Congress Takes on Funding Reform (Part 2)

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Last month we told you about the Pension Protection Act (H.R. 2830) and detailed some of its provisions. In this issue, we continue to analyze the provisions of this groundbreaking pension reform bill.

Increase in Deduction Limitations

The bill would increase the amount of contributions a sponsor of a single-employer plan may deduct to an amount equal to the greater of (i) 150 percent of the funding target plus target normal cost, or (ii) in the case of a plan that is not at-risk, the sum of the plan's funding target and target normal cost determined as if the plan was at-risk for the plan year, less the plan's assets for that year. The bill also provides that the combined plan deduction limitation would not apply to the extent contributions to one or more defined contribution plans do not exceed six percent of compensation.

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Deferred Compensation Restrictions

The bill amends the new deferred compensation restrictions in Code section 409A to provide that if a pension plan is determined to be "at-risk" (i.e., the plan is less than 60 percent funded), then any amounts (i) set aside (directly or indirectly) to fund deferred compensation (or otherwise restricted to pay such benefits) or (ii) set aside upon attainment of "at-risk" status (or other similar financial triggers) will be considered to be a taxable transfer to the individual and such amounts will be subject to the penalties under Code section 409A. The bill is unclear on what it means for amounts to be "set aside," but transfers to rabbi trusts would be covered under this provision and corporate-owned life insurance policies used to fund these arrangements might be covered. The bill does not limit this provision to executives or key employees; any individual who has "deferred compensation," as defined in section 409A, would be covered by this provision. If enacted, this provision should put more pressure on the IRS and Treasury Department to provide exceptions for various broad-based arrangements from the application of Section 409A.

PBGC Premium Increases

Flat-Rate Premiums. Under the bill, the flat-rate premium will increase from $19 per participant to $30 per participant starting in plan years after 2006. The premium increase will be phased in over five years if the plan is 80 percent or more funded and over three years if the plan is less than 80 percent funded. The $30 per participant amount will be indexed annually to reflect increases in wages.

Risk-Based Premiums. Under the bill as originally introduced, the risk-based premium factor of $9.00 for each $1,000 of unfunded vested benefits would have been adjusted annually to reflect increases in wages. The indexing of the risk-based premium was not included in the bill as approved by the Committee.

Lump Sum Distributions

The bill revises the interest rate used to determine the value of lump sum distributions. Under current law, that interest rate is the Treasury Department-determined rate of interest on 30-year Treasury securities. Under the bill, plans must use the three-segment, modified yield curve interest rate used to determine liabilities for purposes of calculating the plan's funding target. The new rates are determined using spot rates (i.e., on a "snapshot" basis). In addition, the bill generally requires plans to use a mortality table based on the RP-2000 Combined Mortality Table, although plan sponsors may request the use of a substitute mortality table (also discussed above). The bill phases-in the use of the interest rate over five years beginning in 2006.

Multiemployer Plans

The bill generally changes the amortization periods from 30 years to 15 years for (i) net increases or decreases in unfunded past service liability arising from plan amendments, and (ii) net losses or gains resulting from changes in actuarial assumptions. The bill increases the maximum deductible limit to 140 percent of current liability, as determined based upon a four-year weighted average of 30-year Treasury rates. The bill also changes the rules for receiving an extension of amortization periods from the Secretary of Treasury, and increases the interest rate applicable to any such amortization period extension.

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In addition, the bill creates new categories of troubled multiemployer plans: (i) "endangered plans," defined as plans that have a funded percentage of less than 80 percent or are projected to have an accumulated funding deficiency within seven plan years; and (ii) "critical plans," defined as plans that fall within a series of triggers. Endangered plans are generally required to come up with a funding improvement plan that, among other things, will increase the plan's funded percentage by one-third within 10 years. Under an amendment adopted during the Committee mark-up, alternative benchmarks apply to endangered plans that are less than 70 percent funded and to certain plans more than 70 percent but less than 80 percent funded.

Critical plans are generally required to develop a rehabilitation plan that provides for a combination of measures to permit the plan to exit "critical" status within 10 years. Under another amendment adopted during the mark-up, employers currently contributing to a plan would be required to make 5 to 10 percent surcharge contributions until the next collective bargaining agreement is adopted. In addition, the trustees of plans in critical status would be provided additional tools to cut certain types of non-core benefits with respect to participants not in pay status for a year and benefit increases in the last 60 months.

Disclosure Requirements for All Plans

Application of Annual Disclosure Requirements to all Pension Plans. The funding notices that currently have to be sent annually to participants, beneficiaries, and labor organizations in a multiemployer plan will have to be provided by all defined benefit plans. The notice must be provided within 90 days after the end of the plan year. Among other things, the notice must provide (i) whether the plan's funding status is at least 100 percent; (ii) a summary of the rules governing plan termination; (iii) the value of plan assets and projected liabilities and the ratio of these two amounts; (iv) the ratio of active participants to inactive participants in the plan; and (v) the plan's funding policy and asset allocation. These new requirements would be effective for plan years beginning after December 31, 2005.

