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Information Release

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Opportunities and Issues for Defined Benefit Plans under the Pension Funding Equity Act of 2004

Congress has enacted a temporary fix to address needed funding reforms for defined benefit pension plans, including cash balance plans. For plan years 2004 and 2005, the Pension Funding Equity Act of 2004 changes the formula used to determine minimum contributions to these plans and changes the formula used to determine the maximum lump sum benefits that can be paid to participants in these plans. The law also provides funding relief to certain multiemployer plans and to certain plans in the airline and steel industries. It also adds additional disclosure requirements for all multiemployer defined benefit plans.

The law is expected to save employers $80 billion over the next two years.

Maximum Lump Sum Benefits

The Act has adopted a new interest rate rule for determining limits on optional forms of benefit under defined benefit plans, including cash balance plans. The new rule was designed primarily to eliminate volatility and the use of an artificially low interest rates for funding purposes. However, the modification of the fixed interest rate portion of the limitation, increased from 5% to 5.5%, will reduce the maximum lump sum that may be paid from a defined benefit plan. Where smaller benefits are expected, contribution levels can be expected to decrease.

This is an important change for a plan that is designed to provide certain highly-paid individuals with the highest benefit permitted by law. Such individuals who become eligible for and elect a lump sum benefit may receive a smaller amount as a result of the change in formula under the new law. Lump sum payments made in the 2004 plan year are grandfathered and may not be less than the amount determined under prior law. However, for the 2005 plan year, the maximum lump sum payment will be calculated under the new law and may be smaller than the plan sponsor intended. The new interest rate rule does not apply in calculating the maximum annuity benefits that can be paid before age 62 or after age 65.

For a plan sponsor that wishes to maximize its deductible contributions, the new interest rate rule may require a decrease in contribution levels. Plan sponsors should consult with their advisors to determine how to anticipate these changes. In certain cases, there may be room to increase contributions for 2004 in advance of an expected decrease or even cessation of contributions for the 2005 plan year attributable to benefits for certain highly-paid employees. In some cases, it may be desirable to take a distribution in 2004.

Planning Opportunity: Participants who anticipate taking a lump sum distribution within the next few years should consider doing so before the interest rate increase goes into effect.

A More Realistic Interest Rate for Minimum Contribution Calculations

Defined benefit plan contributions (including contributions to cash balance plans) are determined, in part, based on the relationship between a plan's assets and its current liability. In order to help ensure that a plan will have sufficient assets to pay benefits, "deficit reduction contributions" may be required if the plan's assets are less than its current liability. Prior to the new law, current liability (which is a measure of the present value of benefits already accrued under the plan) was a function of the yield on 30-year Treasury bonds. In recent years, the yield on 30-year Treasury bonds has declined more than the rates of return on other investments. There are a number of reasons for this, including the Treasury Department's decision in 2001 to stop issuing such bonds. The use of this artificially low rate of return for funding calculations frequently resulted in startling increases in a plan's current liability. Coupled with recent market losses affecting plan assets, the funding burden on some defined benefit plans has increased significantly in recent years.

Beginning in 2004, the new law changes the maximum interest rate that can be used to determine a plan's current liability. The yield on 30-year Treasury bonds is replaced by a new index based on the yield on high-quality, long-term corporate bonds. The IRS has already published tables of its new interest rates. For a plan year beginning January 1, 2004, the interest rate is increased from about 5.5% to 6.55%. How this new rule affects plans will vary. Some plans may not be affected at all. However, for defined benefit plans subject to the deficit reduction contribution requirements, the increased interest rate may result in a substantially reduced current liability.

A decrease in a plan's current liability can have the following effects:

- √ The plan's minimum required contribution may be decreased because the deficit reduction contribution component is decreased.
- √ Deficit reduction contributions may not be required at all, thus reducing the annual funding requirement. The Act permits plan sponsors to recalculate current liability for each of the three preceding plan years using the new rates to determine whether a plan is subject to the deficit reduction contribution requirements.
- √ The plan may become exempt from the requirement to make contributions on a quarterly basis. For purposes of this rule, the Act allows plan sponsors to recalculate last year's current liability using the new rates. This recalculation does not change the quarterly contributions actually required for the preceding year, but only determines the amount, if any, of the quarterly contribution obligation for 2004.
- √ Restrictions on benefit payments to certain highly-paid participants may be eliminated. (When the assets of a plan are less than its current liability, it is prohibited from paying large benefits to certain highly paid participants.)
- √ For plans covered by the Pension Benefit Guaranty Corporation ("PBGC"), the variable rate portion of the premium may decrease or disappear.

