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Plan Funding and Benefit Restrictions: An Analysis of Complex Interactions Among Certain Provisions in Regulations Under Tax Code Sections 430 and 436

BY JAMES E. HOLLAND JR.

In October 2009, the Treasury Department and Internal Revenue Service issued final regulations[1] under Sections 430 and 436 of the Internal Revenue Code[2] that addressed many of the funding issues under the Pension Protection Act (PPA) of 2006.[3] In the months since the issuance of the regulations,[4] certain provisions and interactions in the regulations have turned out to be somewhat more difficult to assimilate than others. This article will discuss some of those provisions and interactions that are of particular interest, such as the treatment of plan amendments.

Although the article assumes a basic understanding of minimum required contributions under Section 430 and the operation of benefit restrictions under Section 436, this paragraph and the next provide a brief summary of those concepts.[5] Under Section 430, a plan sponsor's minimum required contribution to the plan is a sum determined by adding two amounts: the plan's target normal cost, which generally is the present value of benefits earned during the plan year; and the plan's shortfall amortization charges, which are the amounts needed to amortize a funding shortfall. In any given year, the funding shortfall generally is the funding target minus the value of adjusted plan assets. Plan assets are adjusted by subtracting the funding standard carryover balance and the prefunding balance, here referred to collectively as ''credit balances'' or sometimes simply as ''the credit balance.''

Under Section 436, a plan must provide that certain benefit restrictions apply if the adjusted funding target attainment percentage, known by the acronym AFTAP, falls below either one of two thresholds: 80 percent or

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[1] See 74 Fed. Reg. 53,004 (Oct. 15, 2009).

[2] All references will be to the Internal Revenue Code and the regulations thereunder. Title I of ERISA has provisions parallel to those found in the Code.

[3] Pub. L. No. 109-280. For a comprehensive review of the October 2009 regulations, see a report by Stuart Sirkin (6 PBD, 1/12/10; 37 BPR 142, 1/19/10).

[4] Unless otherwise clear from the context, the term ''the regulations'' refers to the October regulations.

[5] For a longer explanation, see the Sirkin report.

60 percent. The 80 percent and 60 percent thresholds are referred to in the regulations as ''the applicable thresholds.''

"The October 2009 regulations establish an order that permits plans to be administered on a dynamic basis without waiting for valuation results or later decisions by plan sponsors and, in doing so, help make a complex law workable for plan actuaries and plan sponsors."

The AFTAP generally is the ratio of adjusted plan assets to the funding target, after adding certain annuity purchases to the numerator and denominator of the fraction. If an AFTAP is below 80 percent, plan amendments cannot take effect, and accelerated benefit distributions, such as lump-sum benefits or other benefits payable faster than a straight life annuity, cannot be paid in full. (This article will refer collectively to all accelerated benefit distributions as lump-sum benefits.) If an AFTAP is below 60 percent, no lump-sum benefits or unpredictable contingent event benefits can be paid. Also, benefit accruals must cease.

If an AFTAP is not certified before the first day of the 10th month of the plan year, which is Oct. 1 for calendar year plans, the AFTAP will be *deemed to be* under 60 percent for the remainder of the plan year, and a later certification will not change that. Because the numerator of the AFTAP (here ignoring annuity purchases) is the value of the plan's assets minus the plan's credit balances, reducing a credit balance will increase the numerator and increase the AFTAP. Any circumstances in which credit balances can be reduced will be of interest to plan sponsors.

Rules for Plan Amendments

Certain provisions of the final regulations interact in ways that affect how plan amendments are treated under Sections 430 and 436. In the order they appear in the final regulations, those provisions are:

1. the rules for taking into account plan amendments in Treas. Reg. § 1.430(d)-1(d),
2. the chronology rules for determining the maximum amount of credit balances and for coordinating those credit balances in Treas. Reg. § 1.430(f)-1(d)(ii),
3. the rules for automatically reducing a credit balance to avoid benefit restrictions in Treas. Reg. § 1.436-1(a)(5),
4. the rules for determining when plan amendments that increase a plan's benefit liabilities take effect in Treas. Reg. § 1.436-1(c)(5),
5. the operational rules that apply to the adjusted funding target attainment percentage (AFTAP) in Treas. Reg. § 1.436-1(g), and
6. the presumption rules, certification rules, and recertification rules that apply to the AFTAP in Treas. Reg. § 1.436-1(h).[6]

The two most important calculations for purposes of Section 430 are those that determine the funding target and target normal cost. Besides its use in determining a plan sponsor's minimum required contribution under Section 430, the funding target is the measure of a plan's liabilities that is used to determine the plan's AFTAP and therefore is a significant funding measure in applying the rules under Section 436 that restrict benefits.

The target normal cost is the measure of the value of benefits accruing during the plan year. Plan amendments can affect the funding target or target normal cost or both by increasing or decreasing plan benefits, including future benefits. Therefore, the rules that determine when changes made by plan amendments must be reflected or taken into account in calculating the funding target and target normal cost also have a direct impact on a plan sponsor's minimum required contribution for a plan year and whether any benefit restrictions might be required.

"Chronology rules are necessary because a plan administrator cannot wait for months to determine if a reduction in a credit balance would permit benefit payments."

