

THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

Code Section 436: Dealing with Amendments and Restricted Benefits

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This article will deal with two aspects of Code Section 436—how to deal with amendments and how to deal with restricted benefits when distributions have to be processed.

Any time a plan is amended to increase benefits, the plan administrator must make sure that the amendment conforms to the rules of Code Section 436(c), or else the amendment does not take effect. This article will help explain how these rules function.

Amendments

Basic Rule 1

An amendment that does not increase the Funding Target (FT) has no effect on an Adjusted Funding Target Attainment Percentage (AFTAP) for the year and can always be adopted. Remember, benefit accruals are restricted once the AFTAP falls below 80% and are frozen once the AFTAP falls below 60%.

If an amendment does not increase the FT (e.g., if the amendment is a fresh start benefit increasing future accruals only), the amendment is *always* permitted to take effect, regardless of the plan's funding level as expressed by its AFTAP when the amendment is adopted.

However, the regulations do address whether an amendment adopted after the valuation date must be recognized for funding purposes for a plan year, even if it has no impact on the FT. For funding purposes under Section 430, if an amendment for a year is adopted after the valuation date, even if the amendment has no impact on the FT and only impacts the Target Normal Cost (TNC) for the year, it must be taken into account for funding for that year if the amendment would not be allowed if it were included in the FT.



Example 1

A plan's 2010 AFTAP has been certified as 85%. The valuation date is January 1, 2010. An amendment is adopted in November of 2010 to increase future benefits via a fresh start amendment effective January 1, 2010 [and a 412(d) (2) election is made to use the amendment for the 2010 funding calculation]. The amendment can be adopted without regard to the impact of the benefit increase because the FT for 2010 is not affected. However, we need to determine what the AFTAP *would be* as of January 1, 2010 if the TNC were included as part of the FT:

- If the AFTAP is more than 80%, then the 2010 valuation does *not* need to reflect the amendment (the impact of it would first be seen in the 2011 valuation);
- If the AFTAP is less than 80%, then the 2010 valuation *must* reflect the amendment. Even though the amendment increasing the TNC was not adopted by the valuation date, the 2010 valuation must reflect the effect of the amendment in the TNC.

One way to avoid having to deal with 436 contributions to permit an amendment is to have the client make an additional prior year contribution that increases the AFTAP for the current year.

Basic Rule 2

An amendment increasing benefits *cannot* take effect in a plan year if:

- The AFTAP before the amendment is less than 80%; or
- The AFTAP before the amendment is more than 80% but would be less than 80% after the amendment.

However, there is an exception to this rule if the employer makes a sufficient 436(c) contribution so that the above limits do not apply. (Note: the employer can post security rather than make a 436 contribution, but since this situation will rarely apply to small plans, this article will not discuss this option.) A 436 contribution is a *current year contribution* needed to permit an amendment to the plan. It is important to realize that a 436 contribution is not permitted to be counted for 430 purposes. (Section 430 sets forth the minimum funding requirements and Section 436 sets forth benefit restrictions for underfunded plans—while these two Code Sections share some common definitions and terms of art, they must be read and applied separately.)

The amount of 436(c) contribution required to permit an amendment depends on the plan's AFTAP before the amendment:

- *If the AFTAP before the amendment is less than 80%*, the 436 contribution required is the increase in the FT attributable to the amendment. So if the AFTAP before the amendment is less than 80%, the AFTAP after the amendment does not need to be more than 80% if the increase in FT attributable to the amendment is funded via a 436 contribution.
- *If the AFTAP before the amendment is more than 80%*, the 436 contribution required is the amount necessary to bring the AFTAP to 80% after the amendment.

A 436 contribution must be made and designated as such at the time the contribution is used to avoid the amendment restriction, and cannot be subsequently recharacterized.

If the AFTAP for a year has already been certified, *and the client makes a 436 contribution to allow the amendment*, then there are different requirements for recertifying the AFTAP:

- If the AFTAP was more than 80%, and the AFTAP after the amendment would have been less than 80%, and a 436 contribution was made to increase the AFTAP after the amendment to 80%, then an AFTAP for the year that takes into account the amendment and the 436 contribution *must* be recertified. The recertified AFTAP must reference the amendment and the 436 contribution.

