



Electronic Dispatch

Employee Benefits Law Action Memo

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PENSION PROTECTION ACT OF 2006 – IMPACT ON CONTRIBUTING EMPLOYERS TO MULTIEMPLOYER PENSION PLANS

As was noted in our August 2006 Employee Benefits Law Action Memo, the Pension Protection Act of 2006 (“Act”) contains numerous funding changes for defined benefit pension plans, including multiemployer plans (“multiemployer plans”).¹ The new funding rules applicable to multiemployer plans under the Act will significantly affect how such plans are administered and funded by employers. For multiemployer plans, most of the new provisions are effective for plan years beginning after 2007. These funding rules generally expire for plan years beginning after 2014.

Many multiemployer plans are currently underfunded (or are projected to become so within the next few years). This underfunding is largely due to poor historical investment performance, and a declining number of contributing employers (who have a declining number of active workers) who are paying for the funding of benefits for a growing number of retirees.

The new funding rules are the result of a compromise among employer and union groups, designed to: (1) improve the funding status of certain financially troubled plans; (2) impose additional discipline on plans beginning to experience a decline in funding; (3) for the most seriously underfunded plans, prevent funding deficiencies that may put contributing employers into bankruptcy and result in a substantial reduction of pension benefits; and (4) limit the exposure of the Pension Benefit Guaranty Corporation (“PBGC”) to funding benefits for insolvent plans.

The Act attempts to accomplish these goals by requiring the trustees of a plan and the bargaining parties to focus on the plan’s funding problems and develop solutions to improve its funding status over time through benefit reductions and/or employer contribution increases. This approach will directly impact contributing employers by changing the traditional collective bargaining process.

I. Multiemployer Plan Funding Reforms

Multiemployer plans are subject to different funding requirements than those required for single-employer pension plans. The Act basically preserves the existing minimum funding standards approach under the Internal Revenue Code which generally requires that employers make contributions to a multi-employer plan sufficient to fund both the normal cost of the plan (the cost of benefits allocable to the current year) and an allocated portion (determined under various amortization schedules) of unfunded past service liabilities, increases or decreases in past service liability, and experience gains and losses. Under these standards, if a multiemployer plan’s assets are insufficient to meet these funding requirements, the plan will have an accumulated funding deficiency (“AFD”) for a plan year. If an AFD occurs, contributing employers must pay a 5% excise tax, which increases to 100% if the employer does not make additional contributions to the plan sufficient to eliminate the employer’s share of the funding deficiency within a certain period.

Amortization Schedule Changes

The Act tightens the funding rules by shortening the amortization periods for recognizing benefit improvements and gains and losses from changes in actuarial assumptions from 30 to 15 years. In addition, certain short-term benefits (such as a one-time “13th pension check” paid at the end of a year to retirees), will require faster funding to ensure that they are funded by the time they are fully paid out. These shorter funding periods will increase the cost of funding plan amendments. Existing amortization schedules and certain “already bargained for” changes will not have to be recalculated, and will continue to be governed by the old rules.



Extensions of Amortization Periods

The Act automatically grants a 5-year amortization period extension if the trustees submit an application to the Internal Revenue Service ("IRS"), provided certain conditions are met. An additional five-year extension is available if the IRS determines the extension is necessary. Such extensions may be invaluable in avoiding or reducing any AFD.

Funding Rules for Plans in Endangered, Serious Endangered or Critical Status

Using a "stop light" analogy, the Act establishes three new classifications for certain underfunded multiemployer plans which are defined under complex rules. In general, plans that are beginning to experience some erosion in their funding status and are less than 80% funded, or have a projected AFD within seven years, are classified as "endangered" (and are considered in the "Yellow Zone"). Plans are classified as "seriously endangered" if they are both less than 80% funded and have a projected AFD within seven years (and are considered in the "Orange Zone"). Plans that have more serious funding deficiencies and are less than 65% funded and have a projected AFD within five years, or will not be able to pay benefits within seven years, are classified as "critical" (and are considered in the "Red Zone"). Plans that are not in any of these categories are considered in the "Green Zone." It is estimated that 20-25% of all multiemployer plans will be in endangered status and 5-10% will be in critical status.

A plan's actuary must annually certify within 90 days of the beginning of each plan year whether the plan is in endangered or critical status for the plan year. Within 30 days of receipt of this certification, the trustees must notify the bargaining parties, participants, beneficiaries, the PBGC and the United States Department of Labor ("DOL") if the plan is in such status. Within 330 days after the start of the plan year, the trustees must then develop and adopt an action plan to improve funding ("action plan") known as a "funding improvement plan" (for endangered or seriously endangered plans) or a "rehabilitation plan" (for critical plans), which must be designed to improve the plan's funded status to certain levels over time. The trustees are subject to a penalty of up to \$1,100 per day if they fail to timely adopt an action plan.

