# How Do You Spell Relief? S-E-C-T-I-O-N 4-1-2-(e)

**by Gene Kalwarski and Peter Hardcastle**



*In recent public meetings and pronouncements, the Internal Revenue Service (IRS) has revealed itself to be very sympathetic to the plight of distressed pension plans. In particular, IRS has been suggesting and even somewhat encouraging plans to consider the pension funding relief that already exists under current law, in what previously was a little-known provision, Section 412(e) of the Internal Revenue Code (IRC).*

*This article describes what the relief is, who can get it, how it works on a given fund, how to get it and why it's good for all affected parties, including the government.*

IRS has the authority to grant relief to any defined benefit (DB) pension plan that applies for it. And the relief is substantial for Taft-Hartley plans. In cases we have tested and submitted applications for, the relief dwarfs any available under the recently enacted pension relief legislation.

In general, the relief potentially available under 412(e) is substantial reductions, over many years, in the minimum annual contribution required by the government under current funding rules.

Under current federal law, DB pension plans (single employer and multiemployer) insured by the Pension Benefit Guaranty Corporation (PBGC) must pay no less into their pension funds than set forth under Section 412 of the IRC. The purpose of the standard, which arose from the creation of ERISA 30 years ago, was to ensure that PBGC, the federal agency that is to pension plans what FDIC is to banks, could viably operate as an insurer of troubled pension plans.

During the 20 years prior to 2000, these standards largely did not challenge most of the pension funds experiencing funding problems today. The raging bull stock markets of that period produced earnings well in excess of what was expected.

In fact, another funding standard did get in the way and contributed to some of the problems we are seeing today. In particular, IRS also sets out maximum funding standards, where any contributions made in excess of these limits were not tax-deductible, as they were below the limit.

During the booming stock market years, this caused many pension funds (with the "blessing" from their actuaries) to increase their benefits. The result was to produce higher maximum standards that could cover contributions being made and enabling plans to avoid paying taxes on those contributions.

But the negative investment returns many plans experienced during 2000, 2001 and 2002 changed everything. The accumulation of those investment losses grew to such proportions that numerous DB pension funds began facing significant challenges, as the minimum standards now came into play.

In simple terms, the relief a pension plan can receive in 2004 under 412(e) is similar to the relief a homeowner would receive on his or her monthly mortgage payments if the lender offered to increase the term of the loan to be paid off by ten additional years, and more importantly, also offered to drop the interest rate charged by 6% (600 basis points!). The impact is enormous, reducing payments in this example by more than 50%.

## Who Can Get the Relief?

Essentially, any DB pension plan is eligible for Section 412(e) relief. However, there is a major difference in the amount of the relief available for multiemployer pension funds (Taft-Hartley) vs. single employer pension funds (e.g., corporate). Both types of funds are eligible for the (up to ten-year) term extension, but only the Taft-Hartley funds are eligible for the dropping of the interest rate.

Also, the deficit reduction contribution applies to single employer funds and this substantially reduces the 412(e) relief. The balance of this article will focus on the funding rules and 412(e) application for only Taft-Hartley funds.

Here's how it works: Under current law, without 412(e) application, in simple terms, a pension fund's minimum required contribution is made up of four components.

1. The annual cost to pay for benefits to be earned in a particular year. This is called the plan's *normal cost.*
2. The annual cost to fund any unamortized increases in unfunded liabilities created in prior years by past benefit improvements, changes in actuarial methods and assumptions, and experience losses due to investment return being less than expected, or added liabilities created by participants living longer, retiring earlier, etc. These costs are called the plan's *amortization charges.*
3. The annual credit to reflect any unamortized decreases in unfunded liabilities created in prior years by past benefit reductions, changes in actuarial methods or assumptions, and experience gains due to investment earnings being greater than the actuary expected them to be, or liabilities reduced by participants living shorter lives that assumed, or retiring later, etc. These costs are called the plan's *amortization credits.*
4. Interest adjustments on all the above.

