Pension Protection Act Series - Single Employer and Cash Balance Plans

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SINGLE EMPLOYER PENSION PLAN NEW FUNDING REQUIREMENTS – CURRENT RULES

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The New Funding Requirements – Comparison with Prior Law

- Under pre-Act law, Sponsors must fund on an annual basis.
- (I) the plan's "normal cost" (i.e., the present value of the portion of projected accruals allocated to the current year); and
- (II) the amount necessary to amortize past service liabilities over thirty (30) years.
  - If the plan has "net experience" gains or losses, they do not have to be taken into account all at once, but can be amortized over five (5) years.
  - Similarly, gains or losses from actuarial adjustments can be amortized over ten (10) years.

Prior Law - Under-Funded Plans

- If the plan's assets are not sufficient to cover at least 90% of its total liability to all participants and beneficiaries on a termination basis (i.e., its "current liability), a "deficit reduction contribution" must be made that is between 18% and 30% of the difference between assets and current liability.
  - This level of under-funding is more likely to occur when a plan has significant past service liabilities, net experience losses, or losses resulting from actuarial adjustments.

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Prior Law - No Requirement of Full Funding

- Under current law, there is no requirement that a plan be fully funded on an ongoing basis:
  - The ability to fund past service liability, “net experience” losses, and losses resulting from actuarial adjustments through amortization increases the likelihood a plan will not be fully-funded.
  - Even “deficit reduction plans” need only make, at most, a 30% contribution to address the shortfall in assets.

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The New Funding Requirements – General Rule

- The Act comes close to requiring that plan sponsors fully fund their plans on an ongoing basis.
- They must annually contribute:
  - Plan's current-year liabilities (i.e., the plan's "normal cost" for benefits expected to accrue in the course of that year, or any increase in previously-accrued benefits by reason of a compensation adjustment or plan amendment); and
  - Amount required to amortize, over no more than seven years, the shortfall between (i) plan assets, and (ii) 100% of accrued liabilities determined as of the beginning of the plan year (termed the plan's "funding target") for the current and six prior plan years.
  - Unlike current (pre-Act) law, the adverse effect of "experience" and actuarial losses on a plan's funding status cannot be softened through amortization.
  - Plans that are significantly under-funded ("at risk" plans) are subject to certain additional funding requirements.

The New Funding Requirements – Use of "Credit Balances"

- In determining a plan's funding target, any credit attributable to pre-funding by the sponsor must be subtracted out of plan assets.
- There are two sorts of such pre-funding (termed, in the aggregate, "credit balances"):
  - Under current law, sponsors can deliberately over-fund (up to the "full funding limit), and thereby reduce the amount they may need to contribute in future years.
  - These amounts are termed under the Act "funding standard carryover balances".
- The Act also allows for such deliberate over-funding, subject to certain limitations. These amounts are termed "pre-funding balances".
- The Act requires that these amounts be subtracted out of assets in making certain determinations in order to prevent the abusive reliance on phantom assets.

The New Funding Requirements – Use of "Credit Balances" (cont'd)

- "One flaw in the current funding rules worth highlighting is the treatment of funding standard account credit balances.
- The credit balance rules allow an employer to apply their additional contributions from an earlier year - with assumed interest - as an offset to the minimum funding requirement for the current year without restriction.
- This allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market.
- More importantly, regardless of the current funded status of the plan."
  - U.S. Treasury Department, "General Explanation of the Administration's Fiscal Year 2007 Revenue Proposals."

The New Funding Requirements – Special Rule

- Credit balances must generally be subtracted out of assets in determining how well a plan is funded with respect to its "funding target."
  - However, if a plan is 100% funded when funding standard carryover balances are *not* subtracted out, any shortfall between plan assets (reduced by credit balances) and the plan's funding target is ignored. In addition, pre-funding (*i.e.*, new law) balances need be subtracted out only if the sponsor is using them to reduce its required annual contribution.
  - The eligibility requirement for this special rule is reduced in years prior to 2011 as follows:
  - 2010 – 96%
  - 2009 – 94%
  - 2008 – 92%
  - This special rule is not available to new plans, plans subject to the deficit reduction rules (in 2007), and plans that don't meet the applicable threshold in the prior year.

The New Funding Requirements – Special Rule (cont'd)

- If a plan sponsor wants to avoid having to make annual contributions in excess of its "normal cost," it may want to add enough funding (taking into account (i) funding standard carryover balances, and (ii) pre-funding balances not used to offset required contributions), to reach these percentages, as applicable.

