PRESENT LAW AND BACKGROUND RELATING TO DEFINED BENEFIT PENSION PLAN FUNDING LEVELS AND INVESTMENT ADVICE RULES

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on October 1, 2009

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 29, 2009
JCX-37-09

CONTENTS

INTRODUCTION AND OVERVIEW

The Committee on Ways and Means of the House of Representatives has scheduled a public hearing on the funding rules that apply to single and multiemployer defined benefit pension plans and the rules governing investment advice provided to employer sponsors and participants in defined contribution plans. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the background and present law relating to the minimum funding rules that apply to single-employer and multiemployer[2] defined benefit pension plans under the Internal Revenue Code ("Code")[3] and the Employee Retirement Income Security Act of 1974 ("ERISA"), as well as a description of the background and present law relating to the provision of investment advice to employers and participants in employer-sponsored defined contribution plans.

There are two basic types of retirement plans that an employer may provide for its employees: a defined contribution plan and a defined benefit pension plan. In the case of a defined contribution plan, a specific contribution is made to the plan for each participant, and the participant's sole retirement benefit under the plan is the amount of such contributions together with the participant's share of the plan's earnings or losses on such contributions. No promise is made by the employer as to the amount of money that will be available to the participant upon retirement, and thus the participant bears the risk of loss, and benefits from any gains, with respect to investment of plan contributions. In contrast, a defined benefit pension plan generally provides a participant with a specified benefit at a specified age (e.g., the plan might provide for annual payments commencing at age 65 equal to one percent of a participant's final average compensation for each year of service with the sponsoring employer). Unlike a defined contribution plan, the sponsor of a defined benefit pension plan is responsible for ensuring that adequate contributions are made to the plan so that benefits earned under the plan can be paid, and the sponsor bears the risk of loss, and benefit from any gains, with respect to investment of plan contributions.

Defined benefit pension plans generally are subject to minimum funding rules that require the sponsoring employer to periodically make contributions to fund plan benefits.[4] The

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Defined Benefit Pension Plan Funding Levels and Investment Advice Rules* (JCX-37-09), September 29, 2009. This document is available at www.jct.gov.

[2] A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement. There are also multiple employer plans, which are plans maintained by more than one employer and to which more than one employer is required to contribute, but that are not maintained pursuant to a collective bargaining agreement. The single-employer plan funding rules generally apply to these plans.

[3] Except as otherwise noted, all references to sections in this document are to sections of the Code.

[4] Sec. 412. Parallel minimum funding rules are also set forth in ERISA. A number of exceptions to the minimum funding rules apply. For example, governmental and church plans are not subject to the minimum

minimum funding rules for single-employer defined benefit pension plans were substantially revised by the Pension Protection Act of 2006 ("PPA").[5] The PPA also revised the funding rules that apply to multiemployer defined benefit pension plans. The PPA's minimum funding rules are generally effective for plan years beginning after December 31, 2007. Delayed effective dates apply to single-employer plans sponsored by certain large defense contractors, multiple employer plans of some rural cooperatives, and single-employer plans affected by settlement agreements with the Pension Benefit Guaranty Corporation ("PBGC").[6]

The Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA")[7] made a number of technical corrections to the PPA. In addition, WRERA made certain amendments to the PPA minimum funding rules to provide funding relief to defined benefit plans affected by the decline in global financial markets during 2008.

For some defined contribution plans, the trustee or other plan fiduciary decides how plan assets will be invested.[8] However, there are many participant-directed defined contribution plans, meaning that the participant (rather than the trustee or other fiduciary) decides, from a range of choices provided under the plan,[9] how the amount in the participant's account balance is invested. ERISA and the Code's prohibited transaction rules generally govern the provision of investment advice to participants in 401(k) and other participant-directed defined contribution plans. The prohibited transaction rules prohibit certain direct and indirect transactions between a

---

funding rules. A governmental plan is a plan established and maintained for its employees by the Federal government, a State government or political subdivision, or an agency or instrumentality of the foregoing. A governmental plan includes a plan established and maintained by an Indian tribal government or political subdivision (or agency or instrumentality) thereof as long as all participants are employees of such entity, all of whose services are in the performance of essential governmental functions (but not in the performance of commercial activities). A church plan is a plan established and maintained for its employee by a church or by a convention or association of churches which is exempt from tax under section 501. A church plan may elect to be subject to the minimum funding rules.

5 Pub. L. No. 109-280.

6 The PPA funding rules do not apply to eligible government contractor plans for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan, (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, and (3) January 1, 2011. The new funding rules do not apply to eligible rural cooperative plans for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan, or (2) January 1, 2017. The new funding rules do not apply to eligible PBGC settlement plans for plan years beginning before January 1, 2014.

7 Pub. L. No. 110-458.

8 Sec. 404 of ERISA describes the standards for fiduciaries making these investment decisions.

9 Sec. 404(c) of ERISA provides a special rule which limits the liability of the trustee or other plan fiduciary when participants direct the investment of the assets in their accounts.

plan and a disqualified person, unless a statutory exemption is available under ERISA or the Department of Labor ("DOL") has promulgated an individual or class administrative exemption covering the transaction. These rules were significantly changed by the PPA, which added a new statutory prohibited transaction exemption for the provision of investment advice provided pursuant to certain fee leveling arrangements and certain computer models.[10] The PPA's investment advice rules are generally effective for plan years beginning after December 31, 2006.

[10] Secs. 408(b) and 408(g) of ERISA, added by secs. 601(a)(1) and 601(a)(2) of PPA.

I. MINIMUM FUNDING AND BENEFIT RESTRICTION RULES FOR DEFINED BENEFIT PENSION PLANS

A. Overview

1. In general

A defined benefit pension plan is generally subject to minimum funding rules, subject to certain exceptions.[11] For example, governmental and church plans that are not subject to PBGC termination insurance also are not subject to the minimum funding rules. The minimum funding rules for single-employer and multiemployer plans are different.

The purpose of the minimum funding rules is to ensure that the sponsoring employer of a defined benefit pension plan makes periodic minimum contributions that will fund adequately benefits promised under the plan. The rules permit an employer to fund the plan over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan.

The PBGC was established for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified annual limits) if the sponsoring employer is not able to fulfill its obligation to fund adequately the plan and the plan is terminated when it is underfunded.[12] The benefit protection function of the PBGC is carried out through an insurance program that applies to defined benefit pension plans. Sponsors of plans that are subject to the insurance program are liable to the PBGC for premium payments. PBGC termination insurance serves as a backstop to the minimum funding rules.

2. Funding waivers

If the application of the minimum funding rules would be adverse to the interests of plan participants in the aggregate, the Secretary of the Treasury is authorized to waive a minimum required contribution (a "waived funding deficiency") if, in the case of a single-employer plan, the employer would be unable to satisfy the minimum funding standard for a plan year without a temporary substantial business hardship or, in the case of a multiemployer plan, if 10 percent or more of the number of employers contributing to or under the plan would be unable to satisfy the minimum funding standard without substantial business hardship. In determining the existence of the required business hardship, factors taken into account include, but are not limited to, whether: (1) the employer is operating at an economic loss; (2) there is substantial unemployment or underemployment in the trade or business and industry concerned; (3) the

---

[11] Sec. 412. Similar rules apply to defined benefit pension plans under the Labor Code provisions of ERISA.

[12] ERISA sec. 4002(a).

sales and profits of the industry concerned are depressed or declining; and (4) it is reasonable to expect that the plan will be continued only if the waiver is granted.[13] Generally, no more than three waivers for a single-employer plan and five waivers for a multiemployer plan may be granted within any period of 15 consecutive plan years.

A single-employer plan seeking a waiver must make application to the Secretary of the Treasury not later than two and one-half months after the close of the plan year. The Secretary is authorized to require an employer maintaining a single-employer plan to provide security to the plan as a condition of granting a waiver.

An applicant for a waiver must provide notice to all plan participants, beneficiaries, alternate payees, and employee organizations representing employees covered by the plan and the Secretary is required to consider any relevant information received from any notified person. In addition, the Secretary is generally required to provide notice to the PBGC of a waiver application from a single-employer plan and is required to consider the PBGC's comments on the waiver application.

