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Pension Funding Relief Enacted

Following many months of lobbying by companies and employee benefits organizations, pension funding relief provisions have finally been enacted. H.R. 3962, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, which was signed into law on June 25, provides much needed defined benefit plan funding relief for employers in today's difficult economic environment.

Introduction

Due to the severe economic conditions during the recent recession, many companies are facing substantially greater contribution requirements for their defined benefit plans than anticipated, at a time when their own cash positions have been weakened. These companies have been seeking pension funding relief for some time. The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (the 2010 Relief Act) contains provisions designed to ease the cash contribution burden for many single employer and multiemployer sponsors.

Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010

Pension Funding Relief – Single Employer Plans

Amortization Extension

Under the funding regime introduced in the Pension Protection Act of 2006 (PPA), the annual minimum contribution requirement for a defined benefit plan is generally equal to the sum of its Target Normal Cost – the value of benefits accrued during the year – plus the amount required to amortize its Shortfall Amortization Bases. The Shortfall Amortization Base established each year is equal to the excess of the plan's Funding Target – the value of benefits accrued to date – over its assets, minus the present value of the remaining installments due on Shortfall Amortization Bases established in prior years. PPA required that each Shortfall Amortization Base be amortized in level installments over the 7-year period beginning with the year that it is established.

Under the 2010 Relief Act, a plan sponsor may elect one of two alternative extensions of the 7-year period otherwise required for amortizing the Shortfall Amortization Base that is established for an "eligible plan year." An eligible plan year is a plan year beginning in 2009, 2010 or 2011 (and a plan year beginning in 2008, but after October 10, 2008). The election is available for up to 2 eligible plan years.

BUCK COMMENT. *The purpose of permitting extended amortization is to improve the plan sponsor's near term cash flow, not to reduce its total contribution obligation.*

"2 Plus 7" Amortization of Shortfall Amortization Base. Under this schedule, the required installments for the first 2 years of the amortization period are equal to the interest on the base at the plan's effective interest rate for the plan year of the election. The balance is then amortized over the following 7 years, in level installments determined using the segment rates for the plan year of the election.

BUCK COMMENT. *If a plan sponsor elects the "2 plus 7" amortization schedule for a Shortfall Amortization Base, the funding requirement attributable to that base will be less than it would have been without the relief for the first 2 years of the amortization period. For the next 5 years, it will be approximately the same as it would have been without the relief. For the last 2 years, it will be more than it would have been, because without the relief the amortization period would have ended.*

15-Year Amortization of Shortfall Amortization Base. Under this schedule, the base is amortized in level installments over 15 years determined using the segment rates for the plan year of the election.

BUCK COMMENTS. *If the plan sponsor elects the 15-year amortization schedule for a Shortfall Amortization Base, the funding requirement attributable to that base will be less than it would have been without the relief for the first 7 years of the amortization period. For the next 8 years, it would be more than it would have been, because without the relief the amortization period would have ended.*

The 2010 Relief Act does not provide an explicit exception to the use of segment rates for the determining the amount of the required installments under either of the alternative amortization schedules for those plans that use the full yield curve instead of segment rates for minimum funding purposes. However, regulations issued in October, 2009 provide general authorization to use the full yield curve instead of segment rates for all purposes under IRC Section 430, including the determination of shortfall amortization. This authorization should be deemed to extend to the alternative amortization schedules made available by the 2010 Relief Act.

Election. The election to apply an extended amortization schedule must follow rules to be provided by the IRS, and must specify which of the alternative schedules will be used. If a sponsor elects to apply extensions for 2 plan years, then the type of extension must be the same for both years.

Notice. Plan sponsors that elect an extended amortization schedule must give notice to participants and beneficiaries, and must inform the PBGC of the election following rules to be provided by the PBGC.

Installment Acceleration Amount. If an amortization extension is elected, an additional contribution referred to as an "installment acceleration amount" may be required during the "restriction period." An installment acceleration amount is the sum of (i) the aggregate amount of excess employee compensation (for all employees) for the plan year, plus (ii) the aggregate amount of extraordinary dividends and stock redemptions for the plan year. With respect to a "2 plus 7" election, the restriction period is the 3-year period beginning with the plan year of the election (or, if later, the first plan year beginning after December 31, 2009). With respect to a "15-year"

election, the restriction period is the 5-year period beginning with the plan year of the election (or, if later, the first plan year beginning after December 31, 2009).

Excess Employee Compensation – The amount of an employee's excess employee compensation in a plan year is the excess, if any, of the amount includible in the employee's taxable income for remuneration during the calendar year in which the plan year begins for services performed by the employee for the plan sponsor (whether or not such services were performed during the calendar year), over \$1,000,000 (indexed beginning in 2011).

