interest to the date actually made) that cannot be added to the prefunding balance. The sponsor contributes this amount on September 15, 2009, and the actuary prepares a revised certification on

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September 22, 2009 that the 2009 AFTAP is 80%. This is not a material change, so the plan is not treated as violating the benefit restriction rules between April 1 and September 22.

Example 3. The facts are the same as in Example 2, except G's sponsor is late getting 2009 participant data to the actuary, and final 2009 valuation results are not available until after the September 15, 2009 contribution deadline for the 2008 plan year. The sponsor cannot make an additional contribution for the 2008 plan year, and the statute and proposed regulations do not permit G's sponsor to make additional 2009 contributions to avoid lump sum restrictions (although additional 2009 contributions can be made to avoid other types of benefit restrictions). The actuary must certify that the 2009 AFTAP is 78.6%, which is a material change from the April 1 certification, resulting in a violation of the benefit restriction rules. The proposed regulations provide no means of correcting this violation. Future IRS guidance may provide a voluntary correction process to avoid plan disqualification, but such a process would undoubtedly involve penalty payments.

Example 4. In March 2009, the actuary estimates that G's adjusted funding target for 2009 is $103 million using roll-forward participant data. On April 1, 2009, the actuary certifies that G's AFTAP is 78.6%, and the plan begins paying only partial lump sums. In July, the actuary determines that the 2009 adjusted funding target is actually $100 million, which would increase the 2009 AFTAP to 81%. The plan would not have imposed partial lump sum restrictions if the actuary had certified the AFTAP was 81% on April 1. Because the increase in the 2009 AFTAP is due to experience gains – not additional contributions or credit balance waivers – if the actuary certifies that the 2009 AFTAP is 81%, the change would be material and the plan would be treated as not operating in accordance with its terms. The proposed regulations provide no explicit means to correct this violation. However, it appears that problems might be circumvented if G's sponsor makes an additional contribution of $1.4 million for the 2008 plan year by the September 15, 2009 deadline and before the actuary revises the AFTAP certification. The additional contribution (which cannot be added to the credit balance) would increase adjusted assets to $82.4 million and the 2009 AFTAP – determined using the roll-forward data that was the basis of the original certification – to 80%, thereby ending the partial lump sum restriction once certification occurs. A material change does not occur if an AFTAP increase that ends a restriction is caused by additional prior-year contributions made after the original certification date. On October 1, 2009, the actuary certifies that the 2009 AFTAP is 82.4%. Even though the experience gain further increased the 2009 AFTAP from 80% to 82.4%, this presumably would not be a material change because 82.4% isn't materially different from 80%.

Example 5. The facts are the same as Example 4 except that the actuary makes no certification on April 1. The AFTAP is presumed to be 70% on April 1, triggering partial lump sum restrictions. When the valuation is completed in July, the actuary certifies that the 2009 AFTAP is 81%, enabling the plan to resume paying unlimited lump sums for the remainder of the plan year. No additional contribution is required in this scenario.

Example 6. The facts are the same as in Example 4, but instead of certifying that the 2009 AFTAP is 78.6%, the actuary tells G's sponsor that an additional contribution of $1.4 million must be made by April 1 to reach a certified AFTAP of at least 80%. G's sponsor wants to avoid lump sum restrictions and makes the contribution, increasing G's adjusted assets to $82.4 million. On April 1, the actuary certifies that G's AFTAP is at least 80%. The actuary completes the valuation in July and determines that the adjusted funding target was only $100 million, so the additional contribution was not required based on the final valuation results. G's sponsor apparently can treat the $1.4 million contribution in one of several ways: (i) as a 2008 plan-year contribution that is not added to the prefunding balance, (ii) as a 2008 plan-year contribution added to the prefunding balance, or (iii) as a 2009 plan-year contribution that counts toward the plan's 2009 minimum contribution requirement. Whichever approach the sponsor chooses would be reflected in the actuary's specific AFTAP certification made by October 1, 2009.