If a waiver is granted, a single-employer plan reduces the amount of its minimum required contribution for the plan year by the amount of the waived funding deficiency and amortizes (i.e., recognizes for funding purposes) that amount over a five-year period. In the case of a multiemployer plan, the plan credits its funding standard account (as described below) with the amount of the waived funding deficiency and amortizes that amount over a 15-year period.

In general, during the time a waiver is in effect, no amendment may be made to a single-employer or multiemployer plan that has the effect of increasing liabilities under the plan by increasing benefits or making any change in the plan's benefit accrual or vesting rules. If an amendment is made in violation of this rule, the funding waiver generally ceases to apply to any plan year ending on or after the date the amendment is adopted. The restriction on amendment does not apply to an amendment determined by the Secretary to be reasonable and which causes only *de minimus* increases in the plan's liabilities, an amendment that repeals certain retroactive amendments or an amendment required to maintain the plan's tax-qualified status under the Code.

3. Failure to comply with minimum funding rules

The due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year. If unpaid minimum funding contributions for a single-employer plan exceed $1,000,000, a lien arises in favor of the plan upon all property and rights to property (real or personal) belonging to the sponsoring employer

---

[13] If a single-employer defined benefit plan is a member of a controlled group, the temporary substantial business hardship requirements must be met for both the employer and the controlled group as a whole (determined by treating all members of the group as a single employer).

(or member of the sponsoring employer's controlled group) in an amount equal to the unpaid minimum contributions. Notice must be given to the PBGC of a funding failure that gives rise to a lien, and generally the lien is enforceable by the PBGC.

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the plan sponsor.[14] The initial tax is 10 percent of aggregate unpaid contributions for single-employer plans and five percent of the plan's accumulated funding deficiency (as defined below) for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the Internal Revenue Service ("IRS") or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary of the Treasury must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

B. Rules for Single-Employer Plans

1. The Pre-PPA minimum funding rules

Funding standard account

Prior to the enactment of the PPA, a single-employer defined benefit pension plan was required to maintain a special account called a "funding standard account" to which charges and credits (such as credits for plan contributions) were made for each plan year. If, as of the close of a plan year, the account reflected credits equal to or in excess of charges to the account, the plan generally was treated as meeting the minimum funding rules for the plan year. Thus, as a general rule, the minimum contribution that an employer was required to make for a plan year was determined as the amount by which the total charges to the funding standard account exceeded total credits to the account. If credits to the funding standard account exceeded charges, a "credit balance" resulted.

Funding methods and general concepts

A plan was required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represented the cost of future benefits allocated to the plan year under the funding method used

[14] Sec. 4971.

by the plan for current employees. The supplemental cost for a plan year was the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a "net experience loss" (described below). Supplemental costs were amortized over a specified number of years, depending on the source.

In determining plan funding under an acceptable actuarial cost method, a plan's actuary generally made certain assumptions regarding the future experience of a plan. These assumptions typically involved rates of interest, mortality, disability, salary increases, and other factors affecting the value of plan assets and liabilities. The actuarial assumptions were required to be reasonable. If the actual unfunded liabilities of the plan were greater than those anticipated by the actuary on the basis of these assumptions (i.e., the plan's assets were not sufficient to fund plan liabilities), then the difference was a net experience loss. If the plan's actual unfunded liabilities were less than those anticipated, then the excess was a net experience gain. Prior to enactment of the PPA, net experience gains and losses for a year generally were amortized over a five-year period, resulting in credits (where there were gains) or charges (where there were losses) to the plan's funding standard account.

In determining the charges and credits to be made to the plan's funding standard account, the actuarial value of a plan's assets could be used instead of fair market value. The actuarial value of plan assets was the value determined on the basis of a reasonable actuarial valuation method that took into account fair market value, provided that the method was permitted under Treasury regulations. However, any actuarial valuation method used by the plan was required to result in a value of plan assets that was not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value. In addition, if the valuation method used average values of the plan assets, the averaging period could not exceed the five most recent plan years, including the current plan year.

The plan was permitted to use certain actuarial valuation methods sometimes referred to as "asset smoothing" valuation methods because they allowed for appreciation or depreciation in the market value of plan assets to be recognized more gradually or smoothly than would be the case if the actual fair market value of plan assets was used. The smoothing effect could be achieved under a variety of permissible actuarial valuation methods. For example, the value of plan assets might be determined on the basis of an average of plan assets over a period of time, with adjustment of the valuations used in calculating the average for subsequent plan contributions, distributions, and certain plan earnings.[15] Another methodology might compare the actual value of plan assets on the valuation date[16] to the expected value of plan assets for such date (which resulted in a loss or gain) and determine the actuarial value of the plan's assets by adding a specified portion of the loss to (or subtracting a specified portion of the gain from)

[15] Treas. Reg. 1.412(c)(2)-1(b)(7).

[16] The valuation date for a plan year is the first day of the plan year, except in the case of a plan with 100 or fewer participants. Sec. 430(g)(1).

the market value for the current year and succeeding years.[17] The specified portion of loss or gain would then be a decreasing fraction based on the number of years in the smoothing period. For example, if the smoothing period was five years and there was a loss, 4/5 of the loss would be added to the market value for the current year to determine the actuarial asset value, 3/5 would be added in the next year, 2/5 would be added in the third year, 1/5 would be added in the fourth year, and the loss would be fully recognized in the fifth year.

2. Minimum funding rules under the PPA and WRERA

Funding target and shortfall amortization charges

Under the PPA rules, the minimum required contribution for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. The plan's funding target for a plan year is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or to be earned during the plan year. WRERA clarified that, under the PPA rules, a plan's target normal cost is increased by the amount of plan-related expenses expected to be paid from plan assets during the plan year, and is decreased by the amount of mandatory employee contributions expected to be made to the plan during the plan year.[18]

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year.[19] In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments that have been determined for the plan year and any succeeding plan year with

---

[17] Rev. Proc. 2000-40, 2000-2 C.B. 357.

[18] This clarification is effective for plan years beginning after December 31, 2008, and is elective for the preceding plan year.

[19] Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that (1) was not in effect for 2007, or (2) was subject to certain deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below a specified threshold). Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. While the PPA provided that the transition rule did not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year), WRERA amended the PPA rules to extend the transition rule to plan years beginning after 2008 even if, for each preceding plan year after 2007, the plan's shortfall amortization base was not zero.

respect to any shortfall amortization bases for preceding plan years. As a result, in any given plan year, a plan may have a number of shortfall amortization installments that relate to the current or prior years. The aggregate of these installments is referred to as the shortfall amortization charge. In the case of a plan with a funding shortfall for a plan year, the minimum required contribution is generally equal to the sum of the plan's target normal cost and the shortfall amortization charge for that year.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over a seven-year period beginning with the current plan year. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero (i.e., negative amortization installments may not offset normal cost).

If the value of the plan's assets exceeds the plan's funding target for a plan year, then the minimum required contribution is generally equal to the plan's target normal cost for the year. Target normal cost for this purpose is reduced (but not below zero) by the amount by which the value of the plan's assets exceed the plan's funding target.

Actuarial assumptions

The PPA minimum funding rules for single-employer defined benefit pension plans specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.

The present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary of the Treasury.

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, a plan sponsor may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above) ("spot" rates). In general, such an election may be revoked only with approval of the Secretary of the Treasury. However, the IRS has indicated that final regulations will provide automatic approval for plan sponsors to make a new choice of interest rates for 2009 and 2010 (regardless of what choices were made for earlier years).[20] In addition, for 2009, the IRS has indicated that it will allow plan sponsors to use the spot rate for the month that includes the plan's valuation date for the 2009 plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date (rather than only for the month preceding the valuation date).[21]

Special assumptions for at-risk plans

Under the PPA rules, special assumptions apply in determining the funding target and normal cost of a plan in at-risk status ("at-risk" assumptions). Whether a plan is in at-risk status for a plan year depends on its funding target attainment percentage for the preceding year. A plan's funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance, both as described below) bears to the plan's funding target for the year. For this purpose, the plan's funding target is determined using the actuarial assumptions for plans that are not at-risk.

