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Financially Stressed Multiemployer Pension Plans Must Act Soon to Comply with PPA Funding Rules Despite Regulatory Uncertainty

The 2008 plan year marks the first year that multiemployer pension plans are required to follow the special funding rules for financially stressed plans added by the Pension Protection Act of 2006 ("PPA"). In March this year, the IRS promulgated a proposed regulation containing the standards for determining whether a plan was in endangered or critical status.

The positions taken by the IRS in an attempt to rationalize the provisions of the law were at odds with the interpretations of funds that had already implemented plans designed to improve their financial condition.

On July 31, 2008, the IRS held a hearing on its proposed regulations. Only one fund strongly supported the IRS's rules. Other funds argued the IRS went beyond the language of PPA, and that its regulations would make it more difficult for plans to comply with the new funding rules, possibly resulting in further employer withdrawals.

For example, The National Coordinating Committee for Multiemployer Plans argued that because of the different reasonable interpretations that could be applied to the new law and the fact that bargaining was either well underway or completed based on those interpretations, the IRS should delay the effective date of any final rules and allow parties that had already begun the compliance process to rely on their good-faith interpretations as outlined in comments.

Ideally, the IRS would adopt this suggestion and extend good faith reliance to any Funding Improvement or Rehabilitation Plan adopted before it publishes the final regulations.

Moreover, the IRS did not have sufficient time to address the myriad questions raised by the PPA multiemployer funding rules. Accordingly, the proposed regulations do not provide guidance on what elements are necessary to construct a valid Funding Improvement or Rehabilitation Plan. This leaves Trustees struggling to formulate such plans in a position where they can only do what seems reasonable guided by fund counsel and their consultants.

The remainder of this Advisory will discuss the most critical outstanding issues, the effect of the IRS's proposal versus other interpretations, and the many critical issues IRS failed to address in the proposed regulations.

Entering Critical or Endangered Status

Many of the tests for critical status are based on whether the plan is projected to have an accumulated funding deficiency within a certain number of years. The law provides that in performing this test, the plan actuary is to ignore any extensions of the amortization period granted under its revised provisions. The proposed regulations take the position that this restriction also applies to extensions granted under the old law.

Because as part of qualifying for the old law extension, plans increased contributions and made other changes, the majority of the comments argued that the IRS should not treat these extensions the same as the extensions available under the new law. The result is that some plans find themselves in critical condition even though they have already committed to measures to improve their funding status. As a result, such plans will need to develop a Rehabilitation Plan.

The advantage to the plans is that critical status generally protects employers from excise taxes for funding deficiency. The disadvantage is that the plans and employers will need to increase contributions even more or reduce benefits.

Where the bargaining parties had already made significant sacrifices to qualify for an extension from IRS under the old

law, this additional burden could make it difficult or impossible to extract further concessions from plan participants and employers. The consequences may be that the parties will seek to withdraw, rather than endure another round of benefit cutbacks and contribution increases. If this were to occur, both PBGC and the participants suffer losses they would not be exposed to if the employers were to continue contributing to the plan.

The law and proposed regulation provide that amortization extensions can be used in determining whether the plan has emerged from critical status.

The use of extending amortization periods is however permissible in determining endangered status whether such extension was approved prior to PPA under Section 412 or after PPA under Section 431(d). This would place endangered plans in a potentially better initial position than critical plans, however resulting contribution increases and benefit reductions under the required Funding Improvement Plan could result in similar consequences for the endangered plan.

Emerging from Critical or Endangered Status

The second issue concerns the so-called revolving door in which a plan can emerge from critical status under the law only to find itself back in critical status the following plan year. IRS dealt with this problem by providing that a plan remains in critical status if any of these conditions exist: The plan fails to meet the statutory emergence test, the plan is unable to project no funding deficiency for the current and nine succeeding plan years, or the plan fails any of the critical tests.

The law and proposed regulation provide that amortization extensions can be used in determining whether the plan has emerged from critical status. Thus, a plan could meet the criteria for emerging from critical status, but because it failed one of the tests for entry into critical status, it would still be classified as critical under the proposed regulation.

Most plans that have developed rehabilitation programs relied on the statutory definition of emergence. That is, they designed a plan that, along with an amortization extension, would allow them to reach a point where they could project no accumulated funding deficiency for 10 years.

The IRS proposed regulation adds a second test; namely, that the plan also not trigger any of the entrance criteria when it meets the emergence criteria. Because the criteria for entering critical status do not use amortization extensions and are based on measures other than the funding standard account, it is quite possible that steps that would allow a plan to meet the emergence criteria might still leave a plan failing the entrance criteria. The proper result under the law is that the plan emerges from critical status in the year it meets the emergence criteria but enters critical status in the next year if it still trips one of the entry tests. The second entry into critical status should be treated as a new critical period.

An endangered plan has a 10-year Funding Improvement Plan period to improve its funding ratio in order to emerge from endangered status (a seriously endangered plan has a 15-year period). The amortization period extensions may be used in either case to determine if emergence is successful.

Implementation of the Default Plan

PPA generally provides that if the negotiating parties are unable to reach agreement on a Rehabilitation Plan, if critical, or Funding Improvement Plan, if endangered (or seriously endangered), 180 days after expiration of the collective bargaining agreement in effect on the date the plan entered either status, the default plan will go into effect. To the extent this plan requires reductions in accruals or benefits, the Trustees must implement the default schedule but only after providing the required advance notice to the parties (including employers).