As these examples illustrate, estimated certifications using roll-forward data and unaudited assets can be risky. When the estimated AFTAP is close to the 60% or 80% restriction thresholds, small liability movements can trigger or end restrictions. As long as the final funding target can be determined before the end of the prior-year contribution grace period, problems can generally be corrected by making additional prior-year contributions – but the employer may have little advance notice of the required contribution amount. Whenever final valuation results might not be available before the end of the prior-year contribution grace period, employers should make additional contributions to provide sufficient cushion to absorb any liability losses.

The examples illustrate two other principles:

- If additional prior-year contributions are required to avoid restrictions in the current plan year, the valuation timing won't affect the *amount* (except for interest adjustments) but can affect the *timing* of those additional contributions. In Example 2, if the actuary had completed the valuation in the first three months of 2009, G's sponsor would have had to contribute the additional $1.4 million on or before the April 1 certification date because the actuary cannot anticipate future contributions in making an AFTAP certification after 2008.

- AFTAP certifications should be used to *avoid* restrictions – not to *trigger* them. As examples 4 and 5 illustrate, unless the actuary's certification would eliminate restrictions that apply under the presumed AFTAP rules, certification generally should take place only after final valuation results are completed. Allowing the presumed AFTAP rules to run their course avoids the possibility of a material change in the certified AFTAP.

Strategies to avoid restrictions in 2008

The strategies for avoiding lump sum and benefit accrual restrictions in 2008 are generally straightforward. To pay unlimited lump sums through 2008 plan year-end, employers must make sufficient contributions for the 2007 plan year by the end of the grace period (September 15,

2008 for calendar-year plans) to achieve a 2008 AFTAP of at least 80%. Similarly, to provide benefit accruals and pay partial lump sums through 2008 plan year-end, employers must make sufficient contributions by the end of the grace period to achieve a 2008 AFTAP of at least 60%. (If the total cessation of lump sums isn't a concern, employers wishing to provide benefit accruals throughout 2008 could provide other security in lieu of plan contributions – an escrow account or surety bond – that, when added to assets, achieves a 2008 AFTAP of 60%.) In any case, the plan will need an actuary to certify the 2007 lookback AFTAP by the first day of the fourth month of the 2008 plan year (April 1 for calendar-year plans) and the 2008 specific AFTAP by the first day of the tenth month (October 1, 2008 for calendar-year plans). Any credit balance resulting from additional contributions made to avoid benefit restrictions generally must be waived in the 2008 plan year, unless the 2008 AFTAP is at least 92%.

Plans with a 2007 lookback AFTAP of at least 60% but less than 70% (or less than 70% if the IRS closes the loophole in final regulations) will need an actuary to certify – by the start of the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans) – that the 2008 AFTAP is at least 80% (to continue paying unlimited lump sums) or at least 60% (to continue benefit accruals and pay partial lump sums). Plans with a 2007 lookback AFTAP of at least 80% but less than 90% (or at least 70% but less than 90% if the IRS changes the final regulations) will need an actuary's certification – by the same date – that the 2008 AFTAP is at least 80% to continue paying unlimited lump sums, but complete cessation of accruals or lump sums would not occur unless this certification is not obtained before the 10th month of the plan year.

If the IRS does not close the loophole in the final regulations – which allows plans with 2007 lookback AFTAP less than 60% or at least 70% but less than 80% to avoid restrictions until the start of the 10th month of the plan year without obtaining an earlier 2008 AFTAP certification – sponsors may be able to move their plans into one of these ranges (or above 90%) using various strategies:

- Sponsors of plans with credit balances that must be subtracted from assets may be able to use the rule that permits including credit balances waived at the start of the 2008 plan year in 2007 adjusted assets to increase their 2007 AFTAP to 70% or 90% (see *Special issues for plans with significant credit balances*).

- Employers can make additional contributions for the 2006 plan year to increase the 2007 AFTAP to 70% or 90%.

- Employers might be able to attribute 2006 grace-period contributions to the 2007 plan year to drop the 2007 lookback AFTAP below 60% or below 80% (but not less than 70%).

