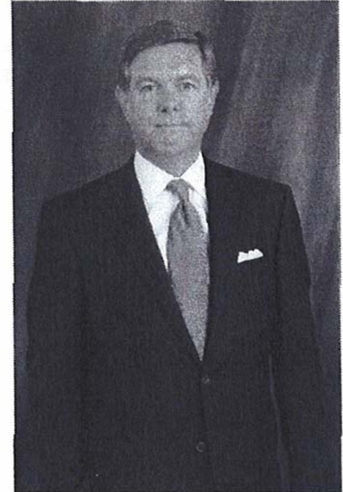
What's new in the US - 2008 pension law changes impact pension underfunding rules



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The New "Worker, Retiree, and Employer Recovery Act of 2008"

The financial turmoil in the U.S. gave Congress an opportunity to make some changes intended to mitigate some of the harsher consequences of the market drops on pension plans, both defined contribution and defined benefit, including some of the consequences resulting from the 2006 Pension Protection Act ("PPA") which was passed before the recent market drops and was intended to significantly tighten defined benefit plan funding requirements. In December, 2008, Congress passed and the President signed The Worker, Retiree, and Employer Recovery Act of 2008 (the "Act"). Provisions of primary interest for pensions in the Act included relief from required minimum distribution rules for 2009 and relief from funding difficulties created by the current economic downturn for defined benefit plans, though the Act also included a number of other technical provisions.

In this article, we will focus on the relief from funding difficulties extended by the Act, and possible further areas for relief in the future.

DB Funding Relief

The overriding concern of many plan sponsors and unions has been that the economic downturn has made PPA's tighter defined benefit plan funding rules even harder to swallow at a time when many sponsors find it difficult to come up with additional contributions. In hopes of a recovery in the markets, the Act provides modest relief, but we expect the new Congress and the

Obama Administration to consider more. The key changes in the act are as follows.

"Smoothing" Relief. The IRS regulations on the valuation of pension plan assets under the new PPA rules did not continue the use of traditional asset smoothing methods, but only allowed averaging of values over a period up to 24 months. The Act would permit some asset smoothing by allowing plans to take expected earnings into account when determining the value of plan assets. This will result in somewhat smaller underfunded amounts and thus somewhat smaller required contributions. However, the smoothed value of assets still must be within 10% of actual fair market value of plan assets. Due to the dramatic market drop, plan sponsor groups asked Congress to widen this 10% "corridor" (prior law had a 20% corridor), but the Act does not do so.

Funding Target Transition Relief. Under the PPA funding requirements, if a plan's assets are less than the funding target, the minimum required contribution is the plan's normal cost plus an amortization of the plan's funding shortfall (the difference between the plan's funding target and the plan's assets). This new PPA funding target is phased-in over three years. Plans with a funding target at or below the set phase-in level for the year (e.g., 92% for 2008, 94% for 2009; 96% for 2010) only need to fund up to that percentage limitation. Under the PPA rules, if the plan does not meet those phased-in funding target percentages, the plan would no longer be eligible for the phase-in period, and the employer would have to fund based on 100% of funding target. The Act would eliminate this so-called "cliff" effect of the transition rule, and instead generally require plans that were at least 90% funded in 2007 to fund up to the specified phased-in funding threshold for the 3 transition relief years. This will modestly reduce the contributions that some plan sponsors will have to make to their plans.

"Look Back" Period. Under the PPA funding rules, if a single-employer pension plan is less than 60% funded for a plan year (as certified by the plan's actuary), the plan sponsor is required to freeze all future benefit accruals for participants. The Act would temporarily allow plans to "look back" to the plan's funding status during the previous plan year to determine whether the plan was at least 60% funded for this purpose. This provision would apply for plan years beginning on or after October 1, 2008 and before October 1, 2009. This would mean that for

plan years beginning January 1, 2009, a plan's funded status as of January 1, 2008 would be used for purposes of the rule.

"At-Risk" Status Transition Rule. Under the PPA funding rules, a plan generally is considered "at-risk" if it is (1) less than 80% funded using the general funding actuarial assumptions and (2) less than 70% funded using special "at-risk" actuarial assumptions. The 80% test under the first prong is phased-in over four years (i.e., 65% for 2008, 70% for 2009, 75% for 2010, and 80% for 2011). The Act would also apply the phase-in transitional rule for determining "at-risk" status to the 70% funded test, which will keep some plans out of "at risk" status. [This also has implications for executive deferred compensation arrangements for public companies. Under the PPA, if a qualified defined benefit plan becomes "at risk," amounts subsequently set aside in a trust or other arrangement to pay non- tax qualified plan benefits for certain executives must be included in the executives' income, and the executives must also pay a 20% penalty tax on this amount and interest. The affected executives are those employed by the company with the "at risk" plan or by a member of its controlled group, and who are subject to either (a) the $1 million deduction cap under Code section 162(m) or (b) the requirements of section 16(a) of the Securities Exchange Act of 1934 (i.e., officers, directors, and 10% owners). Former employees who were covered under one of these sets of rules when they terminated employment are also covered.]

Lump Sum Payments. Under the PPA funding rules, plans that have a funding percentage less than 60%, or where the plan sponsor is in bankruptcy, are not permitted to make any lump-sum payments to participants. The Act provides that lump sum payments of $5,000 or less (or $1,000 if the plan lowered the threshold) can be paid even if an underfunded plan is otherwise prohibited from paying lump sums.

Target Normal Cost. The Act would require that plan sponsors include in the calculation of "target normal cost" the amount of plan-related expenses to be paid from plan assets during the year and mandatory employee contributions expected to be made during the year. This change applies to plan years beginning after December 31, 2008. Thus, the inclusion of plan-related expenses and mandatory employee contributions in target normal cost would not affect 2008 minimum contribution requirements. The technical language and legislative history are not clear as to whether investment-related expenses are to be

considered plan-related expenses that must be included in target normal cost. However, we understand that Congress did not intend for investment-related expenses to be included in target expenses to be included in target normal cost and anticipate that a later explanation of the Act, to be prepared by the Congressional staff, will make that intention clear.

Multiemployer Plan Relief. For plan years beginning on or after October 1, 2008 and before October 1, 2009, the Act would permit "multiemployer" plan sponsors (i.e., collectively bargained plans with multiple employers contributing) to elect to temporarily freeze their actuarial funding certification of endangered status, critical status or neither based on the previous year's funding level. The Act would also extend the current funding improvement or rehabilitation period for multiemployer plans in "endangered" or "critical" status and that have funding improvement and rehabilitation plans in place in 2008 and 2009 by 3 years, from 10 to 13 years. Seriously endangered plans can extend their 15-year plans to 18 years.◆