Treas. Reg. § 1.430(d)-1(d) sets forth the rules for when a plan amendment must be taken into account in determining a plan's funding target and target normal cost. The regulations draw a distinction between plan amendments that are adopted by the plan valuation date and those amendments that are adopted after the valuation date. Plan amendments adopted by the valuation date for the plan year are *taken into account* in calculating the funding target and target normal cost if the plan amendments *take effect* during the plan year. Plan amendments adopted after the valuation date generally are not taken into account for the plan year, whether or not the plan amendments take effect during the plan year. (Plan amendments adopted after the valuation date generally will be taken into account in the following plan year).

Anti-Abuse Exception. The regulations also provide an anti-abuse rule exception to the general rule of ignoring amendments adopted after the valuation date for purposes of calculating the funding target and target normal cost. The anti-abuse rule for amendments adopted after the valuation date applies to benefits that could not take effect if the amendment were subject to restrictions under Section 436(c).

The rule exists to address concerns about amendments made in the current year that increase benefits for prior years if a participant has a year of service in the current year. Normally that type of amendment would not increase the funding target for the current

[6] Treas. Reg. § 1.436-1(h) will not be covered in this article.

year because the increase is conditioned on service in the current year. Similarly, the benefit increase would not be subject to testing under Section 436(c) and would not be taken into account in calculating the target normal cost. However, under the anti-abuse rule, an amendment of the type described here must be taken into account in determining the funding target and target normal cost, and therefore it must be funded in the current plan year as part of the target normal cost. [7]

Plan Amendments. At first blush, the rules for plan amendments appear to be easy to apply. Whether a plan amendment *is taken into account* in calculating the funding target and target normal cost generally depends on when an amendment is adopted relative to a plan's valuation date and the amendment's effective date. However, three factors make applying the plan amendment rules more complicated: Those factors are:

- the provisions of Section 412(d)(2)
- the rules for when a plan amendment is considered to take effect, and
- the question of whether a plan amendment is permitted to go into effect.

Section 412(d)(2) provides that if a plan amendment is adopted after the first day of the plan year but no later than 2½ months after the end of the plan year, the amendment, if the plan administrator chooses to do so, may be treated as having been adopted on the first day of the plan year. If the plan administrator makes an election under Section 412(d)(2), the plan amendment *is taken into account* for calculating the funding target and target normal cost if it *takes effect* during the plan year, even if the actual adoption date of the amendment is after the valuation date. The plan administrator's election under Section 412(d)(2) determines when a plan amendment is considered adopted for purposes of Section 430, but that election does not determine when the amendment takes effect.[8]

The regulations stipulate that a plan amendment that would decrease benefits would take effect on the first date on which the benefits of any person who is or could be a participant or beneficiary under the plan would be less than that person's benefits would be under the pre-amendment plan provisions, assuming that the person met the requirements for receiving the benefits.

Because of anti-cutback rules,[9] a reduction in benefits typically applies in the future and does not take effect until a later plan year. In those cases, a plan amendment cannot *be taken into account* for purposes of calculating the funding target and target normal cost in the plan year in which the amendment is adopted. However, if a plan amendment would reduce or remove benefits that were not protected in the current plan year by the anti-cutback rules, then the amendment *could take effect* in the plan year in which it was adopted.

For plan amendments that would increase benefits, the rules are more complicated. The first question to be answered is *whether* a plan amendment *can take effect*. The second is *when* the amendment *can take effect*. Whether an amendment can take effect is answered under Section 436. For an answer to the second question, the Section 430 regulations refer to Treas. Reg.§ 1.436-1(c)(5).

Under Section 436(c) and Treas. Reg.§ 1.436-1(c), a plan must provide that an amendment that increases liabilities will not take effect if the AFTAP for the year (i) *is less than* 80 percent or (ii) *would be less than* 80 percent if the benefits attributable to the amendment were taken into account in determining the AFTAP. For a plan amendment that would increase benefits, Treas. Reg. § 1.436-1(c)(5) provides that the amendment *takes effect*[10] on the first date on which any person who is or could be a participant or beneficiary under the plan would obtain a legal right to the increased benefit if the person on that date met the requirements for receiving the benefit. Those requirements might include the attainment of a certain age, performance of service, receipt or derivation of compensation, death, disability, or severance from employment.

"Once the AFTAP and credit balances are known, the rules for determining a reduction in the balances can be applied to see whether a plan amendment can take effect."

The rule for when benefit increases *take effect* is in the Section 436 regulations rather than in the Section 430 regulations because the date when benefit increases take effect is used for testing whether a plan amendment can take affect under Section 436. If a plan amendment *cannot take effect* under Section 436(c), then it *will not be taken into account* for purposes of calculating the funding target and target normal cost under Section 430, regardless of when it was adopted relative to the plan's valuation date. If an AFTAP is less than 80 percent or an increase in liability would reduce the AFTAP to less than 80 percent but not less than 60 percent,[11] a plan amendment can take effect only if the plan sponsor makes a Section 436(f) contribution to the plan or reduces a credit balance enough to allow the amendment to take effect.

The previous paragraph set forth the basic rules for determining whether a plan amendment that increases the plan's liabilities can go into effect. To apply those rules, the plan's actuary [12] must know the plan's AFTAP and credit balances and whether there has been or can be a reduction in the credit balances that would allow a plan amendment to take effect. Therefore, at any time during a plan year, the plan's actuary must be able to calculate the AFTAP and credit balances.