- Employers might consider changing their asset valuation methods for 2007, if the method hasn't been changed recently and automatic IRS approval is available, although the implications of the new method for the 2008 plan year and beyond – when new PPA asset valuation rules apply – are not yet known.

But in any of these cases, the cost of revising 2007 valuation results probably will more than offset any savings from avoiding an actuarial certification early in the year, unless the 2007 valuation is still in the very early stages. Furthermore, if IRS decides to close this loophole in final regulations, all plans with 2007 lookback AFTAPs below 90% may need to obtain 2008 AFTAP certifications by the fourth month of the plan year, so these strategies may not be relevant.

If a 2008 AFTAP certification is required at the start of the fourth month, the actuary may – for 2008 only – anticipate 2007 plan-year contributions reasonably expected to be made by the end of the grace period. This means employers need not accelerate their 2007 contributions to support the certification – however, they must actually make the anticipated contributions to avoid potential plan disqualification. (This is also true for 2007 lookback AFTAP certifications, but will generally only be relevant for noncalendar year plans since the 2006 grace period for calendar-year plans closes September 14, 2007).

Although sponsors of plans with significant credit balances should consider making additional contributions to reach the phase-in funding thresholds in the next four years (92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011), making additional contributions for the 2006 plan year to achieve a 2007 lookback AFTAP of 90% doesn't offer material advantages from a benefit restriction standpoint. But if the plan would otherwise be subject to deficit-reduction contribution rules in 2007, funding to 90% may offer other advantages, including the ability to use PPA's phase-in funding rules.

Strategies to avoid restrictions after 2008

After 2008, the fundamental principles are the same: Employers must fund their plans to at least 80% each and every plan year to avoid all restrictions on lump sums and benefit accruals and to at least 60% each plan year to provide uninterrupted benefit accruals. But because the actuary's AFTAP certification cannot anticipate prior-year contributions expected to be paid after the certification date, plan sponsors may use two different ongoing funding strategies, with different implications for contribution timing:

- **10% margin strategy.** Employers that fund their plans to at least 10% above the restriction threshold (90% for partial lump sum restrictions or 70% for benefit accrual and total lump sum restrictions) won't need to obtain AFTAP certifications until the start of the 10th month of the next plan year (October 1 for calendar-year plans). This gives the employer the full 8-1/2-month grace period to make any contributions required to avoid restrictions (or to maintain the 10% margin for the following year). The actuary should be able to estimate the required contributions relatively early in the plan year, giving the employers several months' notice for cash-flow planning purposes. In effect, this strategy requires greater upfront contributions in exchange for more notice of cash-flow requirements.

- **Minimum funding strategy.** Employers that fund at the minimum level required to avoid restrictions (80% for partial lump sum restrictions or 60% for benefit accrual and total lump sum restrictions) and satisfy minimum funding rules will need to obtain AFTAP certifications by the start of the fourth month of the plan year (April 1 for calendar-year plans). Furthermore, employers must make any contribution required to avoid a restriction before the certification can be provided. Since the value of plan assets can't be known until after the start of the plan year, this gives the employer less than three months to determine and make the required contributions. Although total contributions over a period of years will likely be smaller using this strategy, cash-flow timing will be less predictable.

The following example compares and contrasts these two funding strategies. It suggests a trade-off between larger, more predictable contributions, and smaller contributions with potentially significant short-term cash demands. Employers electing to use the minimum funding strategy might also consider adopting asset valuation methods and liability-driven investment strategies that will minimize the chance of large, unexpected contribution requirements

