



# AMERICAN BENEFITS COUNCIL

July 7, 2010

## SUMMARY OF SINGLE-EMPLOYER PLAN FUNDING RELIEF LEGISLATION

PREPARED BY KENT MASON OF DAVIS & HARMAN LLP

### **BACKGROUND.**

On June 25, President Obama signed the “Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010” (the “Act”). This document summarizes the single-employer plan funding relief provided under the Act.

### **SUMMARY.**

In general, the Act contains the following provisions, all of which are explained further below:

- A choice between electing funding relief under the 2 and 7 rule or the 15-year rule for any two years during the 2008-2011 period.
- There is no requirement that a plan provide ongoing accruals in order to be eligible for the funding relief.
- Under the cash flow rule, a plan sponsor that elects funding relief must make an additional contribution to the plan equal to the sum of (1) the aggregate excess employee compensation, and (2) the aggregate amount of dividends and stock redemptions over a specified threshold.
  - Excess employee compensation is very generally taxable compensation over \$1 million (indexed), subject to certain exceptions including an exception for certain amounts paid pursuant to a written binding contract.
  - The threshold against which dividends and redemptions are measured is generally the plan sponsor’s prior year “EBITDA”, i.e., earnings without regard to reductions by reason of interest, taxes, depreciation, and amortization.

- There are a number of exceptions to the dividend and redemption rule, including an exception for historical dividends so that continued payment of an historical dividend amount will not, on its own, trigger the cash flow rule, even if such amount exceeds the plan sponsor's prior year EBITDA. The Act does not protect historical redemptions.
- The cash flow rule lasts for three years in the case of the 2 and 7 rule, and lasts for five years in the case of the 15-year rule.
- Contributions under the cash flow rule are capped at the cumulative amount of relief used, so that a plan sponsor could generally lose all funding relief.
- The Act requires reporting and disclosure by plan sponsors electing funding relief.
- Generally, if a plan is at least 60% funded for the 2008 year, benefit accruals do not need to be frozen for the 2009 or 2010 plan years. The Act provides similar short-term relief from the prohibited payment benefit restriction applicable to social security leveling options.
- The Act provides a lookback rule generally permitting plan sponsors that are charities to use their credit balance for the 2010 and 2011 plan years if their plan was at least 80% funded for the 2008 year. (Use of the credit balance for 2009 would, in this case, already be permitted with respect to all plan sponsors – not just charities -- by the law in effect prior to the Act.)
- Plans subject to the funding rules in effect prior to the Pension Protection Act of 2006 (the "PPA"), are generally permitted to elect modified versions of the 2 and 7 rule and the 15-year amortization rule. In addition, certain plans maintained by charities become subject to the pre-PPA funding rules.

## **RELIEF PROVISIONS.**

### **Period of funding relief.**

Employers are entitled to elect to apply either the 2 and 7 rule or the 15-year rule, both of which are described below, for any two plan years during the period starting with the first plan year beginning in 2008 and ending with the last plan year beginning in 2011. The two plan years need not be consecutive.

There are two caveats. First, an employer may not elect the relief for a year if the due date for contributions for that year is earlier than the date of enactment. So, for example, small calendar year plans that use an end-of-the-year valuation date would not be permitted to use the relief for 2008 since the due date for contributions for 2008 (9/15/09) has already passed.

Second, if a plan sponsor elects to apply the relief for two years, the plan sponsor must elect the same relief provisions—either the 2 and 7 rule or the 15-year rule—for both years.

**2 and 7 rule.**

Under the 2 and 7 rule, employers amortize their “shortfall amortization base” for the year in question over seven years, but the seven-year amortization would start two years late. So, for example, the shortfall amortization base for 2010 is amortized over seven years starting in 2012. During the two-year delay period, the employer only owes interest on the shortfall amortization base.

**15-year rule.**

Under the 15-year rule, employers amortize their shortfall amortization base for the year in question over 15 years.

**No active plan requirement.**

There is not a requirement that, in order to use either the 2 and 7 rule or the 15-year amortization rule with respect to a defined benefit plan, the defined benefit plan must be an active plan that provides ongoing accruals.