[7] See § 1.412(d)-1(d)(2).
[8] See the last sentence of Treas. Reg. § 1.412(d)-1(d)(1)(iii).
[9] See Section 411(d)(6) and the regulations thereunder, as well as related provisions of law.

[10] The meaning is better understood as the date that the plan amendment *would otherwise take effect*, because the plan amendment will not actually take effect if restrictions apply that prevent it from taking effect.
[11] Treas. Reg. § 1.436-1(e)(1) provides that a plan is not permitted to be amended to increase liabilities if the plan is restricted from providing benefit accruals because its AFTAP is less than the 60 percent threshold.
[12] In this article, it is assumed that the plan actuary is the person who makes the calculations with respect to the operations of Section 436.

Once the AFTAP and credit balances are known, the rules for reducing the balances can be applied to see whether a plan amendment can take effect.

Reflecting on the previous paragraph, we can see that at least three other rules are implicated. In the order they appear in the October 2009 regulations, they are the chronology rules in Treas. Reg. § 1.430-1(f)(d)(ii), the rules for deemed reductions in credit balances in Treas. Reg. § 1.436-1(a)(5), and the rules for determining the AFTAP at any time, which appear in Treas. Reg. § 1.436-1(g).

Chronology rules are used to determine the credit balances. Rules for deemed reductions in credit balances increase the AFTAP so that benefit limitations do not apply. Rules for determining the AFTAP at any time are necessary for operating plans in compliance with the rules on benefit restrictions.

Because the rules for determining the AFTAP are the most complicated of the three sets rules, we will discuss those last.

Chronology Rules

The chronology rules provide a means of determining credit balances at the beginning of a plan year. The chronology rules are necessary because of the elective nature of using a credit balance and the elective nature of creating a pre-funding balance. Those elections must be made no later than 8½ months after the end of the plan year.

Chronology rules are necessary because a plan administrator cannot wait for months to determine if a reduction in a credit balance would permit benefit payments. Consider, for example, the operation of a calendar year plan that provides lump-sum benefit payments. If, on Jan. 1, the plan's presumed AFTAP is below 80 percent, the plan's actuary will need to determine whether a credit balance can be reduced to increase the AFTAP to 80 percent. That calculation will depend on the amount of the credit balance on Jan. 1 of the new plan year.

Keep in mind that a credit balance existing on Jan. 1 can be reduced by a decision to apply the balance toward the minimum required contribution for the prior year. Those decisions can be made through Sept. 15 for calendar year plans, although it is impractical to wait until Sept. 15 to determine if a lump-sum benefit can be paid to a participant who elected a benefit in January.

The October 2009 regulations establish two principles for using credit balances. The first is that a credit balance retains its value until it is reduced or fully used to meet the minimum required contribution. Therefore, if a credit balance has not yet been used for a prior year, it exists for the current year and can be used or reduced as necessary. The second principle is that the amount of a credit balance can be adjusted from the prior year to the current year, or from the current year back to the prior year, by a factor based on the market rate of return on plan assets for the prior year.[13]

Those two principles, which are the basis for the chronology rules, enable the plan actuary to calculate a plan's credit balance on Jan. 1 for calendar year plans and at the dates that quarterly contributions would be due.[14]

"The chronology rules allow for planning, but planning requires coordination between the plan sponsor and the plan actuary so that events can be ordered. The ability to plan also is compromised by the automatic nature of certain reductions in credit balances."

Current-Year Exception. The chronology rules apply to elections, including deemed elections, to use or reduce credit balances in the order that the elections occur, whether the elections are for the current or a prior year. The only exception to this ordering is that elections to reduce credit balances for the *current* year are considered to occur as of the first day of the year and before any elections are made to apply the balances to the minimum required contribution for the *current* year. The exception for reductions in credit balances is described in a statutory provision under Section 430(f)(5) and is a principal reason the regulations require that any elective reductions be made by the end of the plan year.

An example will illustrate the chronology rules. Assume a calendar year plan with a Jan. 1 valuation date, a credit balance of $100,000 as of Jan. 1, 2009, and because of asset losses during 2008, a minimum required contribution of $400,000 for 2009. Further assume that no quarterly contributions were required for 2009 because the plan had no funding shortfall for the 2008 plan year, the market rate of return on plan assets for 2009 was 20 percent, and the effective interest rate as defined in Treas. Reg. § 1.430(h)(2)-1(f)(1) for 2009 was 6 percent.

As of Jan. 1, 2010, the credit balance in that example would be $120,000. If on that date a $10,000 reduction in the credit balance would be necessary to increase the AFTAP to 80 percent so the plan could pay lump-sum benefits, the Jan. 1, 2010, credit balance would be reduced to $110,000.

The amount remaining on Jan. 1, 2009, that would be available to apply against the minimum required contribution for 2009 would be $91,667 ($100,000 minus $10,000/1.20). If a plan sponsor elected on Jan. 15, 2010, to apply $50,000 of the funding standard carryover balance against the $400,000 minimum required contribution, then the remaining funding standard carryover balance on Jan. 1, 2009, would be $41,667.

Now assume that a plan amendment were made on Feb. 1, 2010, that would take effect on that date. The plan amendment would bring the AFTAP below 80 percent. However, it is possible that a further reduction in the credit balance would allow the amendment to take effect.