> *Example.* Companies E and F maintain identical calendar-year defined benefit plans P and Q, respectively. At January 1, 2008, both plans have not-at-risk funding targets of $100 million, assets of $80 million, no credit balance, and no annuity purchases in the prior two plan years. Both plans have 2008 AFTAPs of 80%, allowing them to pay unlimited lump sums. Each plan's minimum required contribution for 2008 is $8 million. Both plans pay lump sums and both employers are committed to funding the plans sufficiently to continue paying unlimited lump sums.
>
> Company E decides to use the 10% margin strategy to avoid lump sum restrictions, while Company F elects to follow the minimum funding strategy. To implement the margin strategy, E makes an additional contribution to Plan P for the 2007 plan year on September 15, 2008 and waives the resulting credit balance. This increases P's assets – for both minimum funding and benefit restriction purposes – to $90 million. P's 2008 AFTAP increases to 90%, and the 2008 minimum required contribution is reduced to $6.5 million.
>
> Both companies make the minimum required contributions for 2008 by December 31, 2008. But a market correction in 2008 causes both plans to experience investment losses of 10%. At January 1, 2009, both plans have not-at-risk funding targets of $110 million. P's assets are $87.2 million, while Q's are $79.6 million, reflecting the additional $8.5 million that E contributed to P, adjusted for market losses after the contribution date. To continue paying unlimited lump sums throughout 2009, both plan sponsors must make additional 2008 contributions to produce total assets of $88 million (80% of the $110 million funding target). Because P's 2008 AFTAP was at least 90%, Company E has until September 15, 2009 to make the additional $800,000 contribution. But Company F needs an actuarial certification by April 1, 2009 that Q is at least 80% funded, and Q's actuary can't anticipate future contributions. This means Company F must contribute an additional $8.4 million by April 1, 2009.

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The table below compares the companies' total contributions over the two years. Company F's total contributions were smaller, but it faced large, unexpected cash demands in the first quarter of 2009. Of course, to maintain a 10% margin for the 2009 plan year, Company E would have to contribute an additional $11 million for the 2008 plan year (90% of $110 million minus the $88 million of assets required to avoid restrictions). But this contribution is not required to continue paying unlimited lump sums during 2009. Instead of contributing the additional $11 million to stay with the 10% margin strategy, E can always revert to the minimum funding strategy, which will require a 2010 AFTAP certification by April 1, 2010.

2008–9 contributions	Company E 10% margin strategy	Company F minimum funding strategy
Additional 2007 contribution to establish 10% margin	$10,000,000	$0
2008 minimum required contribution	6,500,000	8,000,000
Additional 2008 contribution required to pay unlimited lump sums throughout 2009	825,000	8,400,000
Total	**$17,325,000**	**$16,400,000**

The example illustrates that employers don't have to commit to one strategy or the other – they can switch at any time. An employer using the 10% margin strategy can revert to the minimum funding strategy in any year when the contributions required to preserve the 10% margin are too high. And an employer using the minimum funding strategy might decide to contribute enough to create a 10% margin in a year when the employer is looking for additional tax deductions. Over the next few years, PPA rules are expected to improve plan funding levels, even if an employer makes only minimum required contributions. As a result, many plans will naturally develop a 10% margin.

Special issues for plans with significant credit balances

As described above, any credit balance is generally subtracted from plan assets in calculating the AFTAP, unless the AFTAP is at least 100% before such subtraction. The 100% funding threshold is phased in over four years – 92% in 2008, 94% in 2009, 96% in 2010, and 100% thereafter – but to take advantage of the phase-in threshold after 2008, a plan must have met the phase-in threshold in each prior year after 2007. The special rules for determining the 2007 lookback AFTAP provide that the credit balance is not subtracted from assets if the AFTAP would be at least 90% without such subtraction. But plans that are less than 90% funded in 2007 still can take advantage of the phase-in thresholds in 2008 and later plan years. So the only advantage from accelerating contributions to reach a 90% threshold in 2007 would be to avoid the need to obtain a 2008 AFTAP certification by the fourth month of the 2008 plan year.

Sponsor of plans that don't meet the 90% lookback AFTAP threshold in 2007 can avoid the credit balance subtraction if they don't use the credit balance toward their 2007 contribution and waive it at the start of the 2008 plan year (see 2007 lookback AFTAP in the Appendix for

details). If the final regulations retain a loophole – which allows plans with 2007 lookback AFTAP below 60% or at least 70% but less than 80% to avoid getting a 2008 AFTAP certification by the fourth month of the plan year – some employers may be able to use the credit balance waiver rule to move the 2007 lookback AFTAP into one of the these ranges.