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The New Funding Requirements – Reducing Contributions by Pre-Funding

- Despite Congressional concern that credit balances are subject to misuse, the Act continues to allow for them, and allows any minimum required contribution to be reduced by them.
- To restrict misuse of such balances by the sponsors of under-funded plans, only plans that are at least 80% funded can use credit balances to reduce annual minimum contributions.
  - In determining whether a plan is at least 80% funded for this purpose, plan assets are reduced by "pre-funding balances" (*i.e.*, by pre-funding under the new law).
  - Current-law "funding standard carryover balances" do not need to be subtracted out from assets for this purpose.

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Actuarial Assumptions Used in Determining Liabilities – Discount Rates

- In order to determine a plan's liabilities more accurately, the Act imposes new rules concerning which discount rates and mortality assumptions must be used.
- In discounting projected benefits down to the present, three different interest rates must be used, based on when benefit payments are due.
- Corporate bonds rated AAA, AA and A must be serve as the source for these rates:
  - Benefits that are anticipated to come due within five (5) years of the valuation date will be calculated using bonds maturing during that period.
  - Benefits that are anticipated to come due after five (5) years have elapsed, but before a total of twenty (20) have elapsed, will be based on bonds maturing during that period.

Actuarial Assumptions Used in Determining Liabilities – Discount Rates (cont'd)

  - Benefits that are anticipated to come due after five (5) years have elapsed, but before a total of twenty (20) have elapsed, will be based on bonds maturing during that period.
  - Benefits payable thereafter will be based on bonds with a commensurately long maturity horizon.
  - This modified yield curve will be phased in over three years, beginning in 2008.
- For 2006 and 2007, certain transitional rates are used.

Actuarial Assumptions Used in Determining Liabilities – Mortality Assumptions

- The Act requires the Treasury Department to prescribe a new mortality table that more accurately reflects the experience of pension plans and projected trends in such experience.
  - Plans can request the right to use a substitute mortality table in certain circumstances.

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Plan Asset Valuation

- In order to ensure that the value of plan assets is not overstated by averaging their value over too long a period, the Act requires that their fair market value not be smoothed over more than two years.
  - As a condition to its use, asset smoothing must yield a value that is 90-110% of the assets' actual fair market value.

Single Employer Pension Plan Benefit Restrictions

- Depending upon a plan's adjusted funding target attainment percentage ("AFTAP"), a plan may be limited in its ability to:
  - Adopt amendments that increase benefits if plan's AFTAP is less than 80% or would be less than 80% taking into account amendment.
  - Pay lump sums and other accelerated payments to purchase annuities.
  - Partial lump sum or accelerated payments permitted if the plan's AFTAP is between 60% to 80% funded; no lump sums or accelerated payments permitted if the plan's AFTAP is less than 60% or during any period the plan sponsor is in bankruptcy proceedings unless the an enrolled actuary certifies that the plan's AFTAP is 100%.
  - Written notice to participants required within 30 days of becoming subject to these restrictions.*

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Single Employer Pension Plan Benefit Restrictions (cont'd)

- Allow for continued accruals.
- Accruals would be frozen if the plan's AFTAP is less than 60% (participants would continue to earn vesting and eligibility service credit).
- Written notice to participants required within 30 days of becoming subject to these restrictions.*
- Provide for "unpredictable contingent event benefits."
  - Unpredictable contingent event benefits cannot be paid if the plan's AFTAP is less than 60% or would be less than 60% upon occurrence of the event.
  - Written notice to participants required within 30 days after the valuation date for the plan year in which the plan's AFTAP is or is deemed to be less than 60%.*

Single Employer Pension Plan Benefit Restrictions (cont'd)

- An employer may make additional contributions or provide security to avoid the restrictions (with the exception of accelerated benefit distributions).
  - *Failures to furnish required participant notices are subject to a $1,000 per pay penalty.
- Certain restrictions are not applicable to new plans.

Single Employer Pension Plan Benefit Restrictions (cont'd)

- Benefit restrictions not applicable if the plan's funding target attainment percentage is 100% funded when assets are determined without reduction for credit balances.
- 100% threshold is phased in at:
  - 92% in 2008
  - 94% in 2009
  - 96% in 2010
  - 100% in 2011
- Benefit restrictions effective for plan years beginning after 12/31/2007, subject to delay for collectively bargained plans.

Variable PBGC Premiums

- Effective for plan years beginning in 2008:
  - The full funding limit exemption is repealed.
  - The variable rate premium is based on the plan's funding shortfall determined under the new minimum funding rules (including the at-risk rules where applicable).
  - The variable rate premium remains at $9 per $1,000 of unfunded vested benefits, however, effective for plan years beginning in 2007, the variable rate for "small employers" is capped at $5 multiplied by the number of participants.
- The additional termination premium applicable to plans terminating with insufficient assets is made permanent.
- The premium (enacted under the Deficit Reduction Act of 2005) is $1,250 per participant, per year, for three years after termination.