**CASH FLOW RULE.**

**In general.**

In general, under the cash flow rule, a plan sponsor that elects to use the 2 and 7 rule or the 15-year rule must make a contribution to the plan, in addition to any contribution otherwise required, equal to the sum of (a) the aggregate excess employee compensation over \$1 million (indexed) and (b) the aggregate amount of dividends and redemptions for the plan year in excess of a specified threshold.

**Excess employee compensation.**

Under the excess employee compensation component of the cash flow rule, if any employee's compensation exceeds \$1 million (indexed), the employer must make a “matching contribution” to the plan for that year of an amount equivalent to the excess. This rule is not limited to the top five employees or any other subset of employees; it applies to all employees of the employer. So the amount that must be contributed is the aggregate excesses with respect to all employees of the employer. It is not clear whether former employees are treated as “employees” for purposes of this rule.

Further clarity is also needed with respect to the application of this rule to nonresident aliens, especially those who have compensation subject to U.S. income tax.

Subject to certain exceptions described below, all taxable compensation for a year is taken into account for purposes of the \$1 million rule, so that, for example, all regular pay, equity compensation, bonuses, incentive compensation, other special pay, etc., are taken into account for the year in which they are includible in income. However, compensation attributable to services rendered before March 1, 2010 is disregarded. Also, if an employer funds its nonqualified deferred compensation (through a rabbi trust or otherwise), that amount must be treated as taxable compensation for purposes of the \$1 million rule in the year of funding (and not in any subsequent year), even though the amount may not actually be currently taxable. This rule applies without regard to when the related services were performed. (In the case of a rabbi trust that relates to a defined benefit nonqualified plan, there is no guidance on how to allocate contributions to particular employees.)

The Act disregards 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. However, the exception does not apply to other amounts paid under a binding contract, such as salary, bonuses, and incentive compensation (unless the bonuses or incentive compensation has been deferred). The Act also provides an exception for commission income. In addition, there is an exception for 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 grant.

### **Dividends and redemptions.**

Under the second part of the cash flow rule, an employer must also make a "matching contribution" to the plan for a year equal to the "extraordinary dividends and redemptions" for the year. "Extraordinary dividends and redemptions" are defined as the excess of (a) the sum of dividends declared by the plan sponsor during the plan year, plus the aggregate amount paid for stock redemptions during the plan year, over (b) the greater of (i) the adjusted net income for accounting purposes of the plan sponsor for the preceding plan year or (ii) the historical dividend amount.

The referenced definition of net income disregards any after-tax gain or loss on assets. In addition, the Act provides specifically that net income is determined before any reduction by reason of interest, taxes, depreciation, or amortization (i.e., "EBITDA"). The statutory language regarding EBITDA raises certain issues. First, assume that a company operates at a loss for a year, so that its EBITDA is a loss of \$10 million. Assume further that the company redeems \$1 million of shares. Is the cash flow contribution \$1 million or \$11 million? The statutory language could be read either way, but the answer should be \$1 million. Otherwise, the law would create an odd cliff whereby a \$1 redemption could trigger a multi-million cash flow contribution.

Second, under the Act, EBITDA is measured on a plan year basis. For companies with different plan and fiscal years, this could be burdensome. It would be very helpful if Treasury were to interpret this language to permit the use of EBITDA for the fiscal year ending with or within the previous plan year.

If the plan sponsor has determined and declared dividends in the same manner for at least the five preceding years, and determines and declares a dividend for the plan year using such manner, the dividend declared in the plan year is the "historical dividend amount" for purposes of the rule described above. In other words, assume that a plan sponsor has paid \$.10 per share for the last five years, and does so again in the current year. In that case, in determining the threshold for extraordinary dividends and redemptions, the \$.10 dividend declared for the current year would be substituted for adjusted net income, but only if such amount were greater than adjusted net income. This rule allows an employer to keep paying its historical dividend even if the employer has a bad year and has little or no net income.

It is not clear whether the historical dividend rule would apply if a plan sponsor determined and declared a dividend in the same manner for the preceding five years but declares a smaller dividend in the current year. Clearly, such a dividend should be protected by the historical dividend rule but the statutory language is not clear on this point.