- If the AFTAP was less than 80%, and the 436 contribution was such that the FT associated with the increase is funded, then an AFTAP for the year that takes into account the amendment and the 436 contribution *may* be (but does not have to be) recertified at the request of the plan administrator. There is no requirement in the regulations that the actuary certify anything as to the cost of the amendment; however, the general principles of ASOP 41 will presumably apply for this communication.
- If the AFTAP was more than 80%, and the actuary determines that the AFTAP after an amendment would still be more than 80%, then an AFTAP for the year that takes into account the amendment and the 436 contribution *may* be (but does not have to be) recertified at the request of the plan administrator. Again, there is no requirement in the regulations that the actuary certify anything as to the cost of the amendment; however, the general principles of ASOP 41 will presumably apply for this communication.

The easiest way to think about these rules is that there is one AFTAP for a plan year, and the impact of the amendment increasing benefits must be funded via a 436 contribution, and the AFTAP must be recertified, such that the AFTAP does not change.

The amount of the 436 contribution is discounted to the first day of the plan year at the effective rate for the year. If the effective rate is not known at the time the 436 contribution is being made (because the valuation for the year has not yet been run), then the third segment rate for the year must be used. If there is excess funding because of this rate, then the excess can be re-designated as a 430 contribution.

The concept of a 436 contribution as a current year contribution that cannot do double duty as a 430 contribution for a year will be very confusing to clients. One way to avoid having to deal with 436 contributions to permit an amendment is to have the client make an *additional prior year contribution* that increases the AFTAP for the current year. The timing of such an amendment can be delayed to within the 2 1/2 months following the end of the plan year to allow prior year contributions to be used to support the amendment.

Example 2

A plan's 2009 AFTAP was 91%. The presumed AFTAP as of January 1, 2010 is 91%. In February of 2010 the client wants to amend the plan to increase benefits effective January 1, 2010, by increasing the FT as of January 1, 2010. The 2010



AFTAP has not yet been certified, but all the data is ready to do so, so the preliminary AFTAP as of January 1, 2010 after the amendment is 75%. The actuary determines that an additional contribution of \$100,000 would increase the AFTAP to 80%.

So the client can:

- Make an additional *prior year* 2009 contribution of \$100,000, adopt the amendment, and the actuary certifies the 2010 AFTAP at 80%; or
- If the 2009 funding has been finalized and the client is unwilling to fund an additional 2009 amount, make a 2010 Section 436(c) contribution of \$100,000, adopt the amendment, and the actuary certifies the 2010 AFTAP at 80%. (However, in this case the \$100,000 cannot also be used as a Section 430 contribution for 2010, which is not a problem if the client is looking for a maximum contribution for 2010, but is a problem if the client only wants to make a \$100,000 contribution for 2010.)

Example 3

A plan's 2009 AFTAP was 91%. In November of 2009, the client wants to increase benefits effective January 1, 2009. The actuary determines that the assets are \$100,000 short of what they need to get the AFTAP to 80% (after the amendment). If the client adopts this amendment in November of 2009, there is no way to make an additional prior year contribution for 2008. So the client can:

- Adopt the amendment in November of 2009 and fund the \$100,000 as a 436 contribution for 2009, which means it cannot also count as a 430 contribution for 2009 (which in most cases will be an unfavorable result); or
- Wait until after December 31, 2009, fund the \$100,000 as a 2009 *prior year contribution*, adopt the amendment before March 15, 2010 effective January 1, 2009 as a 412(d)(2) amendment for 2009 and the actuary can certify the 2010 AFTAP at more than 80%. This approach will likely be the strategy of choice because it allows the amendment with no need for a 436 current year contribution. There will be problems when the client wants to adopt the amendment but does not have the cash to fund the contribution by March 15, 2010. In that situation, the client simply will not be able to amend if the \$100,000 cannot be funded by March 15, 2010.

Note that:

- If a plan has language that automatically restores accruals that were restricted, and an AFTAP is adopted that restores benefit accruals retroactively, the restoration is *not treated as an amendment* if the period of accruals is fewer than 12 months, and the actuary certifies that the AFTAP after the restoration would be more than 60%.

- If there is no automatic restoration language, an amendment reactivating accruals is treated like any other amendment.
- An amendment to increase mandatory vesting is not considered an amendment for this purpose.
- While the Regulations are silent on this issue, the position of the IRS appears to be that automatic Section 415 COLAs in a document are amendments.

Under PPA, amendments increasing benefits are very tricky to manage. Every amendment is now a consulting project, as the plan's funded status, the need to possibly make 436 contributions and the timing of the amendment vis-à-vis prior year contributions all affect when the amendment will be effective and how the amendment will apply.