PBGC Notice Rules

- Annual plan filing: If a plan is less than 80% funded (determined after subtracting credit balances) the Plan Sponsor must file a report with the PBGC.
- PBGC will likely provide for exemptions for small plans.

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Participant Reporting Rules

- The summary annual report requirement and the ERISA Section 4011 notice to participants of funding status is eliminated in favor of single funding notice to the PBGC and to each plan participant and beneficiary.
- Notice must be issued 120 days after the end of the Plan year. Small plans may provide notice when the Form 5500 is filed.
- Department of Labor is directed to issue model notice within one year after 8/17/2006.
- New annual notice provision is effective for plan years beginning after 12/31/2007.

Restrictions on Funding of Nonqualified Plans

- No assets can be set aside in or transferred to a trust or other arrangement for purposes of paying deferred compensation for any current or former "covered employee" under a nonqualified deferred compensation plan of a plan sponsor or controlled group member during the following restricted periods:
  - While the plan sponsor or any controlled group member is in bankruptcy.
  - Within 6 months before or after (12-month period) the involuntary or distress termination of a qualified defined benefit plan of the plan sponsor or controlled group member.
  - While any qualified defined benefit plan of the plan sponsor or a controlled group member is an "at-risk" plan.
- Covered employees are the top five covered employees under Code Section 162(m) or any executive officer subject to Section 16(a) of the Securities Exchange Act of 1934.

Restrictions on Funding of Nonqualified Plans (cont'd)

- An "at-risk" plan is a plan with more than 500 participants during each day of the preceding plan year that has a funding target attained percentage for the preceding year that is:
  - Less than 80% (80% threshold phased in over 4 years (65% in 2008; 70% in 2009; 75% in 2010, 80% in 2011 and thereafter); and
  - Less than 70% determined by applying specified at risk actuarial assumptions.
- If assets are set aside or transferred to pay deferred compensation under a nonqualified deferred compensation plan during the restricted period, affected individuals are subject to immediate income tax on such assets, a 20% additional tax, plus interest imputed back to the date of deferral or vesting even if amounts remain subject to creditors claims.
- Provisions effective for transfers or other asset reservations after August 17, 2006.

CASH BALANCE PLAN ISSUES

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Primary Legal Issues

- Three primary legal issues have "haunted" sponsors of cash balance plans who converted from a traditional DB plan:
  - "Wearaway"
  - "Whipsaw"
  - Age discrimination
- Wearaway is a specific conversion issue; others apply to all cash balance plans
- Though the vast majority of such plans are converted traditional DB plans.

Primary Legal Issues (cont'd)

- Wearaway: Creation of an opening account balance at conversion using lump-sum factors that do not take into account projected early retirement subsidies, and then paying, at retirement, the greater of the current account balance or the lump-sum equivalent of the "old" frozen accrued benefit, with subsidy if earned.
  - Result in many cases: a period of time after conversion during which the participant's old benefit is larger than the new benefit, and no accrual occurs until the old benefit "wears away"
  - Wearaway is not prohibited; see Treas. Reg. 1.411(d)-3(a)(4), Example 2.
  - It has been challenged in various cash-balance suits, and it has been criticized as unfair and discriminatory

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Primary Legal Issues (cont'd)

- Whipsaw: Impact of requirement that a cash balance plan project the account balance to age 65 and then discount it back to present value to pay a lump-sum at termination prior to age 65.
  - If plan uses an interest crediting rate different (higher) than the rate statutorily required for lump-sum conversion, lump-sum ends up larger than the original account balance ("whipsaw").
  - Several plan sponsors with differing interest rates who simply paid the account balance got "whipsawed" in litigation that resulted in their having to recalculate lump sums and pay additional benefits.

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Primary Legal Issues (cont'd)

- Age Discrimination: Theory that cash-balance plans are age discriminatory, since a compensation credit provided to an older employee is less valuable than the same credit provided to a younger employee, if the value of both is projected to age 65.
  - Similar theory applies to pension equity plans.
  - ERISA, the Code and ADEA all prohibit defined benefit plans from having an accrual formula that ceases or reduces the rate of accrual based on attainment of a specified age.
  - This theory assumes that the only way to measure accrual for purposes of this rule is to convert the annual amount accrued into an age 65 annuity.
  - Disregards the fact that if you give a 45-year-old and a 55-year-old the same amount of money, and they both retire at age 65, the 55-year-old gets the money ten years earlier.
  - I.e., it turns the time-value of money into an age discrimination issue.