A number of special rules also apply with respect to the determination of extraordinary dividends and redemptions. Dividends declared, and redemptions occurring, before March 1, 2010 are not taken into account. Dividends paid within a controlled group are similarly disregarded. In addition, redemptions that are made pursuant to an employee benefit plan or are made on account of the death, disability, or termination of employment of a shareholder or employee are not taken into account. Finally, dividends and redemptions with respect to preferred stock are disregarded if (a) dividends accrue with respect to such stock in all events, (b) interest accrues on any unpaid dividends, and (c) either (i) the stock was issued before March 1, 2010 or (ii) the stock is held by an employee benefit plan.

There is no explicit exemption under the Act for stock dividends though it is not clear that Congress intended that such dividends trigger the cash flow rule.

### **Length of time.**

A critical aspect of the cash flow rule is the length of time that it applies. If the employer elects the 2 and 7 rule with respect to a year, the cash flow rule applies for three years, starting with the later of (a) the year for which the relief is elected, or (b) the first plan year beginning after December 31, 2009.

If the employer elects the 15-year amortization rule, the cash flow rule applies for five years, starting with the later of (a) the year for which the relief is elected, or (b) the first plan year beginning after December 31, 2009.

### **Contributions made under the cash flow rule.**

The contributions to the plan made pursuant to the cash flow rule are in addition to any minimum contributions otherwise required. The additional contributions do not give rise to a credit balance; instead, the additional contributions are applied to reduce the last amortization payments with respect to the year for which the employer elected relief. Also, it appears that credit balances can be used to satisfy this obligation to make additional contributions.

The required additional contributions are capped at an amount sufficient to fully pay off the present value of the unamortized portion of the shortfall amortization base for the year for which the employer elected relief.

The required additional contributions for a year are also subject to an additional limit. Under this limit, the additional contributions cannot exceed the excess of (a) the amount that would have been required to be contributed during the relief period without the funding relief, over (b) the amount that was required to be contributed taking the relief into account. In other words, the additional contributions cannot cause the employer to be in a worse situation on a cumulative basis than if the employer had not elected the relief.

Assume, however, that this "no worse than present law" limit applies to limit the additional contributions. For example, assume that, without this limit, the additional contributions would have been \$1 million. But the limit reduces the additional contribution to \$800,000. The extra \$200,000 amount that is not contributed "carries over" to the next year and is treated as a required additional contribution in the next year (subject again to the limit in the next year). These carryovers last for a total of four years (in the case of the 2 and 7 rule) or seven years (in the case of the 15-year rule). So, for example, if relief is elected with respect to 2010, the last year in which the carryover can apply is 2013 (in the case of the 2 and 7 rule) or 2016 (in the case of the 15-year rule).

The additional contributions are disregarded in applying the quarterly contribution rules. Thus, for example, in determining whether sufficient quarterly contributions have been made for a year, all additional contributions required for the current or prior year are disregarded.

If an employer elects relief with respect to more than one plan, the additional contributions must be allocated, under Treasury rules, on a pro rata basis among the plans, including collectively bargained plans, based on the relative reduction in the first year funding relief provided. This rule will produce some odd results where

an employer elects relief with respect to plans that are very different in size. The small plan or plans will almost always receive a share of the additional contributions that is disproportionately large compared to its size.

### **Double counting issue.**

Assume that a plan sponsor elects the 2 and 7 rule for the 2010 and 2011 plan years. Assume further that in 2012, the plan sponsor pays an extraordinary dividend of \$1 million. At first blush, the cash flow contribution required by the Act would appear to be \$1 million. But the statutory language can be read to require a \$2 million cash flow contribution in this case. This is the case because the \$1 million extraordinary dividend is within the three-year period for both 2010 and 2011 and thus arguably is counted twice. It is not at all clear that Congress intended this result.

### **Controlled group basis.**

For purposes of the cash flow rule, all members of a plan sponsor's controlled group are aggregated. Thus, for example, excess compensation paid by one member of a controlled group can trigger requirements to make additional contributions to a plan maintained by another member of the controlled group.