A plan is in at-risk status for a year if, for the preceding year: (1) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent, and (2) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent. Under a transition rule applicable for plan years beginning in 2008, 2009, and 2010, instead of 80 percent, the following percentages apply: 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010.[22]

---

[20] Internal Revenue Service, Employee Plans News, March 2009 Special Edition; Internal Revenue Service, Employee Plans News, September 25, 2009 Special Edition.

[21] Internal Revenue Service, Employee Plans News, March 2009 Special Edition.

[22] In the case of plan years beginning in 2008, the plan's funding target attainment percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

Valuation of plan assets

Under the PPA's minimum funding rules, the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date; and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets at that time. The PPA rules also provide that any averaging must be adjusted for contributions to the plan and distributions to participants as provided by the Secretary of the Treasury.

Proposed Treasury regulations have been issued under the PPA rules that permit the value of plan assets to be determined on the basis of averaging.[23] Under the proposed regulations, the average value of plan assets generally is increased for contributions that are included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period. Similarly, the average value generally is decreased for distributions included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period.

WRERA amended the PPA asset valuation rules to provide that, in determining the value of a plan's assets under the averaging method, in addition to adjusting the average value of plan assets for contributions and distributions, such average value is adjusted for expected earnings as specified by the Secretary of the Treasury. Thus, while the original PPA asset valuation rules did not permit adjustments to average value for expected earnings and, thus, did not permit asset smoothing valuation methods that took into account such adjustments prior to the PPA, the amendments made by WRERA do permit such valuation methods.

The IRS has issued interim rules for determining the expected earnings on plan assets for plan years beginning in 2008 and 2009.[24] These rules are expected to be included in the final plan asset valuation regulations. Expected earnings are determined by a plan's actuary on the

---

[23] 72 F.R. 74215 (December 31, 2007). When finalized, the regulations will be effective for plan years beginning on or after January 1, 2009 except for plans to which a delayed effective date applies.

[24] Notice 2009-22, 2009-14 I.R.B. 741. The Notice also provides automatic approval for a change in the plan's asset valuation method that is permitted under section 430, as amended by WRERA, for a plan year that begins during 2009. For the 2008 plan year, plan sponsors are permitted to use an asset valuation method permitted under the proposed regulations or under Notice 2009-22.

basis of an assumed earnings rate for the plan that is specified by the actuary and that cannot exceed the applicable third segment rate.[25]

Funding standard carryover balance or prefunding balance

In general

Under the PPA rules, credit balances that accumulated under prior law ("funding standard carryover balances") are preserved and, for plan years beginning after 2007, new credit balances (referred to as "prefunding balances") result if a plan sponsor makes contributions greater than those required under the PPA funding rules. In general, plan sponsors may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both.

If a plan sponsor elects to maintain a funding standard carryover balance or prefunding balance, the amount of those balances is generally subtracted from the value of plan assets for purposes of determining a plan's minimum required contributions, including a plan's funding shortfall, and a plan's funding target attainment percentage (discussed above).[26] However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year.

Under the PPA rules, if the value of the plan's assets (reduced by any prefunding balance) is at least 80 percent of the plan's funding target for the preceding plan year, a plan sponsor is generally permitted to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year, thus reducing the amount that must be contributed for the current plan year.[27] If a plan sponsor has

---

[25] If either the funding target or target normal cost for a plan year is determined using the three segment interest rates, the assumed rate of return cannot exceed the third segment interest rate used in that determination. If neither the funding target nor the target normal cost for a plan year is determined using the three segment interest rates, the assumed rate of return generally cannot exceed the average of the third segment rates for the 24-month period ending with the month preceding the month that contains the valuation date for the plan year. *See* Notice 2009-22, 2009-14 I.R.B. 741.

[26] Under proposed regulations, the value of a plan's assets is not reduced by these balances if a binding written agreement with the PBGC providing that all or a portion of the plan's funding standard carryover balance or prefunding balance is not available to offset the minimum required contribution for a plan year is in effect. In addition, for purposes of determining whether a plan is required to establish a shortfall amortization base for a plan year, the funding standard carryover balance is not subtracted from the value of plan assets and the prefunding balance is required to be subtracted from the value of plan assets only if an election has been made to use the balance to offset the plan's minimum required contribution for the plan year. Prop. Treas. Reg. 1.430(f)(c)(2).

[27] In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

elected to permanently reduce a funding standard carryover balance or prefunding balance, any reduction of such balances applies before determining the amount that is available for crediting against minimum required contributions for the plan year.

Funding standard carryover balance

The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For each plan year beginning after 2008, the funding standard carryover balance is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Prefunding balance

The prefunding balance consisted of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the "current" plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed (1) the excess (if any) of the aggregate total employer contributions for the preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

In determining the amount of the increase in a plan's prefunding balance, the amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that would otherwise be imposed for the preceding plan year under the rules relating to benefit limitations for single-employer plans (as discussed below).[28]

[28] Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

For each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions). As discussed above, if any portion of the prefunding balance is used to reduce a minimum required contribution, the value of plan assets must be reduced by the prefunding balance in determining whether a shortfall amortization base must be established for the plan year (i.e., whether the value of plan assets for a plan year is less than the plan's funding target for the plan year). Thus, the prefunding balance may not be included in the value of plan assets in order to avoid a shortfall amortization base for a plan year and also used to reduce the minimum required contribution for the same year.

Other rules

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary of the Treasury to reflect the rate of return on plan assets for the preceding year. The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus, the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary of the Treasury prescribes.

Benefit restrictions

Section 436 imposes certain benefit restrictions on single-employer defined benefit plans in "at-risk" status (as described above) under the PPA minimum funding rules.[29] These benefit restrictions apply if a plan's "adjusted funding target attainment percentage" for a plan year is less than a certain threshold.

---

[29] Two of the benefit limitations override protection under section 411(d)(6) and ERISA 204(g) that otherwise generally preclude an employer from amending its plan, even temporarily, to eliminate or reduce early retirement benefits, retirement type subsidies, and other optional forms of benefit, provided under the plan with respect to benefits already accrued. Generally, the right to unpredictable contingent event benefits and prohibited payments would be subject to these protections.

As discussed above, a plan's "funding target attainment percentage" is defined as the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to at-risk status). A plan's adjusted funding target attainment percentage is determined in the same way, except that the value of the plan's assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years. Special rules apply for determining a plan's adjusted funding target attainment percentage in the case of a fully funded plan and for plan years beginning in 2007, or after, and before 2011. In addition, certain presumptions apply in determining whether benefit restrictions apply with respect to a plan, subject to certification of the plan's adjusted funding target attainment percentage by the plan's enrolled actuary.[30]

In general, the benefit restriction rules apply with respect to plan years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before January 1, 2008, however, the rules do not apply to plan years beginning before the earlier of: (1) the later of (a) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after August 17, 2006 (the date of the PPA's enactment), or (b) the first day of the first plan year to which benefit restriction provision would otherwise apply; or (2) January 1, 2010.

