



WHAT A RELIEF?—CONGRESS FINALLY PASSES PENSION FUNDING LEGISLATION

Congress has passed much-anticipated legislation providing funding relief for pension plan sponsors. The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (the “Act”) was signed by President Obama and became law on June 25, 2010. The Act also provides limited relief relating to funding-based benefit restrictions imposed on underfunded plans.

As the title of the Act suggests, the pension changes were included with provisions relating to the Medicare program. While pension funding relief had been debated in Congress for some time, it finally passed when it was paired with the deferral of the reduction in payments to Medicare providers. By reducing contributions to pension plans and thereby decreasing the tax deductions taken by plan sponsors, pension funding relief is expected to provide increased tax revenues to fund the higher physician payments.

Funding relief has become an important issue for many employers who sponsor a pension plan. With

the enactment of the Pension Protection Act of 2006, plan sponsors were forced to fund plans more quickly under new rules that increased the volatility of required contributions. The effective date of those provisions for most plans coincided with a significant drop in the stock market and in interest rates, which has led to a much higher level of unfunded benefit liabilities and, thus, larger pension contributions for plan sponsors.

Although the Act gives plan sponsors the opportunity to reduce plan contributions by electing an extended period to amortize funding shortfalls, this relief does not come without strings attached. Single employer plans electing relief will be subject to a “cash flow” rule. This rule generally requires additional contributions if an employee of the plan sponsor or *any member of its controlled group* receives compensation in excess of \$1 million during a plan year, or if the plan sponsor or *any member of its controlled group* makes stock redemptions or declares dividends that exceed “adjusted net income” or, if greater for a plan

sponsor that has determined and declared dividends in the same manner for at least the preceding five years, the dividends declared for the plan year.

Furthermore, if a plan sponsor sets its contribution levels above the required minimum, for example in order to achieve a requisite funded status for its plan to avoid funding-based benefit restrictions, being in “at risk” status or being required to provide information to the Pension Benefit Guaranty Corporation (“PBGC”) in a “4010 filing,” the Act may not provide much relief.

The Act also provides funding relief to multiemployer plans and includes special rules for certain large government contractors, PBGC settlement plans, multiple employer plans of certain cooperatives, and plans of charities. This *Commentary* does not discuss these provisions of the Act.

EXTENDING THE AMORTIZATION PERIOD

Under current funding rules, in addition to the cost of benefits that are expected to accrue during the year and the amount of plan-related expenses projected to be paid during the year from plan assets, when the assets of a pension plan are less than the present value of all benefits accrued under the plan as of the beginning of the plan year, the plan sponsor is required to make contributions to the plan to amortize this funding shortfall over seven years. A “shortfall amortization base” is established each year to determine the amount of the installments necessary to amortize the shortfall for the year over this seven-year period. Each year that a plan is not fully funded, the amount necessary to fund the installment for that year’s shortfall is added to the installments for prior years in calculating the minimum required contribution.

The primary component of the Act’s funding relief is the permitted extension of the amortization period for a plan’s funding shortfalls. The Act permits plan sponsors to elect to apply one of the two extended amortization periods described below to the shortfall amortization base for any two of the plan years starting in 2008, 2009, 2010, or 2011. However, a plan sponsor can only make an election with respect to a plan year if the due date for the minimum required contribution for that year falls after the date of the Act’s

enactment. Consequently, an election cannot be made for 2008 for calendar year plans or plans with certain fiscal plan years. If a plan sponsor makes an election for two years, the sponsor must elect the same extended amortization period for both plan years, although the plan years need not be consecutive.

2+7 Amortization. Under this alternative, for the first two plan years beginning with the election year, amortization of the shortfall base is delayed and the minimum required contributions include only interest payments on the shortfall amortization base with respect to the plan year elected. In the next seven plan years, the minimum required contributions include the amounts necessary to amortize the remaining balance of the shortfall amortization base for the election year in level annual installments over seven years.