The required funding goal for endangered plans is to avoid an AFD for any plan year and reduce the plan's underfunding percentage by one-third over 10 years. Seriously endangered plans must avoid an AFD for any plan year and reduce the plan's underfunding by one-fifth over 15 years. Critical plans must emerge from critical status within 10 years.

As part of the action plan, and within 30 days after its adoption, the trustees must provide the bargaining parties and participants with several detailed options (through proposed funding schedules) which provide proposed reduced benefit levels and/or increased employer contributions necessary to improve the funding status of the plan and meet the required funding goal. The bargaining parties must then negotiate over these schedules within a relatively short time frame.

More particularly, for an endangered plan, the trustees must provide the bargaining parties with schedules of employer contribution increases and/or reductions in future benefit accruals needed to meet the required funding goal. One schedule, referred to as the "default schedule," must propose a reduction in future benefit accruals under the plan which are necessary for the plan to achieve its funding goal (with increases in employer contributions only as necessary for the plan to meet the required funding goal). The trustees must also propose a second schedule which provides for increased employer contributions in an amount necessary to maintain the current benefit levels in the plan (without any reduction). The trustees may propose additional schedules if they choose to do so.

For a critical plan, the trustees must provide the bargaining parties with one or more schedules of employer contribution increases, expense reductions (including plan mergers and consolidations), and reductions in both future benefits and certain other already earned and otherwise protected non-core ancillary retirement benefits (such as early retirement subsidies or disability benefits) needed to meet the required funding goal. The "default schedule" must propose a maximum reduction in future benefit accruals (but not protected benefits) under the plan which are necessary for the plan to emerge from critical status (with increases in employer contributions only as necessary for the plan to meet the required funding goal). For critical plans, the trustees may not completely eliminate future accruals (unless the bargaining parties otherwise agree) since the default schedule must provide for a minimum rate of accruals generally equal to 1% of contributions.

For endangered and critical plans, if the bargaining parties do not agree on increased contributions and/or reduced benefits within 180 days after the expiration of the current collective bargaining agreement (or when the DOL certifies that the parties are at impasse, if earlier), the trustees are required to implement an appropriate default schedule (with the likely result that pension benefits will be reduced and employer contributions will be increased over the amount currently required under the governing collective bargaining agreement).

Trustees are required to keep track of a plan's progress toward meeting the required funding goals, and to take any necessary further action. The trustees are generally prohibited from amending the plan to increase benefits or to accept collective bargaining agreements that reduce the contribution rate for any participants, suspend contributions for any period of service, or exclude any younger or newly hired groups of employees in the collective bargaining unit from the plan. This means that the bargaining parties will be restricted in the types of changes that can be negotiated during the bargaining process.

Employers that contribute to either endangered or critical plans are subject to a new excise tax imposed upon the failure to timely make any additional contributions required by the action plan. The amount of tax is equal to 100% of the amount of the required contribution the employer failed to make, and is in addition to all other excise taxes, penalties or damages assessed for delinquent contributions. In the case of a seriously endangered plan, an additional new excise tax applies if the plan fails to meet the required funding goals. The IRS may waive all or part of these excise taxes if the failure was due to reasonable cause and not willful neglect.

For plans in endangered status (but not for critical plans), the employer is subject to the usual 5% excise tax and additional required contributions if the plan has an AFD during the period of the action plan. For plans in critical status, employers are exempt from the usual excise taxes and additional required contributions, provided the parties have fulfilled their obligations under the action plan. However, if a plan fails to leave critical status at the end of the 10-year period, or fails to make the scheduled funding progress for three consecutive years, the plan is treated as having an AFD subject to the general excise taxes and required contributions. The IRS may waive all or part of this excise tax if the failure is due to reasonable cause and not willful neglect.

Importantly, employers that contribute to critical plans are subject to an automatic 5% surcharge on the amount of contributions otherwise required under their existing collective bargaining agreements. This surcharge increases to 10% for subsequent years and continues in effect until a new collective bargaining agreement is implemented that adopts a schedule of contribution rates and benefits acceptable under the action plan. This surcharge is intended to serve as an incentive for the bargaining parties to reach an agreement on an acceptable contribution rate based on the proposed schedules provided by the trustees. Any failure to pay a surcharge is treated as a delinquent employer contribution under the Employee Retirement Income Security Act ("ERISA").

II. Additional Disclosure Requirements

The Act provides for significant enhanced disclosure of plan information to contributing employers, unions and governmental agencies by requiring: (1) trustees to issue new expanded annual funding notices regarding a plan's funded status, funding policy and asset allocation, the value of plan assets and liabilities, the action plan, and the number of active and inactive participants; (2) the issuance of explanatory notices, data and updates to an action plan if a plan is in endangered or critical status; and (3) mandatory disclosure, upon request, of actuarial and financial reports.