What Happens When Benefits are Restricted?

How do you prepare participant distribution elections when there are restrictions in place?

For this article, we will *not* discuss the restricted distribution rules under Treasury Regulations Section 1.401(a)(4)-5, which generally prohibit lump sum distributions to certain highly compensated employees, when plan assets are less than 110% of plan liabilities. Rather, we will discuss the general restrictions imposed by PPA when a plan is less than 80% funded.

A participant terminates and you are asked to prepare his or her distribution election forms. How the distribution proceeds depends on the AFTAP for the plan year. If the:

- AFTAP is more than 80%: the distribution can proceed as normal; the participant is entitled to a lump sum or one of the annuity options under the plan.
- AFTAP is between 60% and 80%: the participant is restricted to a lump sum based on half of his or her accrued benefit or the value of the PBGC guaranteed benefit, if lower.
- AFTAP is less than 60%: no lump sums are available.

However, how these restrictions are handled and how the choices are communicated to participants is very complicated because participants are entitled to all of their options under the terms of the plan. Let's review some examples:

Example 1

A plan's AFTAP is less than 60%. Suzie Q, age 55, terminates employment with an accrued benefit of \$500 per month for life commencing at age 65. The immediate annuity equivalent of this benefit is \$300 per month at age 55. Assume the full lump sum equivalent of this life annuity is \$100,000.

While the plan provides a lump sum option, no lump sums can be paid because the AFTAP is less than 60% and no benefit can be paid which exceeds the life annuity amount.

Assume that the plan offers the following annuity options: Life, Life and 10 Year Certain, Joint and 50% Survivor, Joint and 100% Survivor, and 5 Year Installment.

Suzie's choices are:

- To defer payment of her benefit until such time as there are no restrictions; or
- To go into pay status with respect to an immediate annuity in any of the annuity options under the plan, as long as the payment amount does not exceed the life annuity amount. In this case, all the annuity options can be offered, *except the 5 year installment payment*, because that amount would exceed the life annuity amount.

It is relatively easy to communicate this information to Suzie, as it is only a slight variation of the normal communication for a plan that offers no lump sum benefits.

Example 2

A plan's AFTAP is between 60% and 80%. Suzie Q terminates at age 55 with an accrued benefit of \$500 per month for life commencing at age 65. The immediate annuity equivalent of this benefit is \$300 per month commencing at age 55. While the plan provides a lump sum option, the amount of the lump sum is restricted based on half of her accrued benefit. Assume for the example that the present value of 1/2 of her \$500 accrued benefit is \$50,000, and assume it is less than the value of the PBGC maximum.

Again, assume the plan offers the following annuity options: Life, Life and 10 Year Certain, Joint and 50% Survivor, Joint and 100% Survivor, and 5 Year Installment.

Suzie's choices are:

- To defer payment of her full benefit until such time as there are no restrictions;
- To go into pay status with respect to an immediate annuity of \$300 a month commencing at age 55, with respect to her full accrued benefit in any of the annuity option under the plan, except for the installment option where the amount exceeds her life annuity amount; or
- To choose to receive half of her unrestricted accrued benefit as a lump sum (value of \$50,000) or in any of the annuity forms under the plan; and
 - Defer the balance of the remaining half of her restricted accrued benefit until such time as there are no restrictions; or

- Go into pay status with respect to the remaining half of her restricted accrued benefit as an immediate annuity of \$150 per month commencing at 55, in any of the annuity options under the plan as long as the amount does not exceed the life annuity amount (so the 5 year installment cannot be offered with respect to the restricted piece of her benefit).

It goes without saying that communicating these options is extremely complicated and will likely be extremely confusing to participants. The Service acknowledges this situation in the preamble to the regulations and suggests three ways to handle this issue (but this list is not necessarily an exclusive list):

- Send the participant the normal distribution election form without regard to any restrictions, but if he or she elects a prohibited payment, then go back to him or her and explain that the election he or she made is prohibited, and provide a new form with the available options. This option is really impractical because in most cases the participant will elect a lump sum option and will be really grumpy if you go back to him or her and say "Oh yeah, remember that \$100,000 lump sum option you elected—well, we were really kidding, you actually are not allowed to receive it."
- Send the participant the normal election form with a back-up form in case the participant elects a prohibited amount. This option is also a really impractical option because again the participant will likely elect an option he or she cannot receive and will be very confused by the back-up form.
- Send the participant two sets of forms, one for the unrestricted portion and one for the restricted portion of the accrued benefit. This option is the most practical of their alternatives. However, this option will still be very confusing to participants.