Unpredictable contingent event benefit

Under the PPA rules, if a participant is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan must provide that such benefits may not be provided if the plan's adjusted funding target attainment percentage for that plan year: (1) is less than 60 percent; or (2) would be less than 60 percent

[30] If a plan was subject to a limitation for the preceding year, the plan's adjusted funding target attainment percentage for the current year is presumed to be the same as for the preceding year until the plan actuary certifies the plan's actual adjusted funding target attainment percentage for the current year. If (1) a plan was not subject to a limitation for the preceding year, but its adjusted funding target attainment percentage for the preceding year was not more than ten percentage points greater than the threshold for a limitation, and (2) as of the first day of the fourth month of the current plan year, the plan actuary has not certified the plan's actual adjusted funding target attainment percentage for the current year, the plan's funding target attainment percentage is presumed to be reduced by ten percentage points as of that day, and that day is deemed to be the plan's valuation date for purposes of applying the benefit limitation. As a result, the limitation applies as of that date until the actuary certifies the plan's actual adjusted funding target attainment percentage. In any other case, if the plan actuary has not certified the plan's actual adjusted funding target attainment percentage by the first day of the tenth month of the current plan year, for purposes of the limitations, the plan's adjusted funding target attainment percentage is conclusively presumed to be less than 60 percent as of that day and that day is deemed to be the valuation date for purposes of applying the benefit limitations. For purposes of applying the presumptions to plan years beginning in 2008, the funding target attainment percentage for the preceding year was permitted to be determined using such methods of estimation as the Secretary of the Treasury may provide.

taking into account the occurrence of the event. For this purpose, the term unpredictable contingent event benefit means any benefit payable solely by reason of: (1) a plant shutdown (or similar event, as determined by the Secretary of the Treasury); or (2) any event other than attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability. The determination of whether this limitation applies is made in the year the unpredictable contingent event occurs, regardless of whether the benefits are paid in that year or a subsequent plan year.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 60 percent, the amount of the increase in the plan's funding target for the plan year attributable to the occurrence of the event; or (2) if the plan's adjusted funding target attainment percentage would be less than 60 percent taking into account the occurrence of the event, the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

Plan amendments increasing benefit liabilities

Certain plan amendments may not take effect during a plan year if the plan's adjusted funding target attainment percentage for the plan year: (1) is less than 80 percent; or (2) would be less than 80 percent taking into account the amendment.[31] In such a case, no amendment may take effect if it has the effect of increasing the liabilities of the plan by reason of any increase in benefits, the establishment of new benefits, any change in the rate of benefit accrual, or any change in the rate at which benefits vest under the plan. The limitation does not apply to an amendment that provides for an increase in benefits under a formula which is not based on compensation, but only if the rate of increase does not exceed the contemporaneous rate of increase in average wages of the participants covered by the amendment.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year (or, if later, the effective date of the amendment), if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 80 percent, the amount of the increase in the plan's funding target for the plan year attributable to the amendment; or (2) if the plan's adjusted funding target attainment percentage would be less than 80 percent taking into account the amendment, the amount sufficient to result in an adjusted funding target attainment percentage of 80 percent.

[31] Other rules limiting benefit increases while an employer is in bankruptcy may also apply.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

Prohibited payments

Under the PPA rules, a plan must provide that, if the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any "prohibited payments" after the valuation date for the plan year. For purposes of these limitations, a prohibited payment is (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period, (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract), or (3) any other payment specified by the Secretary of the Treasury by regulations.

A plan must also provide that, if the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable under the plan, and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant[32] during any period of consecutive plan years to which the limitation applies.

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not make any prohibited payment. This limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

With respect to the prohibited payment rule, certain frozen plans, meaning plans that do not provide for any future benefit accruals, are grandfathered. The prohibited payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period.

Cessation of benefit accruals

A plan must provide that, if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year. This limitation applies only for purposes of the accrual of

[32] For purposes of the prohibited payment rules, a participant and any beneficiary of the participant (including an alternate payee) is treated as one participant. If the participant's accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

benefits; service during the freeze period is counted for other purposes (i.e., towards a plan's service requirement for vesting purposes).

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

WRERA amended the PPA rules to provide that, in the case of the first plan year beginning during the period from October 1, 2008, through September 30, 2009, the cessation of future benefit accrual limitation of section 436 is applied by substituting the plan's adjusted funding target attainment percentage for the preceding plan year for the percentage for such first plan year in the period. Thus, the future benefit accrual limitation of section 436 is avoided if the plan's adjusted funding target attainment percentage for the preceding plan year is 60 percent or greater. If, however, the adjusted funding target attainment percentage for the current plan year is greater than the preceding year, the lookback rule does not apply and the adjusted funding target attainment percentage for the current plan year is used in determining whether the limitation applies.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

C. Rules for Multiemployer Plans

1. The Pre-PPA minimum funding rules

Prior to the enactment of the PPA, defined benefit multiemployer plans generally were subject to the same general minimum funding rules as single-employer plans. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.

A multiemployer defined benefit pension plan was required to maintain a special account called a "funding standard account" to which charges and credits (such as credits for plan contributions) were made for each plan year. If, as of the close of the plan year, charges to the funding standard account exceeded credits to the account, the plan had an "accumulated funding deficiency" equal to the amount of such excess. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceeded charges, a "credit balance" resulted. The amount of the credit balance, increased with interest, could be used to reduce future required contributions.

A plan was required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represented the cost of future benefits allocated to the plan year under the funding method used by the plan for current employees. The supplemental cost for a plan year was the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a net experience loss. Supplemental costs were amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. In the case of a multiemployer plan, past service liability was amortized over 30 or 40 years depending on how the liability arose,[33] experience gains and losses were amortized over 15 years, gains and losses from changes in actuarial assumptions were amortized over 30 years, and waived funding deficiencies were amortized over 15 years.

Amortization periods could be extended for up to 10 years by the Secretary of the Treasury if the Secretary found that the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and if the Secretary determined that the failure to permit such an extension would (1) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or employee compensation, and (2) be adverse to the interests of plan participants in the aggregate.

In determining plan funding under an acceptable actuarial cost method, a plan's actuary generally made certain assumptions regarding the future experience of a plan. In applying the funding rules, all costs, liabilities, interest rates, and other factors were required to be determined on the basis of actuarial assumptions and methods, each of which was reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, resulted in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions were required to offer the actuary's best estimate of anticipated experience under the plan.

In determining the charges and credits to be made to the plan's funding standard account, the actuarial value of a plan's assets could be used instead of fair market value. The actuarial value of plan assets was the value determined on the basis of a reasonable actuarial valuation method that took into account fair market value, provided that the method was permitted under Treasury regulations. However, any actuarial valuation method used by the plan was required to result in a value of plan assets that was not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value. In addition, if the valuation method used average values of the plan assets, the averaging period could not exceed the five most recent plan years, including the current plan year.

[33] In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 30 years. Past service liability due to plan amendments was amortized over 30 years.

Unlike the rule that applied to single-employer plans which imposed liability for minimum required contributions to all members of the employer's controlled group, controlled-group liability did not apply to contributions an employer was required to make to a multiemployer plan.

2. Minimum funding rules under the PPA and WRERA

Amortization periods and actuarial assumptions

The PPA also modified the minimum funding rules for multiemployer defined benefit pension plans. These modifications are generally effective for plan years beginning after 2007. Unlike single-employer plans, multiemployer plans continue to maintain a funding standard account and plans continue to have an accumulated funding deficiency when total charges to the account of the plan for all plan years exceeds total credits to the account. The PPA, however, changed the amortization periods applicable to multiemployer plans so that the amortization period for most charges is 15 years. Past service liability under the plan is amortized over 15 years (rather than 30); past service liability due to plan amendments is amortized over 15 years (rather than 30); and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years (rather than 30). As under prior law, experience gains and losses and waived funding deficiencies are amortized over 15 years.

The Secretary of the Treasury, upon receipt of an application, is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss. Included with the application must be a certification by the plan's actuary that (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years, (2) the plan sponsor has adopted a plan to improve the plan's funding status, (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures, and (4) required notice has been provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014. The Secretary of the Treasury may also grant an additional extension of such amortization periods for an additional five years, using the same standards for determining whether such an extension may be granted as under prior law.

In applying the PPA funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations). As under prior law, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

Additional funding rules for plans in endangered or critical status

Under section 432,[34] additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation period (as explained below) expires or the plan emerges from endangered or critical status.

Plans in endangered status

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary of the Treasury and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year.[35] A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80 percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over the accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.[36] A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably

---

[34] Parallel rules apply under ERISA.

[35] Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to $1,100 per day applies). If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC, and the Secretary of Labor.