[13] The factor is equal to 1 plus the market rate of return on plan assets for the prior year.

[14] Proposed regulations issued in April 2008 but not yet finalized would provide that a credit balance can be increased and applied toward a quarterly contribution.

The credit balance as of Jan. 1, 2010, would be $50,000 ($41,667 times 1.20), and calculations could be performed to show whether reducing the credit balance would increase the plan assets enough so the increased liability attributable to the amendment would not bring the AFTAP below 80 percent. If plan assets had to be increased by $90,000 so that the Feb. 1, 2010, plan amendment could take effect, then a credit balance of $50,000 would be insufficient to allow the amendment to go into effect.

A Different Result. If the date of an election to apply a credit balance to a 2009 minimum required contribution was Feb. 15, 2010, instead of Jan. 15, 2010, there would be a different result with respect to the plan amendment. Under the modified facts, the credit balance would be $110,000 after the Jan. 1, 2010, reduction of $10,000, and a reduction of $90,000 could allow the plan amendment to take effect. The remaining credit balance on Jan. 1, 2009, would be $16,667 ($100,000 minus $10,000/1.20 and also minus $90,000/1.20). The difference in the order of the dates results in only $16,667 being available to be applied against the minimum required contribution for 2009.

The previous example illustrates the most important aspect of the chronology rules: Apart from the exception that has been noted, the order of events will be determinative of later events. The chronology rules allow for planning, but planning requires coordination between the plan sponsor and the plan actuary so that events can be ordered. The ability to plan also is compromised by the automatic nature of certain reductions in credit balances.

Reductions in Credit Balances

Section 436(f)(3) and Treas. Reg. § 1.436-1(a)(5) provide for certain deemed reductions in credit balances so that certain benefits can be paid. For all plans, if an election to reduce a credit balance would increase the AFTAP to the 80 percent threshold or to the 60 percent threshold and therefore permit lump-sum benefits to be paid or partially paid, a plan sponsor is deemed to have made an election to reduce the credit balance.[15] Deemed reductions typically will occur on the first day of the plan year (Jan. 1 for a calendar year plan) when a presumed AFTAP applies, or on the first day of the fourth month of the plan year (April 1 for a calendar year plan) if the presumed AFTAP is modified by reducing it by 10 percentage points. However, a deemed reduction also can occur whenever an AFTAP is certified or recertified and the newly certified or recertified AFTAP is below the threshold for paying lump-sum benefits.

For a collectively bargained plan,[16] if an election to reduce a credit balance would increase the AFTAP to a threshold that would permit an unpredictable contingent event benefit to be paid, a plan amendment to go into effect, or benefit accruals not to be frozen, then the employer is treated as having made an election to reduce the credit balance.

For a collectively bargained plan, a deemed reduction can occur whenever there is an unpredictable contingent event or a plan amendment that would decrease the AFTAP below the applicable thresholds, assuming of course that reducing a credit balance would increase the AFTAP to the applicable threshold.

If an election is deemed to be made pursuant to Treas. Reg. § 1.436-1(a)(5), then the plan sponsor is treated as having made that election *on* the date on which a benefit limitation would otherwise apply.[17] The Treasury rules provide an election date for the chronology rules to apply. According to those rules, a reduction in the credit balance is considered to occur for the current plan year and to apply before any other elections are made with respect to the credit balance for the current plan year. A reduction in the credit balance does not affect a prior election, with respect to a prior plan year, that was made before the date on which the applicable benefit limitation would otherwise apply for the current plan year.[18]

Operational Rules and Presumptions

Up to this point, we have covered the rules for when plan amendments can be *taken into account* for purposes of calculating the funding target and target normal cost under Section 430, the date that plan amendments are considered to *take effect*, the chronology rules for determining the amount of any credit balances, and the rules that automatically reduce credit balances so that restrictions are avoided. What remains to be considered is the AFTAP to be used in testing whether a plan amendment can take effect.

Operational rules in Treas. Reg. § 1.436-1(g) deal with how an AFTAP is calculated for purposes of Section 436. With respect to plan amendments, it is the operational rules, together with the rules previously discussed, that determine whether a plan amendment can take effect and, if necessary, the contribution that must be made to the plan before a plan amendment can take effect. The operational rules make use of the presumptions in Treas. Reg. § 1.436-1(h) with respect to the AFTAP.

The operational rules are divided into rules covering three periods: the period before certification of the AFTAP during which a presumption applies,[19] the period before certification during which no presumption applies,[20] and the period after certification of the AFTAP.[21]

The operational rules apply somewhat differently with respect to restrictions on unpredictable contingent event benefits and plan amendments than they do with respect to restricted benefits and benefit accruals. For plan amendments and unpredictable contingent event benefits, the most critical rules are those for the period before certification of the AFTAP for the plan year during which a presumption applies because those rules also are used for other periods but with some modifications.

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[15] Keep in mind that the law and regulations require that a funding standard carryover balance be reduced or used before a prefunding balance is reduced or used.

[16] See the definition of a collectively bargained plan in Treas. Reg. § 1.436-1(a)(5)(ii)(B).

[17] Treas. Reg. § 1.436-1(a)(5)(iv)(A).

[18] Review Treas. Reg. § 1.430(f)-1(d)(1)(ii)(B).

[19] Treas. Reg. § 1.436-1(g)(2).