The information required to be disclosed on a multiemployer plan's Form 5500 has also been expanded to provide more relevant information to employers. Within 90 days after a plan files Form 5500, certain information and basic data about the plan must be displayed on the DOL's web site and any web site maintained by the plan. Any contributing employer may request and receive a copy of the Form 5500. In addition, a contributing employer may request a copy of the plan's summary plan description and any summary of material modifications.

III. Withdrawal Liability

If an employer withdraws from a multiemployer plan, the employer is generally liable for its allocable share of any of the plan's unfunded vested benefits. The Act changes some of the withdrawal liability rules and includes several favorable changes for building and construction industry plans.

The Act provides that a contributing employer may make a written request to the trustees for an estimate of the amount of the employer's withdrawal liability. The trustees must respond within 180 days of the request and provide the estimate, including an explanation of how it was determined, the actuarial assumptions and methods used, the data regarding the employer's contributions, and the application of any limits on such liability.

The Act allows building and construction industry plans to: (1) exempt certain short-term smaller employers from withdrawal liability under the existing "5-year free look" provision; and (2) reduce the amount of withdrawal liability by restarting the mandatory presumptive allocation method to a date when the plan had no unfunded vested liabilities. Employers who currently contribute to such plans (or which may contribute in the future) should ask whether the trustees will adopt these new favorable rules.

The Act imposes partial withdrawal liability on employers who contract work out (outsource) to entities it owns or controls and that have no obligation to contribute to a plan, and updates and clarifies the limited withdrawal liability rules for employers who sell all or substantially all of their assets to an unrelated party in an arm's-length transaction. For small employers, the Act also changes the withdrawal liability payment rules in cases where a plan alleges that a transaction was taken to evade or avoid withdrawal liability.

IV. Deductibility Limits

Effective in 2006, the Act increases the deduction limits for employer contributions to multiemployer plans from 100% to 140% of current liability. For fully-funded plans, this eliminates the pressure to increase plan benefits during profitable years to ensure that negotiated contribution rates remain tax deductible.

Effective in 2006, for multiemployer plans, the Act repeals the 25% of compensation aggregate limitation on contributions to a defined contribution and defined benefit plan that cover the same individuals.

V. Recommended Action by Employers

It is important for employers to become familiar with the new funding rules and monitor the funding status of those multiemployer plans to which they contribute. If not already doing so, employers should take an active interest in how such plans are being administered and invested to avoid the possibility they will either fall into endangered or critical status or become further underfunded.

Although the new funding rules do not take effect until 2008, employers should make sure trustees are: (1) assessing the potential status of a plan and reviewing the plan's actuarial assumptions and methods (and whether they are reasonable); (2) determining whether the plan should use the short-fall method and request any available amortization extension from the IRS; (3) if the plan is already underfunded, taking immediate action to improve the funding status of the plan, rather than waiting until required to do so under the Act (for example, reducing or suspending benefits and changing available distribution options). If trustees wait until 2008, the funding options may be limited and correcting the amount of underfunding will likely be more expensive.

Clearly, the new funding rules will increase the interaction between trustees and bargaining parties and will challenge everyone to identify and correct any underfunding of a plan and prevent further deterioration. Since the bargaining parties are required to negotiate over the level of plan benefits and the cost of employer funding, the interests and responsibilities of the trustees and the bargaining parties will be realigned as they balance benefit and cost concerns.

Unfortunately, the Act does not provide much guidance on how the relationship between the administration of a plan by trustees and the obligation of the bargaining parties to negotiate over plan benefits and funding is to be handled. It is unclear how certain provisions will be interpreted, and what their impact will be on the bargaining parties. Hopefully, these and other issues will be clarified by technical corrections or by regulations.

For those employers who may be subject to the additional surcharges if a plan falls into critical status, they should consider negotiating certain provisions in their collective bargaining agreements that either permit them to reduce other wages or benefits to pay for the added surcharges, or that at least permit them to re-open the collective bargaining agreements in event such surcharges are imposed by trustees.

Employers who are not yet contributing to a multiemployer plan should carefully assess the potential financial costs and risks that may significantly exceed the negotiated contribution rate to the plan (such as potential surcharges for critical plans, withdrawal liability, and penalties for delinquent contributions). Employers who are currently contributing to such plans should consider whether they will be better off in the long run if they withdraw from the plan now and incur withdrawal liability, especially if the plan is projected to become insolvent.

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¹ Multiemployer plans are maintained by two or more unrelated employers established by collective bargaining agreements with a labor union. They are required to be managed by a joint board of trustees composed of an equal number of employer and union representatives. The level of employer contributions is usually specified in the collective bargaining agreements, and the level of benefits is established by the trustees. While only 10% of all defined benefit plans are multiemployer plans, these plans cover 25% of all participants in such plans.