Additional Information in the Annual Form 5500. Under the bill, annual Form 5500 disclosure must be expanded to include (i) the ratio of inactive participants to active participants in the plan, and (ii) the effect of plan mergers during the plan year on the plan's funded ratio. The actuarial statement will be required to include a statement explaining the actuarial assumptions and methods used in projecting future retirements and distributions under the plan.

Distribution of Summary Annual Reports. Summary annual reports (SARs) will now have to be provided to participants within 15 days of the due date for filing the Form 5500. For calendar year plans, that means that a SAR must be provided to participants by August 15. In addition, SARs must set forth the total assets and liabilities of the plan for each of the past three plan years.

4010 Information. Under current law, the sponsor of plans with over $50 million in unfunded vested benefits (on a controlled group basis) is required to provide the PBGC with information about the assets and liabilities of the plan, as well as the sponsor's audited financial statements and other financial information. This information is currently not available to the public (but Congress may request to see that information).

The bill would amend current law to require a plan sponsor whose plan(s) are less than 60 percent funded (on a controlled group basis) to file the section 4010 information with the PBGC. A plan sponsor whose plan(s) are less than 75 percent funded and who the PBGC determines is in an industry in which there is substantial underemployment or unemployment and sales and profits are depressed or declining must also file the section 4010 information with the PBGC.

The sponsor would also be required to provide notice to participants within 90 days containing information regarding (i) how many plans maintained by the plan sponsor are in an "at-risk" status; (ii) the value of the assets for each plan that is in "at-risk" status; (iii) the funding target for each plan and percentage to which assets support the funding target; and (iv) the aggregate of the above numbers for all plans maintained by the plan sponsor, regardless of whether they are in "at risk" status. This notice must also be submitted to Congress (i.e., the House Committee on Education and the Workforce and the Senate Health, Education, Labor, and Pensions Committee).

Investment Advice

The bill would add a new statutory exemption from ERISA's prohibited transaction rules allowing regulated financial institutions to provide investment advice to plans and plan participants where the institution's (or an affiliate's) products are among those available under the program. The exemption expressly covers the sale, acquisition, and holding of assets pursuant to such advice, and the payment of fees to advisers for such advice. The exemption does not regulate the fees that advisers are permitted to receive, but imposes significant disclosure conditions consistent with securities laws, and limits the exemption to arm's-length transactions in which the adviser receives no more than reasonable compensation. The disclosure requirements include fees received and the relationship of the adviser to the available investments (e.g., shares of an affiliated mutual fund).

Prohibited Transaction Rules and Other Related Amendments

During the mark-up, a majority of the Committee agreed to an amendment providing for changes to ERISA's prohibited transaction rules and changes to the regulations defining whether an entity that ERISA plans invest in is deemed to hold ERISA plan assets. The amendment would create new exemptions from the prohibited transaction rules for (i) "block" trading securities under certain conditions, (ii) investing and "blind" trading of plan assets via electronic or alternative trading systems, and (iii) the purchase or sale of securities on a foreign exchange by a bank or broker-dealer, provided certain requirements are met. Under the amendment, plan fiduciaries could correct a prohibited transaction involving a security or commodity within 14 days. In addition, ERISA's bonding requirements would not apply to brokers or dealers who agree to handle (and be liable for) the investment of plan assets. Finally, certain entities (such as partnerships) in which ERISA plans invest would no longer be deemed to hold ERISA plan assets unless 50 percent of the equity interests in the entity are held by benefit plan investors (including ERISA plans and IRAs, but not including governmental or foreign plans).

Hybrid Pension Plans

Under the bill, whether a pension plan violates the age discrimination provisions under ERISA and the Code could be determined by examining the terms of the plan to see if a similarly situated younger employee would receive a greater benefit than an older worker. For example, if a cash balance plan's interest credit is three percent for a 50-year-old participant and five percent for a 30-year-old, the plan would be age discriminatory. In making this determination, early retirement subsidies are not taken into account. In addition, the bill makes it clear that pre-retirement indexing of a benefit does not violate the age discrimination rules.

The bill also solves the "whipsaw" problem. Under current law, whipsaw occurs when a plan sponsor offers an interest rate

credit under the plan that is greater than the 30-year Treasury rate. If the plan's interest rate exceeds the 30-year Treasury rate, the plan must pay a lump-sum benefit that is greater than the participant's account balance. The bill cures the whipsaw problem by permitting plan sponsors to use a "market rate" of interest instead of the 30-year Treasury rate and still pay a lump sum benefit equal to the participant's account balance. The market rate of interest is not clearly defined in the bill. Therefore, it appears that Treasury and the IRS will need to define it in guidance.

The provisions would be effective for plan years beginning on or after June 29, 2005 (i.e., the provisions would be effective on a prospective basis only). The bill does not specifically address cash balance or hybrid conversions.

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