15-Year Amortization. Under this alternative, the minimum required contributions include the amounts necessary to amortize the shortfall amortization base for the election year in level annual installments over 15 years beginning with the election year.

Because the Act provides relief by extending the amortization period used in calculating a plan’s minimum required contribution, it may not provide immediate help to a plan sponsor that is already contributing more than the minimum required amount. A plan sponsor may contribute amounts in excess of the minimum for a variety of reasons, including in order to make the plan at least 80 percent funded to avoid benefit restrictions, at-risk status, or ERISA Section 4010 filings. Depending on future changes in the plan’s assets and liabilities, the Act may provide future relief in these situations.

CONSEQUENCES OF ELECTING AN EXTENDED AMORTIZATION PERIOD

Cash Flow Rule. The ability to elect an extended amortization period may initially appear to provide much-needed relief. However, the Act’s cash flow rule requires increased contributions in certain cases that may make this relief much less valuable for many plan sponsors. This rule requires plan

sponsors to make additional contributions in an amount equal to the aggregate compensation in excess of \$1 million (indexed for changes in the cost of living after 2010) paid to any employee, plus the amounts of any extraordinary redemptions and dividends paid in the applicable year. The cash flow rule applies on a controlled group basis (*i.e.*, to the plan sponsor and, generally, those entities that share more than 80 percent common ownership with the plan sponsor).

Beginning with the election year (or, if later, the first plan year beginning after December 31, 2009), these additional contributions must be made for three years if 2+7 amortization is elected and for five years if 15-year amortization is elected. The cash flow rule does not affect quarterly contributions.

For this purpose, "compensation" is defined broadly to include all taxable remuneration an employee receives during the calendar year in which the applicable plan year begins. The services need not be performed in the same calendar year, but remuneration for services performed before March 1, 2010 does not count. Compensation also includes any amounts set aside in trust in the calendar year for purposes of paying nonqualified deferred compensation even if the amounts are not otherwise includible in income for the year.

Certain forms of equity compensation awards are not included in compensation for this purpose. In general, any grant of common stock subject to a substantial risk of forfeiture for at least five years is not compensation for purposes of the cash flow rule. In addition, any nonqualified deferred compensation, restricted stock, stock options, or stock appreciation rights payable or granted under a binding contract that was in effect on March 1, 2010 is not included in compensation as long as the contract is not materially modified before the remuneration is paid. Commissions based only on account of income generated by the recipient's performance are also not included in compensation.

For purposes of the cash flow rule, generally, dividends and redemptions generate increased contributions to the extent that, after February 28, 2010, the dividends declared during a plan year by the plan sponsor and members of its controlled group plus the aggregate amount paid for the redemption of stock during the year exceed their adjusted net income for the year (or, if greater in the case of a plan sponsor that has determined and declared dividends in the same manner

for at least the preceding five years, the dividends declared for the plan year). Redemptions with respect to employees or made on account of the death, disability, or termination of employment of an employee or shareholder are not taken into account for this purpose. Similarly, dividends that satisfy certain requirements and redemptions with respect to preferred stock issued before March 1, 2010 (or issued thereafter and held by an employee benefit plan subject to ERISA) are not taken into account.

In general, an increase in required contributions as a result of the cash flow rule is intended to not cause the plan sponsor to be worse off than it would have been had it not elected an extended amortization period. If the complicated cash flow calculations yield an excess, the excess is carried forward to future plan years, which can extend the increase in contribution requirements resulting from the cash flow rule for an additional year (in the case of 2+7 amortization) or two years (in the case of 15-year amortization) beyond the otherwise applicable three- or five-year period. Future guidance will provide rules for mergers and acquisitions as well as how to allocate these additional contributions if elections are made for more than one plan in a controlled group. Additional guidance also appears to be needed for situations when funding relief is elected for two years and the cash flow rule requires additional contributions for a plan year pursuant to both elections.

Other Consequences. A plan sponsor electing an extended amortization period is required to notify participants, beneficiaries, and the PBGC of its election. Once made, a plan sponsor cannot revoke an election without the consent of the Secretary of the Treasury. Before approving the revocation, the PBGC will also be given the opportunity to comment on the conditions that will apply to the portion of the amortized payments that remain unpaid.