In total, these four components equal the plan's minimum funding requirement, before recognizing one more possible adjustment in the actual amount that needs to be paid. If in prior years the plan paid more than the minimum, then an "account" is set up to measure the excess amounts contributed.

This account is called the *credit balance.* To the extent a plan has a positive credit balance, any portion of that amount can be used to first offset the minimum required funding requirement. So for example, if a plan has a requirement without respect to the credit

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William T. Cullen.
*Benefits Law Journal,*
Winter 2003, pp. 71-85.
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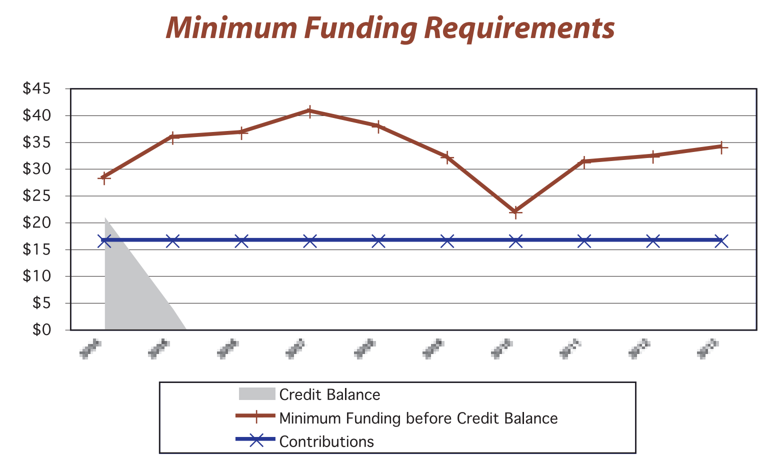
balance to pay $25 million in a given year, but the plan has accumulated from prior years a credit balance equal to or in excess of $25 million, then the net minimum funding requirement is zero.

Note that if a plan does not meet its minimum funding requirement, IRS will impose severe penalties on the plan. In the first year that the minimum is not met, a 5% excise tax will be imposed and interest at the assumed rate will be added to the deficiency which will then be carried over into the next plan year. At that time, if the accumulated deficiency is not made up, a 100% excise tax will be imposed on amounts deficient.

Figure 1




## Example Without 412(e)

We present the case for a plan that as of January 2004 has just gone through a three-year period of investment returns during 2000, 2001 and 2002, that averaged -5% per year. Compared to an expected return of 8%, this produced over that three-year period, accumulated losses of 39% (13% loss for each year). In addition, as has been the case for many pension plans, in 2004 this plan experienced a significant investment gain by earning 20% (12% more than expected).

Without any plan changes, or any pension relief (412(e) or the new legislative relief) the plan's outlook with respect to minimum funding looked like Figure 1.

The figure shows this fund has a starting credit balance of around $22 million, but the credit balance runs out by 2006. At that time, bargained contributions ($16.5 million) would have to increase to over $35 million in 2006 and then $40 million in 2007. That's an increase of almost 250%.

This plan has to either meet this contribution level by increasing current contributions, or it can reduce the minimum funding line by reducing plan benefits. This is an action many plans nationwide have taken, or are contemplating taking now. One might think, "What about future investment returns? That might avoid this problem." It can't. Our calculations show even three consecutive years of 30% per year will not avoid the 2006 deficiency.

Built into the minimum funding line are substantial amortization payments (like a mortgage payment) to pay not only for the accumulated 39% investment losses from years 2000-2002, but any losses prior to that are still not amortized, or any other experience losses or plan improvements. Those accumulated losses over the years still being amortized total almost $300 million. Without a 412(e) amortization extension, payments must be made to make up all those losses over 15 years, and at an interest rate of 8% per year. Think of it as Bill Gates' annual mortgage payments; for a $300 million house, $35 million per year, payable for 15 years, at an 8% interest rate.