[20] Treas. Reg. § 1.436-1(g)(3).

[21] Treas. Reg. § 1.436-1(g)(5).

Period Prior to AFTAP Certification: Presumption Applies

Pursuant to Treas. Reg. § 1.436-1(g)(2), a plan must provide that, for a period during which a presumption applies under Treas. Reg. § 1.436-1(h)(1), (2), or (3), the restrictions under Section 436 are applied *as if* the AFTAP for the year were the presumed adjusted funding target attainment percentage. The presumed AFTAP becomes the basis for making determinations under Section 436 until the actual AFTAP is certified for the year. Understanding how the presumed AFTAP is used to make determinations is key to understanding the operational rules.

The presumed AFTAP is used to determine a *presumed funding target*. The presumed funding target initially is the *interim value of adjusted plan assets* divided by the presumed AFTAP. The interim value of adjusted plan assets is the value of adjusted plan assets[22] as of the first day of the plan year and is determined without regard to contributions and elections made after the first day of the plan year.

To determine the presumed funding target, an actual percentage for the presumed AFTAP is necessary. A presumed funding target cannot be determined if the AFTAP is presumed to be less than 60 percent because there is no certified AFTAP for the prior year.

If the AFTAP is presumed to be less than 60 percent, no plan amendments can take effect, no lump-sum benefits can be paid, and benefit accruals must cease.[23]

In the remainder of this article, we will assume that an AFTAP was certified for the prior plan year and that the certification was made before the first day of the current plan year. We also will assume that the certification met the requirements in Treas. Reg. § 1.436-1(h), including those described in the special rule in Treas. Reg. § 1.436-1(h)(1)(ii)(B).[24]

The certified AFTAP gives us an actual percentage for the presumed AFTAP[25] and a presumed funding target for the current year.

The presumed funding target is a function of the value of plan assets on the first day of the current plan year. If assets have doubled in value compared with plan asset values used in the AFTAP certification for the prior plan year, the presumed funding target will be higher.

For example, if an AFTAP was certified for the prior year as the ratio of adjusted plan assets of $7.5 million to a funding target of $10 million, resulting in an AFTAP of 75 percent, and the current-year adjusted plan assets are $15 million, the presumed funding target will be $20 million ($15 million divided by 0.75). The calculation must be performed even if the plan actuary could reasonably project that the current year AFTAP will be close to 150 percent. Calculating a presumed funding target in the prescribed manner might seem counterintuitive, but it follows from statutory language that describes a presumed AFTAP.

The presumed funding target and the interim value of adjusted plan assets are used for determining any reductions in credit balances as of the first day of the plan year. The amount of credit balances available for any reductions is determined according to the chronology rules. [26] If the presumed AFTAP changes during the year, a new presumed funding target is determined using the new presumed AFTAP and an *updated interim value of adjusted plan assets*.

The updated interim value of adjusted plan assets is the interim value of plan assets as of the first day of the plan year, updated to take into account:

- contributions for the prior plan year, and
- Section 430(f) elections with respect to credit balances made before the date of the change in the presumed AFTAP.

The new presumed funding target is the updated interim value of adjusted plan assets divided by the new presumed AFTAP. The new presumed funding target and the updated interim value of plan assets are used to determine any further reductions in the credit balances.

Practice tip: Market value changes during the current year do not affect the calculations, but contributions made for the prior year are taken into account in the updated interim value of plan assets and could affect the presumed funding target and additional reductions in credit balances.

Reductions in balances at the beginning of the plan year and when a presumed AFTAP changes generally are made to allow lump-sum benefits to be paid or to permit accruals to continue. For plan amendments and unpredictable contingent event benefits, the rules are even more complex. To understand the reasons for the complexity, it is helpful to review the statutory provisions.

'Would Be' Rules

Under Section 436(b)(1)(B), an unpredictable contingent event benefit may not be provided if the AFTAP *would be* less than 60 percent after accounting for the unpredictable contingent event benefit. Similarly, under Section 436(c)(1)(B), no plan amendment may take effect if the AFTAP *would be* less than 80 percent after taking the amendment in account. However, the statute does not explain how the ''would be'' language should be applied. Suppose, for example, that the AFTAP was 85 percent and two proposed plan amendments would each reduce the AFTAP by 3 percentage points.

Collectively, the amendments would reduce the AFTAP to 79 percent, but must they be tested separately or together? Further suppose that there had been an unpredictable contingent event earlier in the plan year and that the benefits were paid. Is that event taken into account when considering the effect of the amendments? What if the event occurs after the amendments?

[22] As defined in Treas. Reg. § 1.436-1(j)(1)(ii).

[23] Unpredictable contingent event benefits can still be paid but only if a sufficient Section 436 contribution is made.

[24] A special rule in Treas. Reg. § 1.436-1(h)(1)(ii)(B) requires that a certification made after the first day of the 10th month of the plan year *take into account* any unpredictable contingent events for which benefits were permitted to be paid, any plan amendments that took effect before the certification, and any associated Section 436 contributions that were made.

[25] The percentage is not static. For example, there may be a reduction of 10 percentage points on the first day of the 4th month of the current plan year.

[26] Treas. Reg. § 1.436-1(g)(2)((ii)(B) refers back to Treas. Reg. § 1.430(f)-1(e)(1) and § 1.430(f)-1(d)(1)(iii).