> *Example.* Employer D sponsors calendar-year pension Plan P, which pays lump sum distributions. At the January 1, 2007 valuation date, P has assets of $880 million, current liability of $1 billion, and a $200 million credit balance. P has not purchased any annuities in the last two plan years. P's minimum required contribution for 2007 – before taking the credit balance into account – is $100 million. Because P's assets, before subtracting the credit balance, are less than 90% of its current liability, the credit balance is subtracted from assets in determining P's 2007 lookback AFTAP of 68% ($880 million in assets minus the $200 million credit balance, divided by $1 billion current liability). This is within the range that requires a 2008 AFTAP certification by April 1, 2008. To avoid this early certification requirement, D could make a $20 million contribution to P for the 2006 plan year by the September 15, 2007 deadline, increasing assets to 90% of current liability and avoiding the credit balance subtraction. Alternatively, under the proposed rules as currently drafted, because D will have at least $100 million of credit balance remaining in 2008 even if D makes no contribution for 2007, D could elect to waive $20 million of credit balance (adjusted for a year's interest at the 2007 valuation date) at the start of the 2008 plan year. This would reduce the credit balance that must be subtracted from plan assets in determining the 2007 lookback AFTAP to $180 million, increasing the AFTAP to 70% and avoiding the need for an April 1, 2008 AFTAP certification.

After 2008, if a plan falls short of the funding thresholds to avoid subtracting credit balance, the credit balance is deemed waived if doing so enables the plan to avoid lump sum restrictions (or continue benefit accruals under a collectively bargained plan). A credit balance waived under the presumed AFTAP rules cannot be reinstated if the actuary ultimately determines that a smaller credit balance waiver would have avoided restrictions. Although the proposed regulations are not entirely clear, a credit balance deemed waived in conjunction with an actuary's AFTAP certification (rather than under the presumed AFTAP rules) apparently could be reinstated if the waiver ultimately isn't necessary. This might occur if the certification (reflecting a deemed waiver) used estimated data that is later revised or if the employer subsequently makes contributions for the prior plan year to reach the funding threshold necessary to avoid subtracting the credit balance.

> *Example.* Employer M sponsors calendar-year pension Plan H, which offers lump sum distributions. H's 2007 lookback AFTAP was 61% (using assets reduced by the credit balance), so H needs an actuarial certification of the 2008 AFTAP by April 1, 2008 to avoid total cessation of lump sums and a benefit freeze. In March 2008, H's actuary determines that, at the January 1, 2008 valuation date, H had $850 million in assets, a $1 billion funding target, and a $220 million carryover credit balance, taking into account M's expected contributions for the 2007 plan year during the grace period. Because H is less than 92%

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funded, the credit balance must be subtracted from plan assets in determining the 2008 AFTAP of 63% ($850 million in assets minus $220 million credit balance, divided by $1 billion funding target), which would trigger partial lump sum restrictions. To avoid these restrictions, $170 million of the credit balance is deemed waived on April 1, 2008, when the actuary certifies that the 2008 AFTAP is at least 80% ($850 million minus $50 million of credit balance, divided by $1 billion funding target).

In September 2008, M contributes an additional $70 million to Plan H for the 2007 plan year, increasing assets to 92% of the funding target. As a result, H meets the phase-in threshold to avoid subtracting the credit balance. The $170 million credit balance waived in conjunction with the April 1 AFTAP certification apparently can be reinstated. The actuary certifies on October 1 that H's 2008 AFTAP is 92%. This is not a material change in the AFTAP.

Employers must consider many different factors in determining whether to preserve or waive their plans' credit balances, including the implications for funding requirements, at-risk status, and benefit restrictions. Employers should also consider whether they can effectively use large credit balances under the new PPA funding regime. Projections of future funding levels and contribution requirements will generally be helpful in making these decisions.