## Same Example With 412(e) Exemption

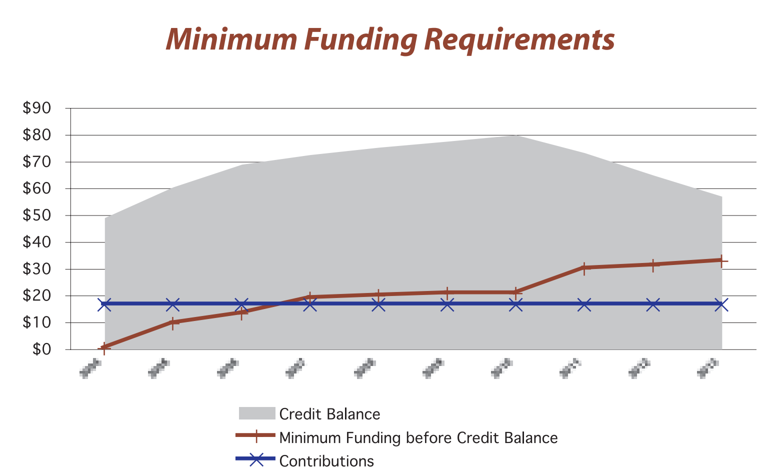
In simple terms, what a Section 412(e) amortization will do for this plan, and Bill's mortgage payments, is to extend the payment period to 25 years, and lower the interest rate to 2%. Figure 2 shows the impact on this plan.

Minimum funding problems are gone. Even in 2013, with the minimum funding line at $30 million, the credit balance is still healthy at $57 million, and is not expected to run out until 2018. But a lot, such as a market rebound, can happen in 14 years.

## Finding Relief

How can a plan get this relief? The law specifies the material that must be submitted; your fund counsel can help you with that. Keep in mind, among other things employer financial information will need to be shared with IRS. More importantly, IRS will ask for long-term projections beyond the next ten years, from the plan actuary.

Figure 2



Details on what the projections need to show are soon going to be announced by IRS. It is our understanding the plan will have to show at least 20 years of projections on the status of minimum funding requirements but, more importantly, the plan must also provide projections of the funded status of the plan (assets and liabilities) and that's the real catch.

For plans that are financially deteriorating, the government is not interested in any way in providing this relief if by providing it, the plan's financial condition (assets vs. liabilities) would get worse. PBGC, the insurer of these plans, has a say and IRS and PBGC will be coordinating on these requests.

Each situation will most likely be judged on its unique circumstances and merits.

At a recent meeting, IRS officials stated that in reviewing applications, they will be focusing on the intent of 412(e) as laid out in ERISA, that:

1. The extension carries out the purposes of ERISA.
2. Granting the extension would still protect participants.
3. Not granting it would not be adverse to the interests of plan participants in the long run (i.e., if there would be a substantial risk of plan termination/curtailment of benefits).

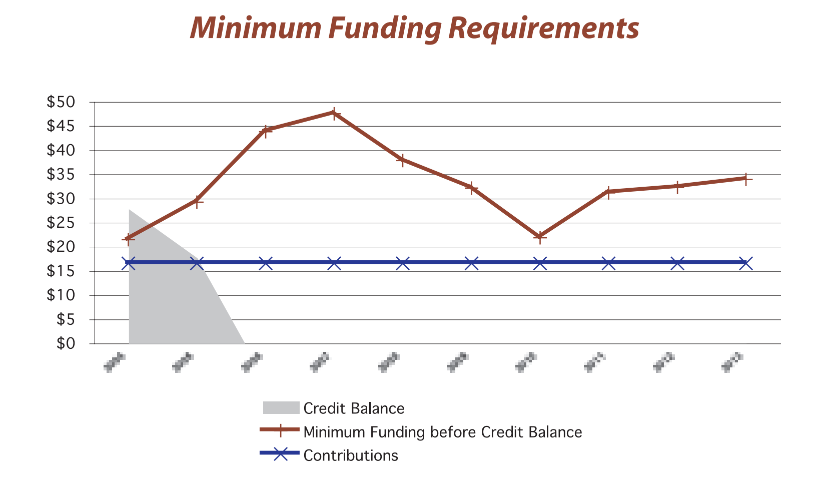
For most plans, we believe IRS will require that unfunded liabilities not grow during the period of the extension. However, for some plans, IRS might consider an extension, we believe, even if unfunded liabilities grow, if significant plan changes are made, say during the next bargaining contract, but the ratio of assets to liabilities (a measure of benefit security) does not get worse.