[36] This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. The funding improvement plan must provide that during the funding improvement period, the plan will have a certain required increase in the funded percentage[37] and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). Once a funding improvement plan has been adopted, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active participants. In the case of a plan in seriously endangered status, meaning funded 70 percent or less, a 15-year funding improvement period is used. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

Certain restrictions apply from the date of certification until the end of the funding improvement period. During the period prior to the approval of a funding improvement plan, subject to certain exceptions, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable. In addition, following the date the plan is certified to be in endangered status through the end of the funding improvement period, the plan may not be amended to provide (1) a reduction in the level of contributions for participants who are not in pay status; (2) a suspension of contributions with respect to any period of service, or (3) any new or indirect exclusion of younger or newly hired employees from plan participation. Upon adoption of a funding improvement plan, the plan may not be amended to be inconsistent with the funding improvement plan or to increase future benefit accruals, unless the plan actuary certified in advance, that after taking into account the proposed increase, the plan is reasonably expected to meet the required benchmarks.

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of (1) the amount of the contributions necessary to meet such benchmarks or (2) the plan's accumulated

---

[37] In general, the plan must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-third during the funding improvement period. A plan in seriously endangered status, meaning funded 70 percent or less, must reduce the difference between 100 percent and its funded percentage at the beginning of the period by at least one-fifth during the funding improvement period.

funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect.

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of $1,100 per day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

<u>Plans in critical status</u>

A multiemployer plan is in critical status for a plan year if, as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses),

2. The plan (A) has an accumulated funding deficiency for the current plan year, not taking into account any amortization extension, or (B) is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization extension,

3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions), or

4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to

be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.[38] A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated to enable, based on reasonable anticipated experience and reasonable actuarial assumptions, the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefits accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions. A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation. A summary of the rehabilitation plan and any modifications, together with annual updates regarding the funding ratio of the plan, must be included in the annual report and summary annual report for the plan year.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of (1) the second anniversary of the date of adoption of the rehabilitation plan or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan. The rehabilitation period ends if the plan emerges from critical status.

Certain restrictions apply from the date of certification to the end of the rehabilitation period. For example, beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid.[39] In addition, following the date the plan is certified to be in critical status through the end of the rehabilitation period, the plan may not be amended to provide (1) a reduction in the level of contributions for participants who are not in pay status; (2) a suspension of contributions with respect to any period of service, or

---

[38] The requirement applies with respect to the initial critical year.

[39] The restriction does not apply if the present value of the participant's accrued benefit does not exceed $5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

(3) any new or indirect exclusion of younger or newly hired employees from plan participation. Once a rehabilitation plan has been adopted, the plan may not be amended to be inconsistent with the rehabilitation plan or to increase benefits, including future benefit accruals, unless the plan actuary certifies that the increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

In the case of a plan in critical status, if the employers adopt and comply with a rehabilitation plan, they are not liable for contributions otherwise required under the general funding rules and the excise tax on failures to make such contributions does not apply. If, however, the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner. In addition, if a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the excise tax applies based on the greater of (1) the amount of the contributions necessary to leave critical status or make scheduled progress or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to meet the rehabilitation plan requirements or make scheduled progress.

Elections permitted under WRERA

Under WRERA, for the first plan year beginning during the period from October 1, 2008, through September 30, 2009, the sponsor of a multiemployer defined benefit pension plan is permitted to elect to treat the plan's status for purposes of section 432 the same as the plan's status for the preceding plan year. Thus, for example, a calendar year plan that is not in critical or endangered status for 2008 may elect to retain its non-critical and non-endangered status for 2009, and a plan that was in either critical or endangered status for 2008 may elect to retain such status for 2009. If section 432 did not apply to a plan for the year preceding the applicable plan year, the plan's sponsor may elect to treat the plan's status for the applicable plan year as the status that would have applied to the plan had section 432 applied for the preceding plan year.

Such an election may only be revoked with the consent of the Secretary of the Treasury and special notice provisions apply with respect to the election and the notification of participants, the bargaining parties, the PBGC, and the Secretary of Labor.[40]

A plan that elects to retain its endangered or critical status is not required to update its funding improvement or rehabilitation plan until the plan year that follows the applicable plan year. If an election is made by a plan and, without regard to the election, the plan is certified by the plan's actuary for the applicable plan year to be in critical status, the plan is treated as a plan in critical status for purposes of the special rules that relieve contributing employers from liability for minimum required contributions (that would apply under the otherwise applicable minimum funding rules) and the excise tax that applies in the case of a failure to make such contributions.

In addition, under WRERA, a plan sponsor of a multiemployer defined benefit pension plan may elect for a plan year beginning in 2008 or 2009 to extend the plan's otherwise applicable funding improvement or rehabilitation period by three years.

---

[40] See Notice 2009-31 for IRS guidance on the election and notice procedures that apply when a plan sponsor makes an election to retain its critical or endangered status under WRERA.

II. THE PENSION BENEFIT GUARANTY CORPORATION

The PBGC was created by Title IV of ERISA for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified limits) if the sponsor of the plan is not able to fulfill its obligation to fund adequately the plan.[41] The benefit protection function of the PBGC is carried out through two insurance programs (collectively "termination insurance"), the first of which is for single-employer defined benefit pension plans and the second of which is for multiemployer defined benefit pension plans.[42] PBGC termination insurance serves as a backstop to the minimum funding rules established by ERISA for defined benefit pension plans.

As of 2008, almost 44 million participants in more than 29,000 defined benefit pension plans were insured under the PBGC's termination insurance programs. Of these, almost 34 million participants are covered by almost 28,000 single-employer defined benefit pension plans, and approximately 10 million participants are covered by approximately 1,500 multiemployer defined benefit pension plans. The PBGC paid over $4.3 billion in benefits in fiscal year 2008. At the end of 2008, the PBGC was directly responsible for the pensions of just fewer than 1.3 million people.[43]

The PBGC was established as a corporation within the DOL and is not funded by general tax revenues. It is instead funded by: (1) premiums paid by employers who sponsor or contribute to plans that are covered by the termination insurance program; (2) assets in terminated plans; (3) amounts recovered from employers who terminate underfunded plans; and (4) investment earnings.

A. Information Reported to the PBGC

Defined benefit pension plans are required to provide certain information related to funding and the funded status of the plan to the IRS, the DOL, and the PBGC. Failure to comply

---

[41] ERISA sec. 4002(a). Many of the rules relating to the PBGC are contained in the Labor Code sections of ERISA. For example, the Labor Code contains the rules that establish the PBGC and the termination insurance programs. Some of the rules relating to the PBGC are found in the Code, or are generally duplicated as parallel requirements in both the Code and the Labor Code sections of ERISA. For example, both the Code and the non-Code provisions of ERISA contain parallel minimum funding rules. However, the Code contains the excise tax that applies in the case of a failure to satisfy the minimum funding rules, while the Labor Code sections authorize a claim of action on the part of plan participants, beneficiaries, fiduciaries, and the Department of Labor to enforce violations of the minimum funding rules. ERISA sec. 502(a)(3), (a)(5), and (b)(1).

[42] Plans that are not subject to the minimum funding rules are similarly excluded from termination insurance coverage. For example, governmental and church plans are excluded from termination insurance coverage.

[43] Source for figures is the *Pension Benefit Guaranty Corporation 2008 Annual Report*. The 2008 Annual Report is available on the PBGC's website, at www.pbgc.gov.

with these requirements may result in the imposition of monetary penalties. In certain cases, such as a willful violation of an ERISA requirement, criminal penalties may apply.

The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan.[44] In the case of a defined benefit pension plan, the annual report must include an actuarial report signed by an actuary enrolled to practice before the IRS, the DOL, and the PBGC.[45] The report must include, for example, information as to the value of plan assets, the plan's normal costs and accrued liabilities, and contributions made to the plan.

If an employer fails to make a required contribution to a single-employer plan and fails to obtain a funding waiver, the employer must notify the PBGC if the total contributions the employer failed to make exceeds $1 million and the plan's funding target attainment percentage (as described above) is less than 100 percent.[46]

The sponsor of a multiemployer plan must give notice to the PBGC if the plan reaches endangered or critical status. As described above, a plan will reach such status if the ratio of plan assets to liabilities falls below specified thresholds.