More to come

The proposed regulations will help employers finalize their contributions for the 2006 plan year. The three-month delay until lump sum or benefit accrual restrictions apply to any plan gives employers a little breathing room to decide on a longer-term funding strategy. It also gives Congress time to adopt PPA technical corrections that may exempt mandatory cashouts from lump sum restrictions (GRIST #20070157, 8/16/07). Unfortunately, the IRS has yet to issue guidance on asset valuation methods, the yield curve, and other aspects of the funding target calculations needed to accurately estimate contributions required to avoid benefit restrictions. Going forward, employers that want to avoid these restrictions will need to collaborate with their actuaries to determine required contributions and obtain timely AFTAP certifications.

GRIST is prepared by the Washington Resource Group of Mercer Human Resource Consulting. For more information, contact the InfoServices team at +1 202 263 3950.

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Appendix – AFTAP and presumed AFTAP calculation rules

AFTAP. The adjusted funding target attainment percentage (AFTAP) is the funded status measure that determines whether benefit restrictions apply. It is calculated as the ratio of adjusted plan assets to the adjusted funding target at the valuation date. Adjusted plan assets generally equal the actuarial value of plan assets plus total annuity purchases for nonhighly compensated employees in the prior two plan years minus the carryover credit balance and prefunding balance (unless the plan is at least 100% funded before this subtraction). The following proposed rules would apply when determining the components of adjusted plan assets:

- **Actuarial value of plan assets.** The actuarial value is determined using the plan's asset valuation method for funding, which may be market value or a calculated value that spreads market returns over no more than two years and is within 90-110% of market value.

- **Subtraction of credit balance.** If waiving credit balance (so it is not subtracted from plan assets) would enable a plan to avoid lump sum restrictions, it is deemed waived. If the waiver happens under presumed AFTAP rules, the credit balance cannot be reinstated if the actuary later determines that a lesser waiver would have been sufficient. But if the waiver happens in conjunction with an AFTAP certification, it appears that the waived amount could be reinstated as long as the AFTAP does not change materially. The 100% funding target to avoid subtracting the credit balance from assets is phased in over four years – 92% in 2008, 94% in 2009, 96% in 2010, and 100% thereafter – but to take advantage of the phase-in target after 2008, the plan must have met the phase-in target in each prior year.

- **Contributions receivable for the prior plan year.** For the 2008 plan year, the actuary can include in adjusted plan assets any contributions for the 2007 plan year reasonably expected to be made between the certification date and the end of the grace period (September 15, 2008 for calendar-year plans). But after 2008, adjusted plan assets may *not* include contributions for the prior year that have not been made by the AFTAP certification date. This means employers may have to accelerate or increase prior-year contributions to avoid restrictions in some situations.

The adjusted funding target is the not-at-risk PPA funding target (even if the plan is at risk for funding purposes) plus total annuity purchases for nonhighly compensated employees in the prior two plan years.

Presumed AFTAP. Before the actuary certifies the AFTAP range or the specific AFTAP for a plan year, presumed AFTAP rules may apply starting the first day of the first, fourth, or tenth month of the plan year:

- **First-day rule.** If the plan was subject to any benefit restrictions in the prior year, the presumed AFTAP starting the first day of the plan year equals the prior year's specific AFTAP (or to be less than 60% if the prior year's specific AFTAP has not yet been certified).

This rule will not apply to any plans during the 2008 plan year since benefit restrictions are not in effect in 2007. After the 2008 plan year, restrictions in effect at the end of one plan year remain in effect the next year until the actuary certifies the AFTAP or one of the following rules triggers more onerous restrictions.

- **Fourth-month rule** If the plan's AFTAP for the prior year was at least 80% but less than 90% or at least 60% but less than 70%, the presumed AFTAP equals the prior year's AFTAP minus 10% on the first day of the fourth month of the plan year (April 1 for calendar-year plans). Because this presumed AFTAP triggers either partial lump sum restrictions (for plans at the higher AFTAP range) or a plan freeze and cessation of all lump sums (for plans at the lower AFTAP range), this rule will drive certifications and accelerate or increase prior-year contributions. To avoid these restrictions, employers must obtain – by the start of the fourth month of the plan year – AFTAP certifications (range or specific) that the affected plan's current-year AFTAP meets the relevant 80% or 60% threshold. After 2008, the actuary making this certification may include in adjusted assets only prior-year contributions made by the certification date. Thus, to obtain AFTAP certifications of the required funding level, employers may have to make prior-year contributions earlier than planned (within three months rather than eight-and-a-half months after plan year-end). And if prior-year market returns or other plan experience was worse than expected, employers may have to make additional, unplanned contributions within this three-month period.