"The regulations effectively provide a set of special rules to apply the words 'would be.' "

The October 2009 regulations answered questions about the statutory ''would be'' language by requiring the calculation of an *inclusive presumed adjusted funding target attainment percentage*, or inclusive presumed AFTAP, and an *inclusive presumed adjusted funding target* for purposes of applying the limitations on unpredictable contingent event benefits and plan amendments.[27] The regulations effectively provide a set of special rules to apply the statutory ''would be'' language. The special rules do not apply to lump-sum benefits and benefit accruals.

The inclusive presumed AFTAP is the ratio of the interim value of adjusted plan assets to the inclusive presumed adjusted funding target. Adjusted plan assets are assets updated to reflect contributions and elections made before the date of an unpredictable contingent event or before the date a plan amendment would take effect. The inclusive presumed adjusted funding target is the presumed adjusted funding target increased by the value of: [28]

- the unpredictable contingent event benefit or plan amendment;
- any unpredictable contingent event benefits that are permitted to be paid as a result of any unpredictable contingent event or a plan amendment that has taken effect in the prior plan year to the extent those benefits or the plan amendment were not taken into account in the prior plan year's AFTAP; and
- any other unpredictable contingent event benefits that are permitted to be paid as a result of any unpredictable contingent event that has occurred or plan amendment that has taken effect in the current plan year to the extent those benefits or the plan amendment were not taken into account in the presumed adjusted funding target for the plan year.

The inclusive presumed adjusted funding target reflects all unpredictable contingent events and plan amendments that have been permitted prior to a current unpredictable contingent event or plan amendment. The target also takes into account the current unpredictable contingent event or plan amendment. The inclusive presumed funding target is in effect a real-time measure of the funding target, which changes as events occur. By adding an inclusive presumed adjusted funding target, the regulations establish a unified ''would be'' rule that reflects all prior and current unpredictable contingent events and plan amendments that are not yet reflected in a certified AFTAP. The inclusive presumed adjusted funding target then is used to calculate an inclusive presumed AFTAP.

[27] Treas. Reg. § 1.436-1(g)(2)(iii)(A).

[28] In the case of an unpredictable contingent event benefit, the increase would be measured as the increase in the funding target because of the unpredictable contingent event. The amount of the increase would depend on the extent to which the benefits were reflected in the funding target before the actual event occurred. Further discussion of the topic is beyond the scope of this article.

Plan sponsors can use the inclusive presumed AFTAP to reduce credit balances under the rules previously described. If the inclusive presumed AFTAP, after any reduction in credit balances, is less than the applicable threshold under Sections 436(b) or 436(c), a plan is not permitted to provide any benefits based on an unpredictable contingent event. Also, a plan amendment may not take effect under operational rules unless a plan sponsor makes Section 436 contributions sufficient to allow unpredictable contingent event benefits to be paid or plan amendments to take effect.[29] Section 436 contributions are based on the inclusive presumed AFTAP.[30] If the inclusive presumed AFTAP is greater than or equal to the applicable threshold, a plan is not permitted to restrict the payment of benefits or to restrict a plan amendment based on an expectation that the limitations will apply when the actual AFTAP is certified for the plan year.[31]

Practice tip: Note the procedure to be followed: A *presumed AFTAP* gives rise to a *presumed adjusted funding target*. The presumed adjusted funding target is increased to determine an *inclusive presumed adjusted funding target*. Next, the *interim value of adjusted plan assets* is divided by the inclusive presumed adjusted funding target to determine the *inclusive presumed AFTAP*. The inclusive presumed AFTAP is measured against the threshold for paying unpredictable contingent event benefits or adopting a plan amendment to determine whether the benefits can be paid or the plan amendment can take effect. If the benefits cannot be paid or the plan amendment cannot take effect, then the plan sponsor may make a Section 436 contribution or reduce a credit balance, based on the inclusive presumed AFTAP.

The regulations assume that events and amendments are tested in a seriatim manner, and they reserve a section (§ 1.436-1(g)(5)(D)) for establishing ordering rules for multiple unpredictable contingent events and plan amendments.

As the presumed AFTAP changes, the presumed adjusted funding target also changes. For example, the presumed adjusted funding target changes when Section 436 contributions or reductions in credit balances are made.[32] The new presumed adjusted funding target will be the basis for a new inclusive presumed AFTAP the next time an unpredictable contingent event occurs or a plan amendment is adopted.

Practice tip: The inclusive presumed AFTAP is used only for unpredictable contingent event benefits and plan amendments. For lump-sum benefits and benefit accruals, the presumed AFTAP, updated for elections with respect to credit balances or contributions made for the prior year, is used. Plan administrators and plan actuaries must be careful to distinguish between the two as the presumed AFTAP changes.

[29] § 1.436-1(g)(2)(iii)(D).

[30] See § 1.436-1(g)(2)(iv).

[31] § 1.436-1(g)(2)(iii)(E).

[32] Treas. Reg. § 1.436-1(g)(4)

Period Prior to AFTAP Certification: No Presumption Applies

In general, under Treas. Reg. § 1.436-1(g)(3), if *no* presumptions apply under Section 436(h)[33] and an actuary has not yet certified an AFTAP for the plan year, then a plan is not permitted to limit lump-sum benefits under Treas. Reg. § 1.436-1(d) or Treas. Reg. § 1.436-1(e).[34] For unpredictable contingent event benefits and plan amendments, the situation is somewhat different. Under Sections 436(b) and 436(c), a plan must still determine if the AFTAP would be below the applicable threshold if unpredictable contingent benefits were paid or a plan amendment were to take effect.