In that case, the relief (extension) that is granted is likely to be only sufficient to get the plan to the next bargaining cycle. We believe IRS recognizes that for some plans, the road to recovery will take several bargaining cycles.

Besides stopping or slowing down the deterioration in the plan's funding status, there is one more thing IRS is likely to require: Changes being contemplated must be *plausible*.

For example, if the change required to get a 412(e) extension is of such magnitude that the likely continuance of the plan is in question, IRS may decide it's better for the government to cut its losses now and not end up assisting a plan later, when it's in worse shape.

**Figure 3**




One example of what IRS might consider as an *implausible* plan change might be if employer contributions are going to increase by so much as to make the withdrawal liability option for each employer cheaper in comparison. In that case, there is a reasonable likelihood for the plan to get into a "death spiral" with employers racing each other out.

## 412(e)=Good Policy

Why is 412(e) in everyone's best interest?

For employers and labor unions, it should be obvious that getting a 412(e) amortization extension buys them much-needed time to deal with their funding crisis, and it makes the amount of change in many cases less drastic than what it would take to meet minimum funding deficiencies without the extension.

Keep in mind, minimum funding problems for many plans do not mean they are in financial trouble. Simply not having built up a credit balance before the year 2000, followed by three years of investment losses, for a plan that is, say, 90% funded at the current time, could lead to drastic short-term minimum funding deficiencies. It's become clear to the authors that the minimum funding rules are in serious need of overhaul, since they do not reflect the plan's true financial condition, as they should.

The reason 412(e) amortization extension is good for the government is that it allows the government the ability to sustain what otherwise is a viable pension plan and thereby protects plan participants. In addition, without 412(e) extensions, there are likely to be more plans than not that will experience significant declines in employers, leading to further deterioration in its funded status.

## Pension Reform Impact

Finally, after all the heated debate and press coverage, the recently enacted pension reform legislation did next to nothing for Taft-Hartley plans. In fact, a strong case can be made that the act hurt these plans, due to the onerous reporting requirements they must now make each year to plan participants.

Without getting into the details of the new law, for the plan reviewed in this article, Figure 3 shows the impact of pension reform "relief."

Comparing this to Figure 1, all that has changed is the projected funding deficiency is delayed one year and, after that, the amount of funding that will be required will be greater since the funding relief granted must be immediately repaid.

In conclusion, if you have a pension fund that you have been told is projected to have a funding deficiency now or in the near future, and Section 412(e) amortization extension has not been considered, the time to consider it is now.

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## What's Next?

While Section 412(e) can provide substantial relief for most Taft-Hartley plans in need of funding relief, it does not address two more fundamental issues. The first one, the need for longer term pension funding rule overhaul, has already been mentioned here. The recent pension reform legislation made reference to that need and in Washington, D.C., various federal agencies and Capitol Hill staffers are gearing up to look at this issue.

The second fundamental issue has not yet been addressed, and it is, in the authors' opinion, the root of the problems facing pension funds today. The investment risk of pension funds, as the baby boomer generation aged, was not adequately analyzed and dealt with by most funds.

Reputed investment leaders are acknowledging their so-called investment models are seriously broken and need to be fixed. Without fixing that, and without long-term pension reform, what hit the pension fund community the past few years will happen again. Remember these plans went more than a decade with returns well in excess of what they assumed. It only took three years of bad returns to undo it all. Look forward to reading more about this issue, as it will most certainly be gaining more visibility in the future. **B&C**


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