### **Mergers and acquisitions.**

The Act provides that Treasury is to prescribe rules for the application of the cash flow rule where there is a merger or acquisition. This is a significant concern. There is a clear need for a transition rule so that the actions and commitments of a company that did not elect relief do not instantly affect a second company that merges with the first company and that did elect the relief. There is a clear precedent in the law for such a transition rule; see, e.g., Code section 410(b)(6)(C). In light of the fact that the Act does not adopt such a transition rule, Treasury may not provide transition relief, which would make the cash flow rule a significant problem with respect to some mergers and acquisitions.

### **REPORTING AND DISCLOSURE.**

Under the Act, if a plan sponsor elects the 2 and 7 rule or the 15-year rule, the plan sponsor must provide notice of this election to participants, beneficiaries, and the PBGC. Guidance is needed regarding the timing and content of these notices.

## **BENEFIT RESTRICTIONS.**

In general, the Act provides that for purposes of applying two benefit restrictions to plan years beginning on or after October 1, 2008 and before October 1, 2010, the plan's funded status is treated as the greater of (1) the actual funded status for that year, or (2) the plan's funded status for the plan year beginning [on or] after October 1, 2007 and before October 1, 2008. (A technical correction is needed to add the bracketed language.) The two benefit restrictions to which this rule applies are (1) the rule requiring plans to be frozen if they are less than 60% funded, and (2) the prohibited payment restriction but only with respect to social security leveling options. Thus, in the case of a calendar year plan, if the plan is at least 60% funded for 2008, it need not be frozen in 2009 and 2010 (thus extending the WRERA rule by one year). Similarly, if the plan is at least 80% funded for 2008, social security leveling options are not restricted for 2009 and 2010.

The retroactive nature of the relief for social security leveling options creates a problem that needs to be fixed. Otherwise, the prior application of the restriction during 2009 or 2010 could give rise to a violation of the qualification rules. Depending on how this issue is addressed, there may also be questions as to how quickly plans must lift restrictions on social security leveling options that were in place as of the date of enactment. It is expected that this provision will give rise to a number of additional issues. For example, the government should also address the prior waiver of credit balances that was required solely because of a social security leveling option. The government should consider permitting such credit balances to be restored. In addition, plans will need guidance on how to apply the presumption rules in the 2011 plan year with respect to social security leveling options.

## **CREDIT BALANCE LOOKBACK RULE.**

Under the PPA, an employer is not permitted to use its credit balance with respect to a plan if the plan was less than 80% funded in the prior year. The Act provides relief with respect to such rule in the case of a plan maintained exclusively by one or more organizations described in Code section 501(c)(3) (generally, charities). Under the relief, a plan's funded status for the last year starting before September 1, 2008 shall, for purposes of this credit balance rule, be deemed to apply for the next two years (if greater than the actual funded status for that year). For example, in the case of a calendar year plan, the 2008 funded status would apply in 2009 and 2010. Thus, if the plan was at least 80% funded for 2008, the plan sponsor could use its credit balance for 2009, 2010, and 2011.



## **PLANS SUBJECT TO THE PRE-PPA FUNDING RULES.**

Plans subject to the funding rules in effect prior to the PPA would generally be permitted to elect modified versions of the 2 and 7 rule or the 15-year rule. Also, “eligible charity plans” — i.e., multiple employer plans (determined without regard to the employer aggregation rules under Code section 414(c)) consisting exclusively of section 501(c)(3) organizations — are treated like “eligible cooperative plans” so that the PPA funding rules will not apply until 2017. This treatment of eligible charity plans is effective for plan years beginning after December 31, 2007 unless the employer elects to delay the application of this rule by one year.

Because, as noted above, employer aggregation under Code section 414(c) is disregarded, it is likely that many plans maintained exclusively by affiliated organizations — such as hospitals — will unknowingly be treated as eligible charity plans. Because there are some unfavorable aspects of such treatment — such as the retroactive application of very different funding rules — it may be appropriate in a technical corrections bill to make treatment as an eligible charity plan elective.