In some cases, certain financial information with respect to the members of a controlled group and actuarial information with respect to plans maintained by members of the controlled group must be reported annually to the PBGC.[47] This reporting is required if: (1) the funding target attainment percentage at the end of the preceding plan year of a plan maintained by the sponsor or any member of its controlled group is less than 80 percent;[48] (2) the conditions for imposition of a lien (i.e., required contributions totaling more than $1 million have not been made) have occurred with respect to an underfunded plan maintained by a member of the controlled group; or (3) minimum funding waivers in excess of $1 million have been granted with respect to a plan maintained by any member of the controlled group, and any portion of the waived amount is still outstanding.

---

[44] Sec. 6058; ERISA secs. 103-104. The annual report is made as a single submission to the Department of Labor on the Form 5500, which forwards copies to IRS and the PBGC. The annual report with respect to a plan year generally must be filed by the end of the seventh month after the end of the plan year unless an extension applies and the information in the annual report is generally available to the public. Sec. 6104; ERISA sec. 106.

[45] Sec. 6059; ERISA sec. 103(d). The actuarial report is provided on Schedule B of the Form 5500.

[46] Sec. 430(k)(4)(A); ERISA sec. 303(k)(4)(A).

[47] ERISA sec. 4010.

[48] Prior to enactment of the PPA, reporting was required if aggregate unfunded vested benefits exceeded $50 million.

Plan sponsors and plan administrators are required to notify the PBGC as to the occurrence of certain events ("reportable" events) unless the PBGC has waived the notice requirement.[49] These events include, for example, failure to meet the minimum funding requirements, inability to pay benefits under a plan when due and certain decreases in the number of active plan participants.

Information provided to the PBGC in accordance with these requirements is not available to the public.

B. Termination Insurance Programs

1. Single-employer plans

In general

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination.[50] The participants and the PBGC must be provided notice of the intent to terminate. The PBGC may also require that a plan be terminated involuntarily (that is, the termination is not voluntary on the part of the employer).

Standard terminations

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.[51] Generally, benefit liabilities equal all benefits earned to date by plan participants, including vested and nonvested benefits (which automatically become vested at the time of termination), and including certain early retirement supplements and subsidies.[52] Benefit liabilities may also include certain contingent benefits (for example, early retirement subsidies). If assets are sufficient to cover benefit liabilities (and other termination requirements, such as notice to employees, have not been violated), the plan may terminate by distributing benefits to participants. The plan may provide for the benefit payments it owes by purchasing annuity contracts from an insurance company or otherwise providing for the payment of benefits, for example by making lump-sum distributions.

---

[49] ERISA sec. 4043.

[50] ERISA sec. 4041.

[51] *Ibid.*

[52] ERISA sec. 4001(a)(16).

If certain requirements are satisfied, and the plan so provides, assets in excess of the amounts necessary to cover benefit liabilities may be recovered by the employer in an asset reversion. Reversions are subject to an excise tax.[53]

<u>Distress and involuntary terminations</u>

If assets in a plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer meets one of four criteria necessary for a distress termination:

- The contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceeding;
- The contributing sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding;
- The PBGC determines that termination is necessary to allow the employer to pay its debts when due; or
- The PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.[54]

The PBGC may institute proceedings to terminate a plan if it determines that the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded nonforfeitable benefits, or that the PBGC's long-run loss with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.[55]

---

[53] Sec. 4980. The excise tax is 20 percent of the amount of the reversion, and the rate generally is increased to 50 percent unless the employer establishes a qualified replacement plan.

[54] ERISA sec. 4041(c)(2)(B). These requirements are designed to ensure that the liabilities of an underfunded plan remain the responsibility of the employer, rather than being shifted to the responsibility of the PBGC, unless the employer meets strict standards of financial need indicating genuine inability to continue funding the plan.

[55] ERISA sec. 4042(a).

PBGC benefit payments

In general

When an underfunded single-employer plan terminates, the amount of benefits that participants receive depends on the plan terms, the degree of the plan's funding, legal limits on the amount of guaranteed benefits that the PBGC can pay to covered participants, asset allocation rules, and recovery by the PBGC on its claims for unpaid employer contributions and employer liability. Guaranteed benefits are paid regardless of plan funding.

When a plan terminates in a distress termination and assets are sufficient to pay guaranteed benefits of plan participants, the plan pays those benefits.[56] When an underfunded plan terminates in a distress or involuntary termination and benefits are insufficient to pay guaranteed benefits, the plan goes into PBGC receivership. The PBGC seeks a court order to become the trustee of the plan, and if the order is granted, the PBGC takes control of any plan assets and assumes responsibility for liabilities under the plan.[57]

Guaranteed benefits

The PBGC guarantees the payment of nonforfeitable benefits provided under an underfunded, terminating plan (other than benefits that become nonforfeitable solely on account of the termination of the plan). Guaranteed (or "basic") benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Certain contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

Three rules limit the amount of the PBGC guaranteed benefit: (1) the accrued-at-normal limitation; (2) the maximum insurance limitation; and (3) the phase-in limitation. A special limit applies in the case of benefits provided to a majority owner of the entity sponsoring the plan.[58]

---

[56] ERISA sec. 4041(c)(3)(B)(ii).

[57] ERISA sec. 4041(c)(3)(B)(iii).

[58] A majority owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, 50 percent or more of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, fifty percent or more in value of either the voting stock of the corporation or all the stock of

Under the accrued-at-normal limitation, the amount of the guaranteed benefit is limited to a monthly amount that is no greater than the amount of the monthly benefit provided as a straight life annuity under the plan at the plan's normal retirement age.[59]

The maximum insurance limitation is a dollar cap, indexed annually for inflation, on the amount that can be paid by the PBGC as a guaranteed benefit. For plans terminating in 2009, the maximum guaranteed benefit for an individual who begins receiving benefits from the PBGC at age 65 is $4,500.00 per month or $54,000.00 per year, payable for the life of the recipient. The guaranteed amount is increased if benefits start after age 65 and is reduced if PBGC payments start before age 65 or if a benefit is payable to a beneficiary upon the recipient's death (e.g., a joint and survivor annuity). If an individual is a participant in more than one terminated plan, the PBGC's combined payments to that individual from PBGC guaranteed funds cannot exceed the maximum guarantee.

The phase-in limitation applies in the case of a plan or plan amendment that has been in effect for less than five years before plan termination. Under the limitation, the amount guaranteed is phased in by 20 percent per year, beginning with the later of the adoption date or effective date of the plan or amendment.[60]

If a contributing sponsor for a plan enters bankruptcy or a similar proceeding, the amount of guaranteed benefits payable by the PBGC is frozen. In the case of bankruptcies (or similar proceedings) initiated on or after September 16, 2006, if the plan terminates during the sponsor's bankruptcy, the amount of guaranteed benefits payable by the PBGC is determined based on plan provisions, salary, service, and the guarantee in effect on the date the employer entered bankruptcy.

Asset allocation

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates.[61] Plan assets available to pay for benefits under a terminating plan include all plan

---

the corporation; or (4) at any time within the preceding 60 months was a majority owner under the plan. ERISA sec. 4022(b)(5).

[59] For example, a plan may provide that a participant is entitled to a straight life annuity of $1,000 per month at age 65 (the plan's normal retirement age), but early retirees who commence benefits at age 60 are entitled to a benefit of $750 per month with a temporary supplement of $400 per month from ages 60 to 62 (for a total benefit of $1,150 per month). The accrued-at-normal limitation reduces the early retiree's benefit to $1,000 per month (a reduction of $150) from age 60 to 62, and the PBGC would pay the participant $750 per month from age 62 onwards (since the plan's terms only provide for the supplemental payment from age 60 to 62).

[60] If the increase is less than $100 per month, the amount phased in each year is $20 per month until the full increase is phased in.