There is a fourth alternative, not suggested by the Service, which is to use a two-step process as follows:

- Step 1 is to provide the participants with a simplified form that outlines their basic options; and
- Step 2 is to provide a detailed form based on the option they select from the Step 1 process.

If the plan administrator uses this alternative, in the case of Suzie in our Example 2 previously, the Step 1 form could look something like the following sample:

To: Suzie Q. Rucker

As a result of your termination of employment you are entitled to your vested Accrued Benefit of \$300.00 per month, payable immediately as of July 1, 2010 as a Life Annuity. If you elect a different form of payment, and/or a different annuity commencement date, the amount you will receive will be different. The lump sum equivalent of your vested Accrued Benefit as of July 1, 2010 is \$100,000.

Under the Pension Protection Act of 2006 (PPA), when a Plan's Adjusted Funding Target Attainment Percentage (AFTAP) is between 60% and 80%, a participant cannot receive a full lump sum. Because the Plan's AFTAP is less than 80%, you cannot receive the full lump sum equivalent of \$100,000 at this time. You are only entitled to receive a partial lump sum of \$50,000 at this time.

The following election must be completed so that the appropriate distribution forms, if applicable, can be prepared for your completion. If you have any questions or would like more detailed information regarding your benefit choices, please contact the individual listed on the cover page.

You have essentially four choices regarding your benefit distribution. Place your initials next to the choice you wish to make:

Choice	Initials	Description of the Choice	If You Make This Choice
1		I elect to take no distribution now and defer receipt of my benefit until the restrictions are lifted.	Complete the attached ELECTION TO DEFER BENEFITS confirming your choice to defer benefits.
2		I elect to take my full vested accrued benefit of \$300 per month now in the form of an annuity under one of the equivalent annuity options in the plan document.	You will receive detailed distribution forms to complete explaining your equivalent annuity options.
3		I elect to take 1/2 of my vested accrued benefit now as a partial lump sum of \$50,000 or in the form of an annuity under one of the equivalent annuity options in the plan, and I elect to take the remaining 1/2 of my vested accrued benefit of \$150 per month in the form of an annuity under one of the equivalent annuity options in the plan document.	You will receive detailed distribution forms to complete explaining your partial lump sum and equivalent annuity options for the remainder of your benefit.
4		I elect to take 1/2 of my vested accrued benefit now as a partial lump sum of \$50,000 or in the form of an annuity under one of the equivalent annuity options in the plan document, and I elect to defer receipt of the balance of 1/2 of my vested accrued benefit until the restrictions are lifted.	You will receive detailed distribution forms to complete explaining your partial lump sum and the equivalent annuity options of the partial lump sum.

After Suzie completes this form, a specific Step 2 form is sent to Suzie based on which of the four options she elected. While this alternative is not described by the Service, this author believes that it meets all the requirements of law and is the most practical way to approach a restricted benefit option. However, I suggest you get the advice of your own ERISA counsel to decide how best to approach dealing with these bifurcated situations.


Caution: For all of the preceding discussion, both on amendments and on dealing with restricted payments, it is critical that everyone involved fully understands all the rules for determining a plan's AFTAP. These rules include the rules for determining presumed AFTAPs as of the first day of the fourth month of the plan year. While determining AFTAPs is the subject of a separate detailed article, a brief example will illustrate how easy it is to make a mistake and create a disqualifying event for a client's plan:

Example 3

In a calendar year plan, the 2009 AFTAP was 79%. As of January 1, 2010, it is determined that the plan's presumed AFTAP is 79%, and the plan administrator advises a participant who terminates in February that he or she *cannot* receive full lump sum payment because the plan's AFTAP is less than 80%. However, the 436 regulations require that you determine a

presumed AFTAP as of January 1, 2010 based on the January 1, 2010 plan assets, and using that presumed AFTAP you determine if there are any deemed burns of credit balances to avoid restrictions. Had this calculation been performed, the AFTAP as of January 1, 2010 would have been determined to be 80% after the deemed burn of the credit balances. Because the plan administrator restricted benefits where no restrictions actually applied, this action is a disqualifying event.

Summary

As we all know well, PPA has made pension life much more complicated, and dealing with routine amendments and routine participant terminations is now no longer routine! Hopefully this article has helped clarify a few of the issues. 



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