Pension Analyst

Important information | Legislation | August 2010

New law provides funding relief for single-employer defined benefit plans

Who's affected

These developments affect sponsors of and participants in most qualified single-employer and multiple employer defined benefit plans. They do not affect multiemployer plans, governmental plans or church plans that do not elect to be covered by ERISA ("non-electing church plans"). A separate publication discusses the changes affecting multiemployer plans.

Background and summary

On June 25, 2010, President Obama signed into law the "Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010" ("PRA 2010"). This new law provides welcome funding relief for plan sponsors whose plan assets have declined due to the downturn in the economy and continued market volatility. For example, it provides plan sponsors several options to extend the funding amortization periods in any two plan years during the 2008-2011 period.

In addition, PRA 2010 provides:

- A notice requirement for plan sponsors that elect funding relief;
- Temporary relief through 2010 that allows participants in plans whose funding percentage is less than 60% to continue to accrue benefits; and
- Temporary relief that allows for the payment of social security leveling income benefits to be paid without restrictions.

The provisions of this new law impact plan funding and administration for plan years beginning after December 31, 2007. Plan sponsors should carefully read the information contained in this *Pension Analyst* and should discuss the new law's impact on their plans with their enrolled actuary. Prudential Retirement's enrolled actuaries are well prepared to respond to your inquiries regarding the effect of the new law on your plan.

In this issue

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Funding relief

If a plan's assets are less than its funding target, the minimum required contribution for the plan year is equal to the plan's target normal cost plus the amortization of the funding shortfall. The target normal cost is the present value of benefit liabilities expected to accrue during the plan year, including increases in past service benefits attributable to current year increases in compensation. A funding shortfall exists when the plan's funding target exceeds the plan's assets. Under the Pension Protection Act of 2006 (PPA), if a plan has a funding shortfall, the shortfall must be amortized in level annual installments over the seven-year period beginning with that plan year.

PRA 2010 provides plan sponsors with funding relief by providing one of two alternatives to extend the period for amortizing the funding shortfall and to lower annual contributions for an eligible plan year.

Two plus seven year rule

Under the two plus seven year option, a plan sponsor continues to amortize the funding shortfall over a seven-year period. However, the seven-year amortization period would begin two years later. During the two-year delay, the employer only pays interest on the funding shortfall. *For Example: The funding shortfall for 2010 is amortized over a seven-year period beginning in 2012. However, for 2010 and 2011, the plan sponsor must pay the interest on the funding shortfall.*

Fifteen-year rule

Alternatively, plan sponsors may elect to amortize their funding shortfall in level annual installments over 15 years.

Conditions for funding relief

In order to take advantage of the funding relief, PRA 2010 attaches the following conditions:

- Plan sponsors may elect funding relief for two eligible plan years. An "eligible plan year" is any plan year beginning in 2008, 2009, 2010 or 2011 where the due date for the payment of the minimum required contribution occurs after June 25, 2010. As a result, plan sponsors with calendar plan years cannot use this relief for the 2008 plan year since the minimum required contribution for that plan year was due on September 15, 2009.
- Eligible plan years do not need to be consecutive, but plan sponsors must use the same funding relief for each eligible plan year.
- Plan sponsors must notify participants, beneficiaries and the Pension Benefit Guaranty Corporation (PBGC) that they have elected funding relief.
- Once a plan sponsor makes an election, the election cannot be revoked without the consent of the Secretary of the Treasury, with an opportunity for comment by the PBGC.
- Plan sponsors must comply with the "cash flow rule" as described below.

There is no requirement that a plan provide for continued benefit accruals in order to take advantage of the funding relief. As a result, plans that have ceased ("frozen") benefit accruals may elect one of the two funding alternatives.

Cash flow rule

Plan sponsors that elect either the two plus seven year rule or the 15-year rule must comply with the "cash flow rule." Under the cash flow rule, a plan sponsor that elects to extend the funding shortfall amortization period must make additional contributions to the plan. This additional contribution is known as the "installment acceleration amount" which is the total amount of:

- Excess employee compensation for all employees for the plan year; plus
- Extraordinary dividends and stock redemptions for the plan year.

The installment acceleration amount applies during the "restriction period" which is:

- Three years if the 2 plus 7 year rule is elected; or
- Five years if the employer elects the 15-year rule relief.

The restriction period begins on the first day of the later of the:

- Plan year for which the relief is elected; or

- First plan year beginning after December 31, 2009.

Excess employee compensation

Excess employee compensation is all taxable compensation paid to any employee in excess of $1 million during a calendar year in which the plan year begins, such as regular pay, bonuses, etc. Beginning in 2011, the $1 million threshold will be adjusted for inflation. Self- employed individuals are treated as employees for purposes of determining excess employee compensation.

In addition, employer funds deposited into a nonqualified deferred compensation arrangement are treated as taxable compensation and are included in the $1 million threshold, regardless of when services are performed.

However, PRA 2010 carves out certain exceptions to the definition of excess employee compensation that are disregarded for purposes of determining the $1 million threshold, such as:

- Compensation for services performed before March 1, 2010;
- Nonqualified deferred compensation, restricted stock, stock options or stock appreciation rights that are paid or granted under a binding written contract that was in effect on March 1, 2010 and which was not materially modified;
- Commissions on income generated directly by the employee's performance; and
- Restricted stock that is granted after February 28, 2010 and that is subject to a substantial risk of forfeiture for at least five years from the date of the grant.

