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Navigating PPA's Special Funding Rules and Ambiguities

The Pension Protection Act's new funding rules for multiemployer plans become effective in 2008. However, important steps can be taken this year to address the new requirements. Plans should be reviewing their projected 2008 status now. Depending on their financial situation, they should be identifying opportunities for avoiding the new stricter funding rules that apply to financially stressed plans or taking steps to mitigate the effect of those rules.

The plan actuary must certify by the 90th day of the 2008 plan year whether the pension fund is in endangered or critical status, which will trigger the Act's new funding rules. These rules create three zones for financially stressed funds, known as endangered, seriously endangered and critical. If a fund falls into one of these zones, the law requires the Trustees to develop a plan by the 330th day of the plan year that will allow the fund to meet the target for its zone within the time period specified. If the Trustees fail to develop a plan, they face a fine of up to $1,100 per day. The options available to the parties and the consequences of failing to meet the applicable targets vary for each zone.

Cheiron Observation – Because of the many uncertainties about how the special funding rules will be interpreted and how the process will actually work, Cheiron believes that many plans may want to avoid the adverse consequences of being certified as endangered or critical for 2008.

This is the first of three Advisories that address the consequences and options related to the new special funding rules of the Pension Protection Act. This Advisory will discuss the ways in which plans can avoid becoming subject to the special funding rules, as well as some of the important uncertainties surrounding the implementation of the rules. The second Advisory will contain studies drawn from actual situations showing how making certain changes this year may allow plans to avoid an adverse certification in 2008. The third Advisory will illustrate various options plans can use if they are unable to avoid being classified as endangered or critical.

Avoiding the Danger Zones

Plans will be classified as endangered or critical based on certain key factors, the most important of which are the Funded Ratio and whether they have a projected Minimum Funding Deficiency. The Funded Ratio is defined as actuarial value of assets as a percentage of accrued liabilities, or present value of benefits earned to date. A Minimum Funding Deficiency occurs if the traditional Funding Standard Account Credit Balance (as revised by PPA) is projected to be less than zero in a future year.

The liabilities used to determine whether a plan will be endangered or critical for the 2008 plan year will normally be based on the 2007 plan year's actuarial valuation. Also, plan changes adopted before the plan year (or possibly before the due date for the actuarial certification) will be taken into account by the actuary in projecting whether the plan will incur a Minimum Funding Deficiency in a future year. Examples of changes include:

- Combining outstanding amortization bases,
- Changing funding methods,
- Reducing future benefit accruals,
- Changing funding assumptions,
- Increasing contributions, or
- Obtaining an automatic 5-year amortization extension (except that this cannot be used to avoid critical status).

Many plans have numerous existing amortization bases relating to plan amendments, actuarial gains and losses, or other factors over the past 30 years. Depending on the timing and magnitude of these bases, combining them into one base, under existing funding rules, can sometimes be advantageous. With regard to funding methods, there are several acceptable methods and the cost impact of alternative methods should be examined. Actuarial assumptions play a crucial role in determining a plan's status. Up until PPA, the law required that multiemployer plan assumptions be reasonable in aggregate. *The new general funding rules require that each actuarial assumption be reasonable in its own right.* Whether an assumption is individually reasonable is based on plan historical experience, expectations of future experience, and industry norms for similar plans. Because of this requirement, many plans, particularly large plans, may need to do experience studies for critical assumptions or otherwise carefully review these assumptions, including the rate of return on assets, retirement age, and mortality. If an assumption change increases actuarial liabilities, and is put into effect for the 2007 valuation, it will be amortized over 30 years, but if the change is not made until the 2008 valuation, it will be amortized over 15 years. Waiting until 2008 could add approximately one-third to the minimum funding charge for that change.

Another example of the importance of timing is a possible decision by the Trustees to reduce future accruals. Depending on the plan's funding method, this may result in an immediate reduction in plan liabilities, and in all cases will result in a reduction of projected future liabilities. If this action is taken in 2007, the reduction will be amortized over 30 years. If the action is taken in January of 2008, for example, the reduction will be amortized over 15 years, which will provide a greater credit against minimum funding. More importantly, any reduction in future accruals will affect the actuary's projections of the fund's future funding requirements if adopted before the certification due date (90 days from the beginning of the plan year). This could mean the difference between being classified as actuarially sound or falling into one of the danger zones.

