Congress Takes On Funding Reform (Part 1)

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On June 30, the House Committee on Education and the Workforce approved the Pension Protection Act (H.R. 2830).

Among other things, the approved legislation would completely overhaul the single-employer funding rules, make significant changes to the multiemployer funding rules, and provide some legal certainty regarding the treatment of cash balance and other hybrid plans under the age discrimination rules.

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The approval of the measure is a first step along the legislative highway. The House Ways and Means Committee may mark-up the bill — possibly as part of broad Social Security and retirement reform legislation — later this summer. Staff for the Senate Finance and Health, Education, Labor, and Pensions Committees are also working on drafts of their own bills. Members in both Houses of Congress and on both sides of the aisle are committed to passing some type of pension funding reforms. Enactment of any reforms, however, may hit a roadblock as Congress debates, among other things, Social Security reform and the Supreme Court nominations.

In this article we summarize several of the major provisions of the bill as they affect single-employer plans. Next month's issue will discuss a few additional single-employer provisions, the cash balance provisions, and changes to the multiemployer plan funding rules.

Minimum Funding Rules

The bill replaces the current funding rules with new funding rules. Generally, these new rules require contributions equal to the "target normal cost" of the plan for the plan year and require amortization of any underfunding over a seven-year period. This is substantially shorter than current law normal funding rules. The bill eliminates the higher deficit reduction contribution required for underfunded plans, but the benefit liability amount that plans have to fund is increased for plans that are less than 60 percent funded.

Determination of Funding Target and Annual Contributions. The bill changes the current law concept of a funding standard account. If a plan's assets equal its "funding target," the minimum required contribution for the year is equal to its target normal cost. The funding target is equal to the present value of all benefit liabilities accrued to date, including early retirement subsidies or similar benefits. The target normal cost is equal to the present value of all benefits accrued or earned during the plan year, including increases in benefits attributable to increases in compensation. If a plan's assets exceed its funding target, the target normal cost is accordingly reduced by the excess (in certain instances the minimum required contribution may be zero). If a plan's assets are less than its funding target, additional contributions are required to amortize that shortfall over seven years (unlike current law where amortization periods differ based

on the source of the shortfall and could be as long as 30 years). There will be a year-by-year determination of shortfall amounts and the related amortization periods; consequently, there could be up to seven different shortfalls being amortized at once. If a plan's assets exceed the funding target in future years, then all of the shortfall amortizations are cancelled.

Under the bill, the funding target is equal to 100 percent of the plan's accrued liability. In order to ease the burden of meeting the 100 percent funding target, the bill phases in the funding requirement ratably over five years. Thus, the funding target in 2006 would be 92 percent of a plan's accrued liability, 94 percent in 2007, 96 percent in 2008, 98 percent in 2009, and 100 percent in 2010.

If a plan sponsor elects to maintain a "funding standard carryover balance" or "pre-funding balance," the plan's assets are reduced by such balances for purposes of determining the plan's minimum required contribution for the year. (See below for a broader discussion regarding "funding standard carryover balances" and "pre-funding balances" and the implications of their use.)

Valuation Date. For purposes of determining annual funding amounts, all large plans must use the first day of the plan year as the valuation date. Plans with 500 or fewer participants can continue to choose the valuation date.

Interest Rates. The bill requires that the interest rate used in determining the funding target (i.e., present value of all benefit liabilities) be based on a modified yield curve of corporate bonds to reflect the duration of the liabilities that are to be valued. Unlike the administration's proposal, which would require a separate interest rate for each payment date, the bill requires that the durations of the liabilities be segregated into three broad categories: those liabilities payable within five years of the valuation date, liabilities payable after five years and before 20 years of the valuation date, and liabilities payable thereafter. The Treasury Department has much discretion in determining the rates for each category. The bill provides that each rate is based on a three-year weighted average of these rates (as compared to a 90-day "spot" rate in the administration's proposal). The weighting will be determined so that the most recent year will be weighted 50 percent, the next most recent year will be weighted 35 percent, and the second most recent year will be weighted 15 percent. The use of this modified yield curve will be phased-in over three years.

Mortality Tables. The mortality table used in determining these benefit liabilities would be based on the RP-2000 Combined Mortality Table, with Treasury to update the tables at least every 10 years. Treasury is instructed to issue regulations that phase-in ratably the change in the mortality table over five years. The bill would also allow a plan sponsor to request to use a different mortality table (for not more than 10 years) if the plan sponsor can demonstrate to Treasury that (i) the RP-2000 Combined Mortality Table does not reflect the actual experience of the plan and projected trends in such experience and (ii) the table is significantly different from the RP-2000 Combined Mortality Table. If Treasury does not otherwise disapprove of the use of the different table within 180 days of the request, its use shall be effective for the following plan year.

The bill imposes two restrictions on the valuation methodology.

Determination of Asset Values. The bill continues the current methodology of determining the actuarial value of assets. That means that the values can be determined under any reasonable actuarial method that is permitted under Treasury Department regulations. However, the bill imposes two restrictions on the valuation methodology. The first restriction is that the smoothing of asset values cannot be for more than three years (instead of five years under current law). The second restriction is that the result of this smoothing cannot provide results which are lower than 90 percent (instead of 80

percent under current law) or greater than 110 percent (instead of 120 percent under current law) of the fair market value of such assets at the time of the valuation. The administration's proposal would eliminate smoothing and instead require the use of the market value of assets.