Because electing an extended amortization period will slow the funding of a plan, the plan may well have a lower funded percentage (depending on the amount of the plan's liabilities, which, in turn, is dependent on interest rates). Thus, taking advantage of the funding relief will likely increase the variable PBGC premium that the plan sponsor will have to pay.

Since slower funding may delay improvements in a plan's funded status, the likelihood that the plan will be subject to

benefit restrictions, “at risk” status, and 4010 filing requirements may be increased, or the period during which the plan is subject to these negative consequences may be prolonged.

RELIEF FROM CERTAIN FUNDING-BASED BENEFIT RESTRICTIONS

Funding-based benefit restrictions added by the Pension Protection Act have impacted many underfunded pension plans. Certain restrictions relating to benefit accruals, plan amendments increasing benefits, accelerated benefit payments (such as lump sums or Social Security level benefit options), and shutdown benefits arise when a plan’s “adjusted funding target attainment percentage,” or “AFTAP,” drops below 80 percent or 60 percent (or, for certain restrictions, below 100 percent if the plan sponsor is in bankruptcy) for a plan year. A plan’s AFTAP is a special calculation of the plan’s funded status for these purposes prepared and certified by the plan’s actuary. In most cases, it is essentially the same as the calculation to determine if a plan is at risk for funding purposes.

For plan years beginning on or after October 1, 2008 and before October 1, 2010, the Act provides relief for funding-based restrictions on benefit accruals and on the payment of benefits in the form of a Social Security level benefit option, but not on other benefit restrictions or the determination of whether the plan is at risk. The Act provides that a plan’s AFTAP for the plan year beginning after October 1, 2007 and before October 1, 2008 should be used if it is greater than the AFTAP that would otherwise apply. In other words, for a calendar year plan, the 2008 AFTAP, if larger, is used instead of the 2009 and 2010 AFTAP. However, if prior relief under the Worker, Retiree, and Employer Recovery Act of 2008 provides a higher AFTAP, it is used with respect to any restrictions on benefit accruals. The Act provides no guidance on applying this relief in situations where these restrictions have already been implemented.

CONCLUSION

The pension funding relief provided by the Act comes as a long-awaited and welcome development for pension plan sponsors, many of whom are facing dramatic increases in required cash contributions at a time when employers are already straining to manage costs and can least afford an increase in funding requirements.

Unfortunately, many plan sponsors will have to move quickly to determine whether an election should be made for the 2009 plan year; for a calendar year plan, the final due date for 2009 plan year contributions is September 15, 2010. Because the cash flow rule will apply in 2010 and 2011 if an election is made to apply the funding relief for 2009, plan sponsors will need to move quickly to assemble information, including estimates of future compensation. Plan sponsors should be discussing possible elections with their actuaries and other advisors now, gathering information and evaluating the benefits of possible elections.

This may be challenge enough for an employer with a single pension plan for whom the cash flow rule has little or no effect. However, for a plan sponsor for whom the cash flow rule will have meaningful impact, the decision process may be much more difficult, particularly if necessary compensation information is difficult to obtain. These difficulties will be compounded if the plan sponsor maintains multiple plans or is a member of a controlled group, particularly if the sponsor and its affiliates are unaccustomed to regularly sharing information. A plan sponsor with no employees of its own who have compensation in excess of \$1 million may find that its ability to take advantage of the Act’s funding relief is limited by the cash flow rule, solely due to the compensation paid by a controlled group member to its employees.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Michael K. Blais

Dallas

+1.214.969.4564

mkblais@jonesday.com

Tricia Eschbach-Hall

Cleveland

+1.216.586.7746

peschbachhall@jonesday.com

Daniel C. Hagen

Cleveland

+1.216.586.7159

dchagen@jonesday.com

Jeffrey S. Leavitt

Cleveland

+1.216.586.7188

jleavitt@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.