Another feature of the new law that can help plans avoid endangered or seriously endangered status is the automatic amortization extension. To qualify for the extension, the plan must have taken action to improve its funding status. In addition, the actuary must certify that (i) the plan would otherwise have a minimum funding deficiency within 10 years, (ii) the plan will have sufficient assets to pay benefits through the extension period, and (iii) the required notice has been provided to participants and affected parties. If the Trustees have already taken action such as reducing future accruals or subsidies, eliminating ancillary benefits, increasing contributions or any combination of such actions, and the Trustees decide to apply for the automatic extension, the actuary can take this into account in doing the required projections for the 2008 actuarial certification. Note, however, that the amortization extension cannot be reflected in determining critical status.

Some plans may find that either they cannot avoid endangered or critical status, or they are better positioned to start out endangered or critical. In that situation there are differences in the requirements for each status that must be considered. There are four very important differences between critical and the other two zones.

Under critical status:

1. Employers are not responsible for any funding deficiencies.
2. The plan may not pay benefits in lump sums.
3. The bargaining parties or under certain circumstances defined by the law, the Trustees may eliminate all adjustable benefits for active employees who retire after receiving notice that the plan is critical. Adjustable benefits include early retirement subsidies and ancillary benefits, such as disability benefits, optional forms of retirement benefits, supplemental benefits and lump-sum death benefits. In addition, adjustable benefits include benefits for retirees stemming from amendments within the preceding 60 months.
4. The Trustees may determine that after eliminating all adjustable benefits, required contributions are so high that it is unreasonable to increase them further and that either more time is needed to get out of critical status or the plan will be unable to ever get out of critical status.

Because of these features, in some instances the bargaining parties and Trustees may decide that the plan has a better chance of continuing if it is in critical status than if it is endangered or seriously endangered. The law allows the actuary to perform an early certification of critical status now, effectively preventing participants from making a run on the bank by retiring before 2008.

Uncertainties

In addition to some of the conditions and restrictions mentioned above, there are many areas of uncertainty as to how the new PPA rules will be implemented. IRS and DOL guidance are needed to provide Trustees and their advisors with appropriate guidance. Some of these uncertainties are described below.

Trustees' responsibilities after certification

Once an actuarial certification of endangered or critical status is filed, the Trustees are forbidden to accept any collective bargaining agreement that:

1. Reduces the level of contributions for any participants. How does this apply to new employers?
2. Suspends contributions with respect to any period of service. If the plan has traditionally not required contributions during an initial period of service for new hires, will this continue to be acceptable?

Contribution increase for default plans

For both endangered and critical plans, the Trustees are required to prepare a default schedule, which is designed to reduce benefits before calling for contribution increases. As a practical matter, for many plans, even after reducing or eliminating benefits to the maximum extent permitted by the law, the default schedule will still require contribution increases to meet the required targets. Is there any limit on the amount of contribution increase?

Maximum extent of benefit accrual reduction

For endangered and seriously endangered plans, the default schedule reduces future accruals to the extent needed to meet the benchmarks, including reductions in future accruals to the maximum extent permitted by law. However, the law does not define what constitutes the maximum extent, nor does it require the elimination of ancillary benefits. There is, however, broad agreement that the default schedule may freeze all future accruals. In any event, plans that cannot avoid a danger zone may benefit from getting an early start on examining the options available in an effort to reach a jointly acceptable solution in a timely fashion.

Measuring a plan's progress

Once the correction period begins, the plan actuary is required to measure the plan's progress toward meeting the benchmarks and the Trustees are required to update the Funding Improvement Plan. However, the law provides no guidance on how to measure a plan's progress, and it is unclear what the effect of a revised Funding Improvement Plan will be when contracts entered into at the beginning of the process expire and the revised plan requires additional contributions. Note that if the plan emerges from endangered status before the end of the ten year period, it is no longer required to meet the benchmarks.

Reductions in adjustable benefits

The default schedule for critical plans allows future accruals to be reduced, but not below a level of 1% of contributions. It also requires that non-normal retirement benefits for active and deferred vested participants be reduced or eliminated to the extent necessary. However, it is unclear whether the law allows or directs the Trustees to reduce the adjustable benefits of employees for whom no contributions are being made, e.g., deferred vested employees, without waiting for the outcome of collective bargaining over the Rehabilitation Plan, if the Trustees deem it necessary.

Modification of Rehabilitation Plan

The Trustees are required to modify the Rehabilitation Plan based on progress toward meeting the goal of not having a projected funding deficiency for at least ten years into the future. Some interpret this provision as also requiring the Trustees to modify the benchmarks. Although the correction period for a critical plan is also 10 years, one interpretation of the law would allow Trustees to modify the rehabilitation period if they determine that after taking all reasonable steps, the plan will be unable to emerge from critical status by the end of the tenth year; the Trustees may even determine that the plan will never be able to emerge from critical status. If the IRS does not agree with this interpretation, then the parties could well be faced with a substantial funding excise tax.