[61] ERISA sec. 4044(a).

assets other than those required for expenses incurred or benefit payments due prior to plan termination. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories.[62] If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next priority category. This process is repeated until all benefits in the priority category are provided or until all available plan assets have been allocated. Thus, an underfunded plan may have sufficient assets to pay certain participants more than the guaranteed benefit amount, depending on the priority category of the participant's particular benefit. Special rules apply in allocating assets within a priority category if there are not sufficient assets to pay for all benefits in the category.

Asset recoveries

In addition to the basic guaranteed benefits described above, ERISA provides that the PBGC pay the portion of a plan's recovery ratio to a plan participant to the extent that the amount of the recovery ratio funds the participant's benefits (other than basic guaranteed benefits).[63] The numerator of the recovery ratio is the amount recovered by the PBGC from the employer responsible for the terminated plan, and the denominator is the total amount of unfunded benefit liabilities under the plan. For example, if PBGC recovers $100,000 on a $2 million claim for unfunded benefit liabilities, the PBGC pays five percent of the unfunded non-guaranteed benefit liabilities of the plan. The allocation of the recovery ratio among the unfunded benefits of participants follows the asset allocation priorities described above, except that the moneys are allocated only to unfunded non-guaranteed benefits. For plans with unfunded benefit liabilities equal to $20 million or less (generally small plans), however, the recovery ratio is determined by an average recovery ratio computed based on the PBGC's recovery experience in recent past years.[64]

2. Insolvency of multiemployer plans

In the case of multiemployer plans, the PBGC insures the risk of plan insolvency, rather than plan termination. Accordingly, a multiemployer plan need not be terminated to qualify for PBGC financial assistance, but must be found to be insolvent. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year. If it appears that available

---

[62] *Ibid.*

[63] ERISA sec. 4022(c).

[64] A similar average recovery approach is used to determine the value of unpaid contribution recoveries to be allocated along with other plan assets.

resources will not support the payment of benefits at the guaranteed level, the PBGC will provide the additional resources needed as a loan. The PBGC may provide loans to the plan for multiple years. If the plan recovers from insolvency, it must begin repaying loans on reasonable terms in accordance with regulations.

Under ERISA, an employer that withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the withdrawal liability.[65] In general, "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.[66] A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.[67] When an employer withdraws from a multiemployer plan, the plan sponsor is required to determine the amount of the employer's withdrawal liability, notify the employer of the amount of the withdrawal liability, and collect the amount of the withdrawal liability from the employer.[68] The employer's withdrawal liability generally is based on the extent of the plan's unfunded vested benefits for the plan years preceding the withdrawal.[69]

The PBGC guarantees benefits under a multiemployer plan of the same type as those guaranteed under a single-employer plan, but a different guarantee ceiling applies. The limit for multiemployer plans is the sum of 100 percent of the first $11 of monthly benefits and 75 percent of the next $33 of monthly benefits for each year of service (i.e., a limit of $35.75 for each year of service).[70]

---

[65] ERISA sec. 4201.

[66] ERISA sec. 4203.

[67] ERISA sec. 4205.

[68] ERISA sec. 4202.

[69] ERISA secs. 4209 and 4211.

[70] ERISA sec. 4022A(c).

III. INVESTMENT ADVICE

A. Overview

ERISA and the Code prohibit certain transactions, including the provision of investment advice, between an employer-sponsored retirement plan[71] and a disqualified person. In 2006 the PPA significantly altered the investment advice rules contained in ERISA and the Code. Subsequent guidance issued by the DOL, under the administrations of President Bush and President Obama, has further altered the PPA rules relating to the provision of investment advice.

B. The Pre-PPA Investment Advice Rules

1. In general

ERISA and the Code prohibit certain transactions ("prohibited transaction") between an employer-sponsored defined contribution retirement plan and a disqualified person (referred to as a "party in interest" under ERISA).[72]

Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. A fiduciary includes any person who (1) exercises any authority or control with respect to the management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act dealing with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. However, certain transactions are statutorily exempt from prohibited transaction treatment, for example, certain loans to plan participants. Other

---

[71] This pamphlet only discusses the rules regarding investment advice as they apply to employer-sponsored defined contribution plans. The prohibited transaction rules under the Code, however, generally apply to all employer-sponsored retirement and welfare benefit plans, including qualified retirement plans, qualified retirement annuities, individual retirement accounts and annuities, health savings accounts, Archers MSAs, and Coverdell education savings accounts. The prohibited transaction rules under ERISA apply to any plan covered by Title I of ERISA.

[72] Sec. 4975; ERISA sec. 406. The prohibited transaction rules of the Code and ERISA are nearly identical, however, several differences do exist between the two sets of rules.

transactions have been exempted, either on an individual or class basis, from prohibited transaction treatment by the DOL pursuant to its authority under ERISA.

Under ERISA, the Secretary of Labor is empowered to assess a civil penalty against a person who engaged in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code. The penalty is not permitted to exceed five percent of the amount involved in the transaction for each year or part of a year that the prohibited transaction continued. If the prohibited transaction is not corrected within 90 days after notice from the Secretary of Labor, the penalty could be up to 100 percent of the amount involved in the transaction. Under the Code, if a prohibited transaction occurs, the disqualified person who participated in the transaction is subject to a two-tiered excise tax. The first tier tax is 15 percent of the amount involved in the transaction. The second tier tax, imposed if the prohibited transaction is not corrected within a certain period, is 100 percent of the amount involved.

2. The SunAmerica opinion

The DOL has the authority under ERISA section 408 to permit exemptions to the prohibited transaction rules by issuing prohibited transaction exemptions to individual fiduciaries and classes of fiduciaries on a wide range of transactions. In addition, the DOL may furnish advisory opinion letters regarding issues that may not require an exemption from the prohibited transaction rules, but which nevertheless warrant DOL guidance or approval.

In 2001, SunAmerica Retirement Markets, Inc. requested exemptive relief under ERISA section 408 from the prohibited transaction rules of ERISA section 406(b). In December 2001, rather than providing an individual exemption from the prohibited transaction rules, the DOL issued Advisory Opinion 2001-09A (the “SunAmerica opinion”). In the SunAmerica opinion, the DOL took the position that, generally, a plan advisor would not be involved in a conflict of interest if it arranged for investment advice to be given to participants based solely on a computer model designed and exclusively controlled by an independent third party. The SunAmerica opinion was based, in large part, on the following factual determinations: (1) the plan fiduciaries responsible for selecting the SunAmerica investment program would be fully informed about, and would have to approve, the program and types of services provided, including the role of the financial expert; (2) the investment recommendations provided to, or implemented for, participants would be the result of methodologies developed and maintained by a financial expert independent of SunAmerica and any of its affiliates; and (3) the arrangement between SunAmerica and the financial expert would preserve the financial expert's ability to independently formulate the basis of the asset allocation.

C. The Pension Protection Act of 2006

1. In general

The PPA added a new category of prohibited transaction exemption under ERISA and the Code in connection with the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan.[73] If the requirements under the provision are met, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice; (2) an investment transaction (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. The prohibited transaction exemptions provided under the PPA do not in any manner alter individual or class exemptions provided by statute or administrative action in existence prior to the PPA's passage (e.g, the SunAmerica opinion).

2. Eligible investment advice arrangements

The exemptions provided by the PPA apply in connection with the provision of investment advice by a fiduciary adviser under an eligible investment advice arrangement. An eligible investment advice arrangement is an arrangement (1) meeting certain requirements (discussed below) and (2) which either (a) provides that any fees (including any commission or compensation) received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected (the "level-fee rule"),[74] or (b) uses a computer model under an investment advice program as described below in connection with the provision of investment advice to a participant or beneficiary.[75] In the case of an eligible investment advice arrangement with respect to a defined contribution plan, the arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan, or (3) any affiliate of (1) or (2).

---

[73] The PPA rule applies to beneficiaries of IRAs, HSAs, Archer MSAs, and Coverdell education savings accounts as well.