The *Cooper* Case

- This theory was accepted by the federal district court in the *Cooper* case, a class-action lawsuit challenging IBM's cash-balance plan design (and a related pension equity formula).
- The results of that loss by IBM in 2003 were that:
  - IBM settled the case by agreeing to pay a minimum of about $300 million (with a maximum exposure of about $1 billion) pending appeal.
  - IBM froze its plan and shifted to a defined contribution model.
  - Many other employers were "chilled" from converting their plans.
  - Various employer groups lobbied for legislative relief (preferably retroactive) to "thaw" this chill.

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PPA ’06 Provisions

- PPA ’06 provides relief for all of these issues.
  - Subject to specified conditions and limitations.
- These provisions are applicable both to cash balance plans and pension equity plans.
  - Plans that define a participant’s accrued benefit as a lump-sum equal to a multiple of average final annual compensation.
- PPA ’06 was designed to “revive” and encourage the maintenance and future creation/conversion of cash balance and pension equity plans (PEPs).
  - Query whether it actually accomplished that purpose – we’ll discuss later.

PPA ’06 Provisions (cont’d)

- PPA ’06 on Age Discrimination: No age discrimination as long as annual credits are the same for similarly situated employees (compensation, years of service, position, date of hire, work history) without regard to differences in age.
  - Caveat: Beginning in 2008, cash-balance plans must credit interest at no greater than a “market rate” (can be the greater of a market rate and a fixed floor rate).
- Relief is prospective only (post-June 29, 2005); no inference as to prior law.
- BUT: *Cooper* decision was reversed on appeal by Seventh Circuit several days after PPA ’06 was adopted by Congress.
- Judge Easterbrook’s opinion was so well-reasoned and convincing that it, plus PPA ’06, have effectively wiped out the age discrimination issue.

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PPA ’06 Provisions (cont’d)

- PPA ’06 on Whipsaw: No longer an issue.
  - DB plan can define the accrued benefit as the account balance (in a cash balance plan) or as an accumulated percentage of final average compensation (in a pension equity plan).
  - Rather than an age 65 annuity, thus eliminating the need for a projection and discount.
- Allows for the use of a market rate for interest crediting, rather than using the required-law lump sum conversion rate.
- Side benefit: Allows hybrid plans to avoid the effect of the new, lower lump-sum interest rates and mortality factors mandated by PPA ’06.
- Plans can apply this rule to any distributions after the date of enactment of PPA ’06.
  - With later amendment to reflect this change within the PPA ’06 remedial amendment period, i.e., end of 2009 plan year.

PPA ’06 Provisions (cont’d)

- PPA ’06 on Wearaway: All conversions after June 29, 2005 must use an “A + B” method:
  - The participant’s benefit at termination must be the sum of (i) his accrued benefit at the time of conversion, plus any early retirement subsidy later earned with respect to that pre-conversion accrued benefit, and (ii) the post-conversion credits.
  - i.e., Wearaway is not permitted for conversions.
- Post-June 29, 2005 conversions would have to be conformed, but it’s unlikely they were many (or any) such conversions.
- Pre-June 29, 2005 conversions can likely rely on IRS regulations and other authority to uphold Wearaway
  - No negative inference from PPA ’06.

PPA '06 Provisions (cont'd)

- Other Applicable PPA '06 Provisions:
  - Cash balance plans and PEPs must provide full vesting after 3 years of service (beginning in 2008).
  - If plans use a variable market rate for crediting interest, at distribution, losses cannot reduce the account balance below the aggregate amount of compensation credits (except for variable annuities).
  - Special rules regarding how benefits are determined at termination of a cash balance plan or a PEP.
  - Regulations to be issued providing special relief for conversions that occur in connection with mergers and acquisitions.

Will PPA ’06 Save the Cash Balance Plan?

- Existing plans: Probably will be maintained; PPA ’06 (and *Cooper* appeal) significantly reduce the litigation risks.
  - But still may be a potential claim, depending on a plan’s particular provisions.
  - See *PWC* case (dismissing the “standard” cash balance claims, but upholding a claim based on use of 5 years of service as normal retirement benefit).
  - Pending “standard” cases will likely be favorably settled or dismissed.

New Conversions

- Unlikely to be many.
- PPA '06 and the *Cooper* appeal are probably too late
- Current trend is to freeze a traditional DB plan and go to a DC model, not convert to cash balance.
- Many prominent employers have done so in the past two-to-three years.
- The bandwagon is rolling, and these developments are unlikely to slow it down.
  - If anything, PPA '06 funding requirements will just speed it up.

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