Imposition of Default Schedule

If the parties are unable to agree on a Funding Improvement or Rehabilitation Plan within 180 days after expiration of a collective bargaining agreement that was in effect when the plan entered one of the danger zones, the Trustees must impose the default schedule. It is not clear what that means if the default schedule calls for an increase in contributions. Does that increase apply only during the continuation of negotiations? Does it apply until the parties reach a true impasse and the employer's last offer is to withdraw? Does it apply as long as the employer performs previously covered work and the union retains its certification as bargaining representative? Does it apply until the company goes out of business or closes its plant? Does it apply until the bargaining parties reach a new contract? These questions must be answered in order to administer the plan during the period before a Funding Improvement or Rehabilitation Plan is adopted or rejected.

Excise Taxes

PPA imposes an excise tax on any employer who fails to timely remit contributions required under a Funding Improvement or Rehabilitation Plan. If those contributions are due under a collective bargaining agreement, the plan already has a cause of action for contributions, interest, attorneys' fees and penalty under Section 515 of ERISA. PPA imposes an additional excise tax equal to 100% of the contributions due if they are not remitted to the plan in a timely manner. How will "timely manner" be defined? The 100% excise tax, when added to the remedies already available under ERISA, creates additional incentive for employers to withdraw before a plan falls into one of the danger zones.

An excise tax is also payable should a critical plan fail to meet three consecutive annual benchmarks. However, if the IRS agrees to the interpretation for the modified Rehabilitation Plan, the benchmarks become a moving target that will be difficult to fail. In the event that the benchmarks are not adjustable, the excise tax is levied on the greater of the amount of contribution needed to meet the benchmark or the deficiency that would have existed in the funding standard account.

The Yo-Yo Effect

The special funding rules make it possible for a plan to be in a danger zone one year, out of danger the following year, and then back into a danger zone the year after that. The result will be that the Trustees could be required to develop a plan to meet the relevant benchmarks, which will then be rendered moot, only to find themselves required to develop another plan in a subsequent year. This process of dropping in and out of a danger zone will greatly complicate plan administration and add to the administrative expense. Will there be any relief granted from this potential "yo-yo effect"?

Multiple Contracts

The Funding Improvement or Rehabilitation Plans must be developed for the entire pension fund. Where the fund is maintained under multiple collective bargaining agreements, there is a risk that not all employers will accept the Funding Improvement Plan or Rehabilitation Plan and the default schedule will be put into effect. This creates two potential difficulties: first, if not all employers agree to the same Funding Improvement Plan or Rehabilitation Plan, the underlying assumptions may not hold true, and it is possible that the applicable benchmarks will not be met. And second, plan administration will be complicated by the addition of different benefit levels for different employers.

Early Notification of Critical Status

The law allows the plan actuary to certify this year if it is reasonably expected that the plan will be in critical status in 2008. The Trustees have the option of notifying participants of the plan's critical status any time prior to 120 days after the beginning of the 2008 plan year. The notice must include a statement that subsidies, supplements and optional forms of benefits for participants who retire after the date of the notice are subject to reduction. The purpose of early notification is to stop a "run on the bank," but the law contains no standards for deciding whether to issue an early notice.

Cheiron Observation – As described above, there are many unanswered questions regarding the operation of the new funding rules, and the requirements imposed on Plan Trustees of endangered or critical plans. It would seem prudent to avoid the danger zones, if possible, until the agencies provide more guidance or plans have developed experience with administration of the danger zone requirements.

Summary of Major Uncertainties

- Implementing the rule against accepting contracts that reduce contributions
- Measuring plan progress and revising the Funding Improvement or Rehabilitation Plan
- Implementing a default plan that requires an increase in contributions
- Determining when and by how much to reduce adjustable benefits for terminated vested participants
- Dealing with multiple collective bargaining agreements that adopt different plans
- How and when the special excise taxes for not making contributions required under a Funding Improvement or Rehabilitation Plan will be imposed
- Whether to provide participants early notification of expected critical status
- Whether a critical plan can change annual benchmarks as part of required progress evaluation to avoid excise tax
- What impact, if any, do automatic amortization extensions have for plans after they have classified as critical

Conclusion

As described above, complexity and uncertainty abound in the Funding Improvement and Rehabilitation Plan processes. Therefore, plan Trustees should work with their actuaries and legal counsel this year to study their options. In particular, they should seek opportunities to avoid falling into a danger zone next year, or to minimize the actions needed to comply with the new funding rules.

Cheiron is a full-service actuarial consulting firm assisting corporations, public employers and Taft-Hartley sponsors to manage their benefit plans proactively to achieve strategic objectives and safeguard the interests of plan participants and beneficiaries.