Credit Balances. One of the major concerns raised by employer groups regarding the administration's proposal was the loss of the use of credit balances in determining annual funding amounts. The bill addresses that concern in part by permitting plan sponsors to elect to maintain a "pre-funding balance" which may be used to reduce a plan's minimum required contribution for the year. Under a transition rule, pre-2006 plans that were pre-funded are permitted to maintain a "funding standard carryover balance," which may also be used to reduce a plan's minimum required contribution. Plan sponsors may elect to reduce the amounts held in the funding standard carryover or pre-funding accounts in an attempt to minimize any reduction in plan assets (discussed below), although the mechanics are unclear. The funding standard carryover balance must be used before the pre-funding balance may be used under all circumstances. As of a plan's valuation date, the pre-funding and funding standard carryover balances would be adjusted to reflect investment performance in the underlying plan assets (i.e., market to market).

The bill, however, would impose the following rules and restrictions on the use of pre-funding and funding standard carryover balances:

- If a plan is less than 80 percent funded for a plan year, the plan may not elect to use its funding standard carryover or pre-funding balance to reduce the minimum required contribution for the year. For purposes of applying the 80 percent limitation, a plan sponsor is required to reduce its plan assets by its pre-funding balance (but not the funding standard carryover balance).
- Consistent with the current deficit reduction contribution rules, plan assets must be reduced by the funding standard carryover and pre-funding balances for purposes of determining the minimum required contribution for the year.
- Significantly, plan assets must also be reduced by the funding standard carryover and pre-funding balances for certain other purposes, including the application of the benefit restrictions and the "at-risk" rules under the bill (described below). If a plan is 100 percent funded (i.e., the plan's assets equal or exceed its funding target), the plan's assets would not have to be reduced for the purposes of determining whether the benefit restrictions apply.

At-Risk Plans. The bill requires additional funding for plans in "at-risk" status. A plan is in "at-risk" status based solely on whether the plan's assets are less than 60 percent of the funding target. The underlying financial health of the company (as determined by its credit rating) is not considered. This differs from the administration's proposal, which looks to both the credit status of the plan sponsor as well as the funding status of the plan to determine whether the "at-risk" requirements apply. Under the bill, if a plan is in "at-risk" status, the value of plan benefits is determined as if all participants elect benefits that will result in the highest present value of benefits (e.g., lump-sums at the "most subsidized" age). In addition, a load factor of $700 per participant and four percent of the funding target would be added, which is intended to reflect the higher costs involved in terminating a plan. These changes will result in a higher funding target and higher contributions being made to plans in "at-risk" status. This higher funding requirement for "at-risk" plans is phased in over five years from when a plan is first determined to be in "at-risk" status.

Benefit Restrictions

Shutdown Benefits and Unpredictable Contingent Event Benefits. The bill prohibits pension plans from offering shutdown benefits and other unpredictable contingent event benefits that currently can be provided under these plans. These benefits are benefits that are payable upon an event other than the attainment of any age, performance of any service, receipt of any compensation, or the occurrence of death or disability, or which is an event that is reasonably and reliably predictable. Plant shutdown benefits (even if reasonably predictable) and severance benefits could not be paid from a pension plan. These restrictions would become effective for events occurring after 2006, with a delayed effective date for benefits offered under a plan maintained pursuant to a collective bargaining agreement.

Benefit Restrictions Based on Funding. Like the administration's proposal, the bill includes restrictions on increasing benefits, paying lump sums, or accruing new benefits if the plan falls below a certain funded percentage.

Benefit Increases. A pension plan cannot be amended to increase benefits if the plan is less than 80 percent funded (determined as if the amendment was adopted). However, the amendment would be allowed if the plan sponsor made contributions to the plan to pay for the increase or that would result in the plan satisfying the 80 percent threshold. This restriction would not apply to a plan for the first five years of the plan (or a predecessor plan).

Benefit Payments. A pension plan cannot make payments in a form other than a life annuity if the plan is less than 80 percent funded. The plan administrator must notify participants of this restriction within 30 days after the plan has become subject to the restriction. Failure to notify could result in a penalty imposed by the DOL up to $1,000 per day. If a plan subsequently becomes 80 percent or more funded, a plan must be amended in order to resume other forms of distributions (e.g., lump sum distributions). This restriction would not apply to a plan that is frozen as of June 29, 2005.

Benefit Accruals. All future benefit accruals must cease under a pension plan if the plan is less than 60 percent funded. The plan sponsor can provide for a resumption of benefit accruals after the plan assets exceed 60 percent of its funding target; however, the plan must be amended to provide for the resumption of benefit accruals. This restriction would not apply to a plan for the first five years of the plan (or a predecessor plan).

Other Rules

Many of the current pension funding rules (e.g., timing of contributions, quarterly contributions, and security requirements) generally follow current law. However, there are a number of small changes in the ways the current rules work that reflect the overall change in the funding rules. For example, the bill makes changes relating to section 420 transfers of assets in an overfunded plan to a section 401(h) account to pay for the current year's retiree medical expenses. Under current law, the assets transferred to the 401(h) account are still counted for purposes of determining the funded status of the plan; however, the transferred amount is treated as a net experience loss, which must be amortized over five years. Under the bill, the assets transferred will not be treated as assets of the plan for purposes of determining whether the plan has met its funding target. In addition, since there is no funding standard account under the bill, there is also no need for any amortization of the transferred amount.

Effective Date

In general, the new rules would be effective for plan years beginning after 2005. The benefit restrictions would be effective for plan years beginning after 2006, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. Stay tuned for more analysis of the approved bill, and any breaking developments, in your September issue of *Benefits & Compensation Law Alert.*

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