[74] Under a level fee approach, any fees or other compensation received by the fiduciary adviser or received directly or indirectly by any employee, agent, or registered representative that provide investment advice on behalf of the fiduciary adviser cannot vary based on the investment options selected by a participant or beneficiary. The exemption for level fee arrangements stemmed from a series of individual exemptions previously granted by the DOL for arrangements with level or substantially level fees among funds. See, for example, Prohibited Transaction Individual Exemption 2000-45, 65 Fed. Reg. 54,315 (Sept. 9, 2000).

[75] The exemption for computer models stemmed from Prohibited Transaction Individual Exemption 97-60 (62 Fed. Reg. 59,744 (Nov. 4, 1997)) which led to Advisory Opinion 2001-09A (discussed above).

Investment advice program using computer model

If an eligible investment advice arrangement provides investment advice pursuant to a computer model, the model must (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, (2) use relevant information about the participant or beneficiary, (3) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan, (4) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person, and (5) take into account all the investment options under the plan in specifying how a participant's or beneficiary's account should be invested without inappropriate weighting of any investment option. An eligible investment expert must certify, before the model is used and in accordance with rules prescribed by the Secretary of Labor, that the model meets these requirements. The certification must be renewed if there are material changes to the model as determined under regulations. For this purpose, an eligible investment expert is a person who meets requirements prescribed by the Secretary of Labor and who does not bear any material affiliation or contractual relationship with any investment adviser or related person.

In addition, if a computer model is used, the only investment advice that may be provided under the arrangement is the advice generated by the computer model, and any investment transaction pursuant to the advice must occur solely at the direction of the participant or beneficiary. This requirement does not preclude the participant or beneficiary from requesting other investment advice, but only if the request has not been solicited by any person connected with carrying out the investment advice arrangement.

Audit requirements

In the case of an eligible investment advice arrangement with respect to a defined contribution plan, an annual audit of the arrangement for compliance with applicable requirements must be conducted by an independent auditor (i.e., unrelated to the person offering the investment advice arrangement or any person providing investment options under the plan) who has appropriate technical training or experience and proficiency and who so represents in writing. The auditor must issue a report of the audit results to the fiduciary that authorized use of the arrangement.

Notice requirements

Before the initial provision of investment advice, the fiduciary adviser must provide written notice (which may be in electronic form) containing various information to the recipient of the advice, including information relating to: (1) the role of any related party in the development of the investment advice program or the selection of investment options under the plan; (2) past performance and rates of return for each investment option offered under the plan; (3) any fees or other compensation to be received by the fiduciary adviser or affiliate; (4) any material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction; (5) the manner and under what circumstances any participant or beneficiary information will be used or disclosed; (6) the types of services provided by the fiduciary adviser in connection with the provision of investment advice; (7) the adviser’s status as a fiduciary of the plan in connection with the provision of the advice; and (8) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. This information must be maintained in accurate form and must be provided to the recipient of the investment advice, without charge, on an annual basis, on request, or in the case of any material change.

Any notification must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and sufficiently accurate and comprehensive so as reasonably to apprise participants and beneficiaries of the required information. The fiduciary adviser must maintain for at least six years any records necessary for determining whether the requirements for the prohibited transaction exemption were met. A prohibited transaction will not be considered to have occurred solely because records were lost or destroyed before the end of six years due to circumstances beyond the adviser's control.

Other requirements

For the exemption to apply, the following additional requirements must be satisfied: (1) the fiduciary adviser must provide disclosures applicable under securities laws; (2) an investment transaction must occur solely at the direction of the recipient of the advice; (3) compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable; and (4) the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

Fiduciary adviser

For purposes of the PPA investment advice rules, "fiduciary adviser" is defined as a person who is a fiduciary of the plan by reason of the provision of investment advice to a participant or beneficiary and who is also: (1) registered as an investment adviser under the Investment Advisers Act of 1940 or under State laws; (2) a bank, a similar financial institution supervised by the United States or a State, or a savings association (as defined under the Federal Deposit Insurance Act), but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities; (3) an insurance company qualified to do business under State law; (4) registered as a broker or dealer under the Securities Exchange Act of 1934; (5) an affiliate of any of the preceding; or (6) an employee, agent or registered representative of any of the preceding who satisfies the requirements of applicable insurance, banking and securities laws relating to the provision of advice. A person who develops the computer model or markets the investment advice program or computer model is treated as a person who is a plan fiduciary by reason of the provision of investment advice and is treated as a fiduciary adviser, except that the Secretary may prescribe rules under which only one fiduciary adviser may elect treatment as a plan fiduciary. "Affiliate" means an affiliated person as defined under section 2(a)(3) of the Investment Company Act of 1940. "Registered representative" means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 or a person described in section 202(a)(17) of the Investment Advisers Act of 1940.

Fiduciary rules

Subject to certain requirements, an employer or other person who is a plan fiduciary, other than a fiduciary adviser, is not treated as failing to meet the fiduciary requirements of ERISA, solely by reason of the provision of investment advice as permitted under the PPA or of contracting for or otherwise arranging for the provision of the advice. This rule applies if: (1) the advice is provided under an arrangement between the employer or plan fiduciary and the fiduciary adviser for the provision of investment advice by the fiduciary adviser as permitted under the provision; (2) the terms of the arrangement require compliance by the fiduciary adviser with the requirements of the provision; and (3) the terms of the arrangement include a written acknowledgement by the fiduciary adviser that the fiduciary adviser is a plan fiduciary with respect to the provision of the advice.

The PPA does not exempt the employer or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary adviser with whom the employer or plan fiduciary has arranged for the provision of investment advice. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary adviser. The PPA also provides that nothing in the fiduciary responsibility provisions of ERISA is to be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

D. DOL Guidance

On January 21, 2009, the DOL published final regulations (the "final rules") regarding the PPA provisions on investment advice offered to participants and beneficiaries of employer-sponsored defined contribution retirement plan.[76] The final rules contained the DOL's interpretation of the PPA investment advice rules as well as a class exemption issued pursuant to the authority granted to the Secretary of Labor under ERISA section 408(a).

Under the PPA guidance in the final rules, participants could receive investment advice from a computer model certified as unbiased, and through a fiduciary adviser compensated on a "level-fee" basis. The computer model could not favor investment options that generated the most income for the fiduciary adviser or a person with a material affiliation or material contractual relationship with the fiduciary adviser. The level-fee requirement applied only to investment advisors, not to their affiliates. Affiliates of investment advisors were subject to the level-fee requirement only if they provided investment advice to plan participants or beneficiaries.

The class exemption in the final rules permitted advisers to provide individualized investment advice to persons following the furnishing of computer-modeled recommendations, even if the follow-up advice differed from the original advice. Different advice was only

[76] 74 Fed. Reg. 3,822 (Jan. 21, 2009).

permitted, however, if the fiduciary adviser concluded that the advice was prudent and in the participant's or beneficiary's best interests and explained why and how the follow-up advice differed from any computer modeled recommendation provided. The class exemption in the final rules applied the level-fee requirement on an individual level rather than an entity level (in contrast to the final rules for the statutory exemption). Thus, the requirement only covered individuals who provided investment advice on behalf of the fiduciary (i.e., employees, agents, and registered representatives) rather than the fiduciary advising entity itself.

After the final rules were published, the Obama Administration instructed heads of executive departments and agencies to consider extending the effective date of regulations that had not yet become effective.[77] Subsequently, the DOL decided to delay implementation of the final regulations until November 18, 2009.[78] The Assistant Secretary of Labor has stated that "[w]e believe the final investment advice regulation published in the January 21 Federal Register went too far in permitting investment advice arrangements not specifically contemplated by the statutory exemption."[79] According to the Assistant Secretary, the DOL is "taking a fresh look at the regulation that was issued and [is] working to bring it more closely in line with the [PPA's] statutory language."[80]

[77] 74 Fed. Reg. 4,435 (Jan. 26, 2009).

[78] 74 Fed. Reg. 23,951 (May 22, 2009).

[79] Statement of Phyllis Borzi at "DOL Speaks" Conference, September 14, 2009.

[80] *Ibid*.