Extraordinary dividends and stock redemptions

PRA 2010 defines extraordinary dividends and redemptions as the total:

- Dividends declared during the plan year by the plan sponsor; plus
- The total amount paid for redemptions of the plan sponsor's stock redeemed during the plan year minus the greater of the:
  - Plan sponsor's adjusted net income for the preceding plan year; or
  - Historical dividend amount.

Adjusted net income is determined without regard to reductions for interest, taxes, depreciation or amortization. Adjusted net income is measured on a plan year basis.

Historical dividends are dividends declared in the same manner for at least five preceding years.

When determining extraordinary dividends and redemptions, the following transactions are disregarded:

- Dividends declared and redemptions occurring before March 1, 2010;
- Dividends paid within a controlled group;
- Redemptions made on account of the death, disability or termination of employment of a shareholder or employee; and
- Certain dividends and redemptions with respect to preferred stock issued before March 1, 2010 or which is still held by the plan.

Controlled groups

PRA 2010 does not provide any relief for controlled groups under the cash flow rule. As a result, if one employer in the controlled group pays excess employee compensation, other members of the controlled group may need to make accelerated installment payments to their plan.

Benefit restrictions

Frozen benefit accruals

For plan years beginning after December 31, 2007, PPA imposed benefit restrictions on certain underfunded plans. *For example, a plan sponsor must freeze all future benefit accruals under any plan that is less than 60% funded for the current plan year.*

The Worker, Retiree, and Employer Recovery Act of 2008 temporarily allowed underfunded 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 solely for determining whether benefit accruals must be frozen. This provision applied to plan years beginning during the period beginning on October 1, 2008, and ending on September 30, 2009.

PRA 2010 extends this relief for an additional year to September 30, 2010.

Social security leveling option

PPA does not allow a plan to make a prohibited payment for participants with annuity starting dates occurring when the:
- Plan has a funding percentage of less than 60%; or
- Employer is in bankruptcy and the plan's funding percentage is less than 100%.

If a plan's funding percentage is between 60% and 80%, the plan cannot make a prohibited payment if the amount of the payment exceeds the lesser of:
- 50% of the amount that could be paid in the optional form that includes the prohibited payment; or
- The present value of the participant's maximum PBGC guarantee.

A "prohibited payment" is any:
- Payment exceeding the monthly amount payable under a single life annuity (plus any social security supplements) to a participant or beneficiary whose annuity starting date occurs during a period when the benefit restriction is in effect;
- Payment for the purchase of deferred annuities from an insurer to pay benefits; and
- Other payments specified by the IRS.

The most common prohibited payment is a lump sum payment. However, under PPA, a social security leveling option is also a prohibited payment. A social security leveling option is a payment that increases payments under the plan before a participant starts receiving social security benefits and reduces payments after a participant starts receiving social security benefits in order to provide a level stream of income.

PRA 2010 provides that a plan may apply its 2008 funded status for the 2009 and 2010 plan years for the purpose of applying the restriction attributable to social security leveling options.

Some underfunded plans may have restricted social security leveling options in 2009 and 2010. Further guidance will be needed to address how these restricted benefits should be treated. For example, there is a question as to whether social security leveling options that were restricted in 2009 and 2010 will need to be recalculated.

Relief for charities

Under PPA, an employer may use some or all of a credit balance to offset the minimum required contribution for the current plan year, provided the plan's prior plan year funding ratio was at least 80%. PRA 2010 provides temporary relief for plan sponsors that are 501(c)(3) charities. The relief allows a plan's funding ratio for the plan year beginning after August 31, 2007 and before September 1, 2008, to apply for the next two plan years. For a calendar year plan, the 2008 funding ratio would apply to the 2009 and 2010 plan years. Therefore, if the 2008 plan year was at least 80% funded, the plan sponsor could apply any credit balance to the 2009, 2010 and 2011 plan years. Further guidance is needed to describe what actions a plan sponsor must take to elect this funding relief.

Mergers and acquisitions

The new law authorizes the Secretary of the Treasury to issue regulations regarding the application of the cash flow rules where there is a merger or acquisition.

Future guidance and Form 5500 filing relief

On July 30, 2010, the IRS issued Notice 2010-55, which contains information regarding future guidance to be issued with respect to the PRA 2010 special funding rules and special rules for Form 5500 filings that must be filed before this guidance is issued.

Future guidance

The IRS intends to issue future guidance regarding the:

- Calculation of the alternative amortization schedules permitted under PRA 2010 and the effect on funding balances;
- Rules relating to installment acceleration amounts;
- Procedures for making the election to use an alternative amortization schedule; and
- Notice requirements.

However, the IRS has not indicated when this guidance will be issued.

Form 5500 filings

In the case of a plan year that ends before guidance is issued, the plan sponsor may elect to use the alternative amortization schedule permitted under PRA 2010 regardless of whether the Form 5500 and Schedule SB have been filed for that plan year. *For example, the sponsor of a plan with a calendar plan year can elect to use an alternative amortization schedule for 2009 even though the Form 5500 and Schedule SB have been filed for that plan year.* The IRS intends to issue future guidance that will address reporting requirements when an alternative amortization schedule is elected after the plan's Form 5500 and Schedule SB for the plan year have been filed.

Next steps

Prudential Retirement will continue to monitor the IRS published guidance regarding these new rules. We will keep you informed as additional guidance is made available that clarifies the provisions of PRA 2010 discussed in this *Pension Analyst.*

If you have questions about the new provisions regarding funding requirements, the cash flow rule or benefit restrictions, you should contact your plan's enrolled actuary.

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