Income for this purpose includes the value of assets set aside or reserved or transferred to a trust during the calendar year for purposes of paying deferred compensation under a nonqualified deferred compensation plan, as defined under IRC Section 409A, regardless of whether such amount is otherwise includible in income.

BUCK COMMENT. *The 2010 Relief Act does not specify how amounts set aside to pay benefits under a nonqualified defined benefit program are to be allocated among covered executives for purposes of determining excess employee compensation.*

For purposes of determining excess employee compensation, income does not include –

- remuneration attributable to services performed before March 1, 2010
- any amount includible in income with respect to a grant of employer stock that is subject to a substantial risk of forfeiture for at least 5 years from the date of the grant
- commissions paid solely on account of income generated by an individual's performance
- remuneration consisting of nonqualified deferred compensation, restricted stock, stock options or stock appreciation rights payable or granted under a written binding contract in effect on March 1, 2010 which was not materially modified before remuneration was paid.

Extraordinary Dividends and Redemptions – The amount of extraordinary dividends and redemptions is the excess, if any, of the sum of the dividends declared during the plan year by the plan sponsor, plus the aggregate amount paid for the redemption of stock of the plan sponsor redeemed during the plan year, over the greater of –

- the adjusted net income of the plan sponsor for the preceding plan year, determined without regard to any reduction by reason of interest, taxes, depreciation, or amortization, or
- in the case of a plan sponsor that has determined and declared dividends in the same manner for at least 5 consecutive years immediately preceding the plan year, the aggregate amount of dividends determined in such manner and declared for the plan year.

For this purpose, dividends and redemptions do not include –

- dividends declared and redemptions occurring before March 1, 2010
- dividends paid by one member of a controlled group to another member of the controlled group
- redemptions made pursuant to a plan maintained with respect to employees, or that are made on account of the death, disability, or termination of employment of an employee or shareholder

- dividends and redemptions of preferred stock issued before March 1, 2010, or issued after March 1, 2010 and held by an ERISA employee benefit plan, to the extent that dividends accrue at a specified rate, without regard to the plan sponsor's income, and interest accrues on unpaid dividends.

Future guidance will be provided by the IRS regarding elections made by a plan sponsor for more than one plan and in the case of a merger or acquisition involving a plan sponsor.

Adjustments to Future Installments – If an installment acceleration amount is required for a plan year, future shortfall amortization installments are reduced, in reverse order starting with the final scheduled installment, so that the present value of the future installments does not exceed the present value of the remaining shortfall amortization base.

Annual Limitation – There is an annual limitation that prevents an installment acceleration amount for any year from causing the cumulative amortization installments under the relief election, including the installment acceleration amounts, from exceeding what the cumulative amortization installments would have been absent the election. Also, the total installment – shortfall amortization installment plus installment acceleration amount – for any year cannot be greater than the present value of the remaining shortfall amortization base.

Carryover – If an installment acceleration amount is limited by the annual limitation, then the excess amount is treated as an installment acceleration amount for the following plan year. However, no amount can be carried over to a plan year that begins after the last plan year in the restriction period, or, in the case of a 15-year election, the second plan year after the last plan year in the restriction period.

Plans with Delayed PPA Funding Rule Dates

Extended amortization is provided for plans that have delayed effective dates for complying with the PPA funding rules.

Benefit Restrictions

The 2010 Relief Act provides limited relief for certain benefit restrictions under IRC Section 436. For purposes of the restrictions on benefit accruals for plans with an Adjusted Funding Target Attainment Percentage (AFTAP) less than 60% and the restrictions on paying benefits in the form of a Social Security leveling option for plans with an AFTAP under 80%, for plan years beginning on or after September 1, 2008 and before October 1, 2010, the AFTAP is the greater of the actual AFTAP for such year, or the AFTAP for the plan year beginning after October 1, 2007 and before October 1, 2008, under rules to be provided by IRS.

BUCK COMMENT. *The limited relief from benefit restrictions is stated to be effective for plan years beginning after October 1, 2008. The 2010 Relief Act does not address whether plan sponsors will be permitted or required to apply the relief retroactively to participants whose benefits commenced after the first day of the first plan year beginning after October 1, 2008 but prior to the date of enactment. Guidance is needed on this issue.*

Use of Credit Balance for Plans Maintained by Charities

Under PPA, credit balances (prefunding and funding standard carryover balances) may be applied toward satisfaction of minimum required contributions only if the ratio of plan assets to funding target is at least 80% for the prior year.

The 2010 Relief Act provides an exception for plans maintained exclusively by one or more 501(c)(3) tax-exempt organizations, for plan years beginning after August 31, 2009 and before September 1, 2011. Under this exception, the 80% ratio test will be based on the greater of the ratio for the prior year, or the ratio for the plan year beginning after August 31, 2007 and before September 1, 2008, as determined under rules to be prescribed by the IRS.