Plan sponsors are urged to consult with their advisors to determine whether the new interest rate will affect their minimum contribution obligations before the next quarterly installment is due (July 15). For employers whose quarterly contribution obligation has been reduced, any overpayment for April 15 may be taken into account for the succeeding installments. As we determine 2004 contribution levels, Kravitz consultants will be contacting those of our clients whose quarterly contributions will be affected.

For plan sponsors who wish to fund up to the maximum allowable amounts, the Act permits the use of the old interest rate for purposes of determining the maximum deductible contribution limit.

New Rules Are Temporary

The rule changes relating to current liabilities and maximum lump sums will apply for plan years beginning after December 31, 2003 and before January 1, 2006. The change in the calculation of current liability is automatic. The changes to the calculation of the maximum lump sum limit will require plan amendments before the end of the 2006 plan year. The retroactive application of the latter rule will not violate the anti-cutback provisions of the Internal Revenue Code. Before the new rules expire, it is anticipated that Congress will act to create a permanent overhaul of the funding rules.

Other Provisions of the New Law

Funding Relief for Airline and Steel Industry Plans

The new law provides certain plans in the airline, steel and related iron ore industries and the Transportation and Communication Workers' Union Plan with two years of relief from 80% of the deficit reduction contributions that otherwise would be required. The relief is available only if the plan had assets in 2000 that were sufficient to avoid the deficit reduction contribution requirement. Employers who take advantage of this provision generally cannot increase plan benefits during the relief period.

Multiemployer Plan Disclosure

The Act imposes new disclosure requirements on all multiemployer plans (plans that are sponsored by more than one employer and are established pursuant to a collective bargaining agreement.) Such plans must provide an annual notice to participants, beneficiaries, unions and contributing employers and the PBGC that includes the following information:

- √ the extent to which the plan's current liability is funded (stated as a percentage),
- √ a statement of the value of the plan's assets, the amount of benefit payments, and the ratio of the assets to the benefit payments for the plan year,
- √ a summary of the rules governing insolvent multiemployer plans, and
- √ a description of the benefits under the plan that are guaranteed by the PBGC

Multiemployer Plan Funding Relief

The new law provides funding relief for certain multiemployer plans. Eligible plans will be permitted to delay for two years a portion of the amortization charge for any experience losses during its 2002 plan year. Plans are eligible for this relief if they had an investment loss of 10% or more in 2002 and are projected to have an accumulated funding deficiency for any plan year beginning after June 30, 2003 and before July 1, 2006.

Transfers to Retiree Health Plans

Under certain conditions, overfunded defined benefit plans are permitted to transfer some of their excess assets to pay for retiree health benefits. Under prior law, this provision was scheduled to expire at the end of 2005. The new law extends the expiration date to the end of 2013.

What You Should Do

If you sponsor a defined benefit plan or a cash balance plan, you should discuss the impact of this new law with your advisor. Here are some of the questions you might ask.

- √ Will the new law reduce the amount of my lump sum? (In some cases, it might be advisable to take a lump sum distribution a little earlier than planned to avoid decreases that might be caused by the new law.)
- √ Will my contribution levels be changing?
- √ Can I stop making contributions on a quarterly basis?
- √ Will my PBGC premium decrease?

Kravitz will be reviewing our clients' plans as we perform work for the 2004 plan year and will discuss with you those provisions of the new law that affect your plan. In the meanwhile, please contact your Kravitz consultant if you have any questions.

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Louis Kravitz & Associates, Inc. is the largest independent firm of retirement consultants headquartered in Southern California. We specialize in the design, implementation and administration of virtually every type of retirement plan. Our consultants, actuaries and other specialists have the experience and ability to make certain your retirement plans are properly designed, meet your needs and operate to your satisfaction. We have been dedicated to providing high quality service since our firm was founded in 1977. One of our specialties is working with our clients to maximize benefits for their key executives.