Treas. Reg. § 1.436-1(g)(3)(ii) provides that if *no* presumptions under Section 436(h) apply to a plan during a period and the plan's actuary has not yet certified an AFTAP for the plan year, any limitations on unpredictable contingent benefits and plan amendments must be applied during that period by following the rules of paragraph (g)(2)(iii). Those rules are based on the inclusive presumed adjusted funding target calculated by using the prior plan year's adjusted funding target attainment percentage. The plan basically arrives at the inclusive presumed AFTAP from a different starting point.

Instead of using a presumed AFTAP as the starting point, the plan uses the certified AFTAP for the prior year, combined with the interim value of plan assets, to determine the presumed adjusted funding target. That target is further adjusted to reflect prior unpredictable contingent event benefits that were permitted to be paid but were not taken into account in the certified AFTAP, plan amendments that took effect but were not taken into account in the certified AFTAP, and current-year events or plan amendments. [35] From that point forward, the application of the limits is the same as that under the rules for periods when a presumption applies.

Period After AFTAP Certification

After an AFTAP has been certified for the plan year, assuming that the certification was made *before the first day of the 10th month of the plan year*, which would be before Oct.1 for a calendar plan year,[36] the certified AFTAP must be used to apply the limitations on prohibited payments and annuity stating dates *on or after* the AFTAP certification date, and for benefit accruals *on or after* the AFTAP certification date.[37] Certification of the AFTAP does not affect limitations on prohibited payments and benefit accruals for periods *prior to* the date of certification.[38] For unpredictable contingent event benefits and plan amendments, the rules are more complex.

Timing Rules. Before unpredictable contingent event benefits can be paid with respect to an event that occurred*on or after* the AFTAP certification date and before a plan amendment that was adopted on or after the AFTAP certification date can take effect, the plan actuary must determine *if the AFTAP would be at or above the applicable threshold* if the certified AFTAP were modified[39] to take into account:

- the unpredictable contingent event benefits or plan amendment;
- any other unpredictable contingent event benefits that were permitted to be paid as a result of any unpredictable contingent event that occurred or plan amendment that took effect earlier during the plan year, to the extent those benefits or the plan amendment were not taken into account in certifying the AFTAP; and
- any earlier Section 436 contributions made for the plan year to the extent those contributions were not taken into account in certifying the AFTAP. [40]

For unpredictable contingent event benefits and for plan amendments that take effect *on or after* the date that the AFTAP is certified, the ''would be'' rules [apply much like they apply during?] the period before the certification date. A starting point, which is the certified AFTAP, is established and then adjusted to reflect the current unpredictable contingent event or plan amendment and prior events or amendments.

The adjustment is made by adding to the funding target any increase in the funding target that would occur if the unpredictable contingent event benefits were permitted to be paid or the plan amendment took effect. If the certified AFTAP, as adjusted, is below the applicable threshold, an unpredictable contingent event benefit cannot be paid and an plan amendment cannot take effect without making Section 436 contributions or reducing a credit balance.

Special Rule for Benefits Not Paid Prior to Certification. Except as otherwise provided, the AFTAP certification does not affect the application of limitations on unpredictable contingent event benefits or plan amendments that occur when the inclusive presumed AFTAP is used.[41] With respect to unpredictable contingent events that occur during a plan year prior to the certification, the regulations contain a special rule for benefits that *are not paid*.[42]

Under the special rule, a plan must pay the benefits attributable to the unpredictable contingent event if the benefits would be permitted by rules under Section 436 based on a timely certified or re-certified AFTAP that takes into account the increase in the funding target caused by the unpredictable contingent event benefits.

Under that special rule, if the unpredictable contingent event benefits are not paid during the period in which the inclusive presumed AFTAP was used, the

[33] No presumptions means that the AFTAP has been certified for the prior plan year and is at least 80 percent.

[34] If a plan sponsor is in bankruptcy, then the threshold for restricting prohibited payments increases to 100 percent, and a restriction applies even though no presumption applies.

[35] In many cases the presumed AFTAP and the certified AFTAP will be the same, but differences might appear if the certified AFTAP takes into account unpredictable contingent event benefits that were permitted to be paid or plan amendments that took effect.

[36] If the certification is on or after the first day of the 10th month, then the AFTAP is presumed to be less than 60 percent and all restrictions apply for the remainder of the plan year.

[37] See Treas. Reg. § 1.436-1(g)(5)(i)(A).

[38] See Treas. Reg. § 1.436-1(g)(5)(ii)(A).

[39] See Treas. Reg. § 1.436-1(g)(5)(i)(B).

[40] Any reductions in credit balances would be taken into account in the certified AFTAP.

[41] Specifically, during the periods during which Treas. Reg. § 1.436-1(g)(2) and (g)(3) apply. See Treas. Reg. § 1.436-1(g)(5)ii)(A).

[42] See Treas. Reg. § 1.436-1(g)(5)(ii)(B).

benefit limitations must be reapplied using the certified AFTAP. The reapplication must take into account any unpredictable contingent event benefits that were permitted to be paid or plan amendments that were permitted to take affect, and any Section 436 contributions that were made earlier in the plan year.