- **Tenth-month rule.** If the actuary has not certified the plan's specific AFTAP by the start of the 10th month of the plan year (October 1 for calendar-year plans) the AFTAP is deemed to be less than 60%. Under this scenario, benefits must be frozen and lump sums may not be paid for the remainder of the plan year.

2007 lookback AFTAP. To determine whether the fourth-month rule applies in the 2008 plan year and if so, to apply it, employers must know their plans' 2007 lookback AFTAP. The proposed rules generally determine the 2007 AFTAP as (i) the 2007 actuarial value of assets (but subject to a narrower 90% - 110% corridor around market value) plus total annuity purchases for nonhighly compensated employees during the 2005 and 2006 plan years, minus the funding standard account credit balance, divided by (ii) the 2007 current liability plus total annuity purchases for nonhighly compensated employees during the 2005 and 2006 plan years. But the credit balance is not subtracted from the actuarial value of assets if the 2007 AFTAP would be at least 90% without such subtraction or the employer waives the credit balance in 2008.

The proposed regulations aren't entirely clear on when and what actions must be taken to avoid subtracting some or all of the credit balance from plan assets in determining the 2007 lookback AFTAP. Here are the action steps we think are required:

- Employers will need to decide by the fourth month of the 2008 plan year (April 1, 2008 for calendar-year plans) the *minimum* amount they will contribute for the 2007 plan year and the resulting credit balance they are willing to waive and communicate these decisions to the

certifying actuary. To be waived for 2007 lookback AFTAP purposes, the credit balance must have existed at the start of the 2007 plan year and must still exist at the start of the 2008 plan year. Employers that have used the credit balance toward minimum funding requirements for the 2007 plan year must make contributions to re-establish the credit balance at the start of the 2008 plan year to then waive the balance and include it in assets for the 2007 lookback AFTAP certification. Although employers need to make these decisions in the first quarter of the 2008 plan year, they have until the end of the grace period (September 15, 2008 for calendar-year plans) to make the contributions – although they risk plan disqualification if any anticipated contributions are not actually made.

- The actuary will certify the 2007 lookback AFTAP by the fourth month of the 2008 plan year, taking into account the employer's planned contributions for the 2007 plan year and credit balance waivers at the start of the 2008 plan year.

- The employer must make a formal election to waive the credit balance (stating the amount waived) in writing to the actuary and the plan administrator by the end of the 2008 plan year. To avoid a material change in AFTAP and possible plan disqualification, the employer's election must be consistent with the actuary's earlier 2007 lookback AFTAP certification.

As illustrated in *Special issues for plans with significant credit balances*, judicious use of this credit balance rule may help sponsors attain a 2007 lookback AFTAP that is outside the ranges subject to the fourth-month rule. Assuming the IRS doesn't change the final regulations so as to apply the fourth-month rule to all plans, this strategy will avoid the need for a 2008 AFTAP certification early in the year and postpone any restrictions until the 10th month of 2008 or until the 2008 certification is final.

Section 436 measurement date. A section 436 measurement date is a date when a plan's AFTAP is determined for benefit restriction purposes, whether by an actuary's range or specific certification or by a presumption effective at the start of the first, fourth, or 10th month of the plan year. Lump sum and benefit accrual restrictions start on the first section 436 measurement date when the plan's presumed or certified AFTAP is below the relevant 80% or 60% threshold and stop on the date the actuary certifies that the AFTAP is at or above the relevant threshold. A plan may have only one or several section 436 measurement dates during a plan year, generally depending on the prior year's AFTAP and the sponsor's funding strategy.