For a Funding Improvement Plan, the standard notice for amendments reducing accrued benefits is required. For a critical plan that reduces adjustable benefits, PPA contains its own notice requirement and the IRS has said in a proposed regulation that the PPA notice requirement will satisfy the standard notice requirement for amendments reducing accruals as well.

The more uncertain issue concerns the effect of a default plan that also increases contributions. Some interpret the law as requiring employers to make those contributions so long as they are under a labor law obligation to continue contributing to the plan. If this is the case and the employer later withdraws, the issue is whether the employer's annual withdrawal payment is based on the old contribution schedule or the default contribution schedule. The Trustees may need to seek guidance from the PBGC to determine if this is an obligation to contribute within the meaning of Title IV of ERISA.

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Early Certification of Expected Critical Status

PPA allowed Trustees to certify that a plan was expected to be critical before the effective date of the critical rules. The critical rules forbid critical plans from paying benefits in lump-sums or in any form other than an annuity.

Many plans that used early certification also implemented the PPA restrictions on forms of benefit payment to prevent a "run on the bank." The IRS-proposed regulations took the position that the benefit payment restrictions did not go into effect until the 2008 plan year and would require plans that had implemented the restrictions when they provided the advance notice of critical status to make affected participants whole.

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There were no comments that supported the IRS in its position. Affected plans will need to decide whether to follow the proposed regulations or wait until the final regulations before taking any action regarding those participants that had their payment forms limited under an early certification of expected critical status.

Projecting the Funding Standard Account Balance

In several cases, Cheiron has found that even after eliminating all adjustable benefits such as early retirement benefits, special supplements, and period certain benefits, a plan will still need such a significant increase in contributions that one might expect greater than normal withdrawal activity.

In projecting the Funding Standard Account balance, the actuary must make assumptions about the contribution base. If the contribution needed to eventually emerge from critical status renders some employers uncompetitive and they withdraw, the projections should take that fact into account. Often, the Trustees will have a good idea what tolerance employers and employees have for contribution rate increases. The Trustees and actuary will need to work closely together in order to project both the contribution base for future years and expected withdrawal liability payments.

The actuary must prepare a progress report each year a plan is endangered or critical, and the Trustees will need to revise their plan to take into account future developments. An overly optimistic projection of work levels and contributions that does not pan out could lead to a contribution shock in later years. Thus, both the projection of the Funding Standard Account and the Rehabilitation Plan or the Funding Improvement Plan becomes a delicate balancing act.

The Default Plan and Other Options

The Trustees of endangered plans must present the bargaining parties with at least two options. The first option would freeze future accruals before it could include any contribution increases. If a plan could meet its funding target through a reduction or freeze in future accruals and elimination of benefits not protected by the anti-cutback rules (e.g., lump-sum death benefits), the first option would not increase contributions. The second option would only increase contributions and not reduce benefits.

The Trustees may, at their discretion, also present other options. Our experience so far is that the Trustees usually try to develop a middle option that contains both some accrual cuts and some contribution increases.

The Trustees of critical plans are required only to present one option to the bargaining parties, which is the default option. That option reduces accruals and cuts back adjustable benefits (early retirement, optional forms of benefit not in pay status and certain ancillary benefits) when the plan was certified as critical and only then provides for contribution rate increases.

Our experience so far has been that critical plans require very large contribution rate increases. These contribution rate increases usually come on top of years of sacrifice by the bargaining parties so that there is extremely high resistance on the part of both labor and management to the default plan. The Trustees are also permitted to present other plans.

Most Trustees present a default plan and a preferred plan. We have seen cases where the default plan is even more unpalatable than the preferred plan. This may be because the Trustees anticipate that the default plan will lead to greater withdrawals and thus the contribution increase needed to emerge from critical status will be even higher.

The preferred plan usually preserves some benefits and spreads out the contribution increases over a longer period of time, making it more likely to be adopted by the bargaining parties.

The Escape Clause

PPA recognizes that in some cases, plans will not be able to obtain the contribution increases needed to emerge from critical status. For this reason the law provides that if the Trustees determine that "after exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status," a Rehabilitation Plan may consist of "reasonable measures to emerge from critical status at a later time or to forestall possible insolvency . . ."

The unanswered question is whether the determination of what constitutes "reasonable measures" rests solely with the unfettered discretion of the Trustees, whether the IRS will issue some guidelines for making the determination, and whether the IRS will review the Trustees' determination for reasonableness.

The answers to these questions are critical because if the Trustees can make the required determination, contributing employers that agree to a Rehabilitation Plan are protected from an excise tax. But, if the IRS believes it can review and not accept the Trustees' determination, the protection from excise taxes for the contributing employers is lost and the Trustees could be subject to a penalty for failing to adopt a Rehabilitation Plan. Thus because of this uncertainty, Trustees may alternatively need to consider a mass withdrawal termination.

Nevertheless, because of the lack of specific statutory or regulatory standards, in order to reach an appropriate course of action, the Trustees must engage in intensive discussions with counsel, consultants and perhaps even industry economists.

Conclusion: Time to Act

Trustees of critical and endangered plans must develop respectively a Rehabilitation Plan or Funding Improvement Plan. The existing proposed regulations raise questions about interpretations on which some of those plans already developed have been based.

The factual requirements for use of the escape clause, which may be the only way that some critical plans can avoid a mass withdrawal, are still undefined. The IRS is unlikely to promulgate guidance in enough time to allow Trustees and bargaining parties to be sure what they are doing or have done complies with the law.

In this highly fluid situation, all that Trustees can do is to apply the provisions of PPA in good faith, relying on their counsel in those areas where the law needs interpretation. It is difficult to imagine that the IRS would punish those plans that have acted in good faith in the absence of final guidance.

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