Practice note: The preceding analysis clarifies the phrase ''that would be permitted under the rules of Section 436'' found in Treas. Reg. §§ 1.436-1(g)(5)(ii)(B) and (C).

Special Rule for Plan Amendments. Similarly, the regulations contain a special rule for plan amendments. If a plan amendment did not take effect during the period in which the inclusive presumed AFTAP was used, the limitations must be reapplied using the certified AFTAP. If a plan amendment were permitted to take effect under the rules of Section 436, based upon the certified AFTAP adjusted for an increase in the funding target caused by the plan amendment, the plan amendment must go into effect *unless* the plan amendment provides otherwise.[43] The reapplication must take into account any unpredictable contingent event benefits that were paid, plan amendments that took effect, and Section 436 contributions made earlier in the plan year.

A provision in the special rule for plan amendments could be important to plan sponsors whose financial circumstances change between the date an amendment is introduced and the date an AFTAP is certified. That provision permits language stating that an amendment might not take effect even if the amendment is later permissible on the basis of the plan's certified AFTAP.

Practice tip: Plan sponsors should consider whether to include language in amendments that would prevent the amendments from springing into effect at a later date if the plan's AFTAP changes.

Different Treatment for Other Restrictions

The special rules require that limitations on unpredictable contingent event benefits and plan amendments be reapplied after the AFTAP is certified. The same treatment is not required with respect to limitations on prohibited payments and benefit accruals. The different treatment reflects differences in the statutory provisions pertaining to benefit limitations.

Section 436(d) restricts the payment of lump-sum benefits after the valuation date for a plan year if the AFTAP is less than the applicable thresholds.

Similarly, Section 436(e) requires that benefit accruals cease as of the plan's valuation date for the plan year if the AFTAP is less than 60 percent. Presumably that means a plan with a valuation date at the beginning of a plan year must comply retroactively with the benefit limitations once the AFTAP is certified. Clearly, however, imposing those benefit limitations retroactively would be unworkable.

Further complicating the statutory rules is a rule that presumptions under Section 436(h) treat *the first day of the fourth month* and *the first day of the 10th month* of the plan year as valuation dates if benefit limitations apply because of the application of the presumptions. The regulations resolve the ambiguity by defining a Section 436 ''measurement date'' as the date that limitations apply or cease to apply.

[43] See Treas. Reg. § 1.436-1(g)(5)(ii)(C).

The terms of Sections 436(b) and 436(c) imply that the benefit limitations apply beginning not on the plan valuation date but [for?] the entire plan year on the basis of the certified AFTAP, assuming that it was timely certified. Those terms leave open questions about the retroactive application of limitations. However, Sections 436(b) and 436(c) state that benefit limitations apply if the AFTAP *would be* below the applicable thresholds, taking into account an unpredictable contingent event benefit or plan amendment. The October regulations provide an orderly interpretation of the statutory rules by using the Section 436 measurement date and establishing ''would be'' rules.

The regulations further recognize that the benefit limitations under Sections 436(b) and 436(c) apply for the entire plan year, not simply from the valuation date forward. A special rule in the regulations requires that benefit limitations be reapplied after the AFTAP certification if the reapplication would permit unpredictable contingent event benefits to be paid. It is relatively easier to pay a benefit that was missed than it is to retroactively limit the payment of a benefit. Therefore, the special rule on reapplication applies only if the unpredictable contingent event benefit payments were permissible.

A similar rule applies to plan amendments, although the rule permits an amendment not to take effect if the amendment provides for that option. The rule is an administrative convenience for plan sponsors by providing that a plan amendment that cannot take effect can, in effect, self-destruct without further action. The rule also helps prevent conflicts when there are sequential plan amendments but only one amendment can take effect.

Generalization of the 'Would Be' Rules

Practice tip: Applying the limitations on unpredictable contingent event benefits and plan amendments can be expressed as a series of steps in a general testing procedure:

Step 1: Determine a starting point, which is a relevant AFTAP under the operational rules.

Step 2—Modify the relevant AFTAP to take into account the effect of earlier unpredictable contingent event benefits that were permitted to be paid and plan amendments that were permitted to take effect, to the extent not taken into account in the relevant AFTAP.

Step 3—Further modify the relevant AFTAP to take into account the unpredictable contingent event benefit or plan amendment that is to be tested.

Step 4—Permit unpredictable contingent event benefits to be paid or a plan amendment to take effect if the result of the previous steps is a percentage that is not less than the applicable thresholds, or make Section 436 contributions or reductions in credit balances or both to permit the benefits to be paid or the amendment to take effect.

Practice tip: Modify the relevant AFTAP using a relevant presumed funding target.

Conclusion

The application of funding rules under Section 430 and the benefit limitations under Section 436 involve interactions among several provisions of the law and regulations. The October 2009 regulations establish an order that permits plans to be administered on a dynamic basis without waiting for valuation results or later decisions by plan sponsors and, in doing so, help make a complex law workable for plan actuaries and plan sponsors.

The October 2009 regulations are incomplete, however, and future guidance is necessary to address practical issues such as mergers and spin-offs, plans with valuation dates that are not the first day of the plan year, and simultaneous events.

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