Special Funding Relief – Eligible Charity Plans

The 2010 Relief Act permits sponsors of "eligible charity plans" to elect the same deferred effective date for the PPA funding rules that was originally provided for certain eligible cooperatives. The deferred effective date is the first day of the first plan year beginning after January 1, 2017. An eligible charity plan is a plan maintained by more than one employer, determined without applying the controlled group rules, where all employers are 501(c)(3) tax-exempt organizations. The election is effective for plan years beginning after December 31, 2007, but a sponsor may elect to apply this relief only for plan years beginning after December 31, 2008.

Pension Funding Relief – Multiemployer Plans

Amortization Extension of Net Investment Losses

Multiemployer plans that meet the "solvency test" (see below) may elect to treat the portion of any experience gain or loss attributable to "net investment losses" incurred in either or both of the first two plan years ending after August 31, 2008 as an item separate from other experience losses, to be amortized in equal annual installments over the period –

- beginning with the plan year in which such portion is first recognized in the actuarial value of assets, and
- ending with the last plan year in the 30-plan year period beginning with the plan year in which such net investment loss was incurred.

BUCK COMMENT. *Under the terms of the 2010 Relief Act, the period for amortizing the net investment loss is 29 years, not 30 years.*

If this election is made, an extension of the amortization period by application to IRS under existing rules will not be available. If a plan has been granted an extension by the IRS under existing rules before this election is made, the total amortization period is limited to 30 years.

Net investment losses are to be determined based on the difference between actual and expected returns on assets under rules to be provided by the IRS.

BUCK COMMENT. *The 2010 Relief Act is unclear on how net investment losses are to be determined and how the amortization extension is to be applied for plans that determine their minimum funding requirements on the basis of an actuarial value of assets, rather than the fair market value of assets.*

Expanded Asset Smoothing

Plans that meet the “solvency test” (see below) may change asset valuation methods to apply either or both of the following rules –

- for either or both of the first two plan years ending after August 31, 2008, spread the difference between expected and actual returns over a period of up to 10 years
- for either or both of the first two plan years beginning after August 31, 2008, limit the value of plan assets to a corridor of 80% to 130% of fair market value (instead of the otherwise applicable 80% to 120% corridor)

These changes are deemed to be approved by IRS.

If a plan sponsor elects to apply both extended amortization of net investment losses and the expanded asset smoothing for a plan year, any reduction in unfunded liability resulting from the application of the expanded smoothing will be treated as a separate amortization base to be amortized over 30 years.

BUCK COMMENT. *The 2010 Relief Act does not specify the period for amortizing the reduction in unfunded liability resulting from the application of the expanded smoothing period, if the plan sponsor does not also elect extended amortization of net investment losses. Guidance issued under pre-PPA law concerning a change in asset valuation method provided for an amortization period of ten years and the IRS has informally indicated that multiemployer plans may continue to rely on at least some of that guidance. Further guidance from the IRS would be welcome.*

Solvency Test

A plan meets the solvency test if the plan’s actuary certifies that the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period, taking into account any amortization extension and the expanded asset smoothing elections.

Restrictions on Benefit Increases

If a plan sponsor elects to apply either the extended amortization of net investment losses or the expanded asset smoothing, the plan may not be amended to increase benefits during either of the 2 plan years immediately following a plan year to which such election is applicable, unless the amendment is required as a condition of qualification or to comply with other applicable law, or the plan’s actuary certifies both of the following -

- Any benefit increase is to be paid for by additional contributions not allocated to the plan immediately before the election(s).
- The plan's funded percentage and projected credit balances for the 2 plan years are reasonably expected to be at least as high as the percentage and balances would have been if the benefit increase had not been adopted.

Reporting

Plan sponsors electing the amortization extension or the expanded asset smoothing, or both, must give notice to participants and beneficiaries, and inform the PBGC of the election(s) following rules to be provided by the PBGC.

Effective Date

The multiemployer plan provisions generally apply as of the first day of the first plan year ending after August 31, 2008, except that any election that affects the plan's funding standard account for the first plan year beginning after August 31, 2008 will be disregarded for purposes of applying the IRC Section 432 rules for plans in endangered or critical status to such plan year.

BUCK COMMENT. *For calendar year multiemployer plans, certifications of the plan's status for its 2010 plan year were required to be made by March 31, 2010. The 2010 Relief Act does not explicitly address whether a plan's actuary is permitted to revise a certification that the plan was in endangered or critical status for a plan year after the first plan year ending after August 31, 2008.*

The provisions regarding restrictions on plan amendments increasing benefits are effective as of June 25, 2010, the 2010 Relief Act enactment date.

Conclusion

The 2010 Relief Act provides much needed relief to sponsors of defined benefit plans, and will allow them to apply cash to their business operations that otherwise would have been contributed to the plan. Buck's consultants are prepared to discuss the effect these provisions have on your plans.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.