

Pension Funding Relief: How It Works and Why Your Executive Compensation, Dividend and Stock Buy-Back Practices May Erode Your Potential Relief

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EXECUTIVE SUMMARY

The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (P.L. 111-192; H.R. 3962) (the "Act") gives plan sponsors the opportunity to elect one of two methods for determining their defined benefit pension funding obligations for up to two plan years for the period between 2008 and 2011. By doing this, the Act provides limited funding relief by allowing plan sponsors with underfunded plans to extend the time they have to make certain funding contributions. Any funding relief is limited, however, by "add-backs" for any individual employee's compensation in excess of \$1 million and the aggregation of dividends and stock buybacks that exceed a certain threshold.

Please refer to the attached Comprehensive Summary for a more detailed description of the Act.

Because the Act's funding relief is only available for a limited number of plan year, employers with defined benefit pension plans should take the following actions in the near term:

- Consider whether and to what extent an election under the Act would reduce current and/or projected funding obligations; and
- If an election is potentially desirable, an employer should work with its board of directors and/or

relevant board committees to understand how the add-backs might erode the company's projected pension funding relief;

- ♦ The add-backs include (i) all compensation paid to an employee in excess of \$1 million, including all W-2 pay plus any amount of deferred compensation funded or otherwise set-aside in that year and (ii) the aggregate amount of dividends declared and the amount paid to buy back company stock in excess of the greater of EBITDA and the company's normal annual dividend (determined by looking at the dividend policy over the past five years).
- ♦ One important exception to the employee compensation add-back is restricted stock awarded after February 28, 2010 that is subject to a five year vesting schedule.
- Employers will want to consider whether to modify their compensation policies, dividend practices and buyback programs in light of how those items affect projected funding relief.
- While we believe the add-backs likely will not have a significant effect on large companies, it will be important for management to understand the impact of the add-backs on pension funding for the purposes of guiding the board (and relevant committees) on the subject.

One important thing to keep in mind is that there is little downside to making an election under the Act. Even if compensation and dividend/stock buy-back amounts are added to a company's pension funding obligation, they are capped at what they otherwise would be absent an election. Thus, the only downside is the obligation to notify participants and the PBGC about the election.

Finally, companies that are currently subject to pre-PPA funding rules (e.g., large government contractors) are eligible for relief similar to that provided to other companies.

COMPREHENSIVE SUMMARY

Introduction

The Act gives plan sponsors the opportunity to elect a longer period in which to fully fund plans. Funding relief is limited, however, by "add-backs" for individual employee compensation in excess of \$1 million and "extraordinary" dividends and stock buybacks (on an aggregate basis).

Funding rules modified by the Pension Protection Act of 2006 (the "PPA") require plan sponsors to make yearly contributions toward a plan's funding shortfall (known as the "shortfall amortization base") in addition to contributions for yearly accrued benefits. The shortfall amortization base is amortized over a seven year period under PPA. Plans are required to make annual installment payments, known as "shortfall amortization installments," of such amortized amounts over the seven year period.

The Act gives sponsors the option to extend the amortization period for their funding shortfalls under two new rules:

- **The 2 and 7 Year Rule.** Under the 2 and 7 year rule, the amortization period for the funding shortfall would remain seven years, but the period would start two years later. The sponsor would only pay interest on the shortfall amortization base during the initial two-year period.
- **The 15-year Rule.** Under the 15-year rule, the sponsor would amortize the funding shortfall over 15 years.

Plans that are currently subject to pre-PPA funding rules (e.g., large government contractors) are eligible for relief similar to the two options listed above.

PLAN SPONSOR'S ELECTION

Generally, plan sponsors can only elect these relief options for up to 2 eligible plan years (2008,¹ 2009, 2010 or 2011) and must elect the same type of relief for both years. The period in which to elect relief is limited because the Act does not allow plan sponsors to elect relief for shortfall amortization bases created in plan years beginning in 2012 or later. The Secretary of the Treasury will promulgate rules governing how elections are made, and plan sponsors electing relief will need to give notice to participants, beneficiaries and the PBGC (pursuant to notice rules that will be promulgated by the PBGC). Elections cannot be revoked without permission of the Secretary of the Treasury.

ADDITIONS TO FUNDING DURING A "RESTRICTED PERIOD" FOR EXCESS COMPENSATION, EXTRAORDINARY DIVIDENDS AND STOCK REDEMPTIONS

Under certain circumstances, plan sponsors that elect funding relief may be required to increase their contributions for an "installment acceleration amount."

- **Installment Acceleration Amount.** The installment acceleration amount is the sum of:
 - ♦ The aggregate amount of **excess employee compensation** for all employees for the plan year (see below for how to calculate this amount); and
 - ♦ **Extraordinary dividends** and **company stock redemptions** paid during the plan year (see below for how to calculate this amount).
- **Restriction Period.** Such installment acceleration amounts are required during the plan's "restriction period."
 - ♦ For the 2 and 7 year rule, the restriction period is the 3-year period beginning with the plan year of the election (or, if later, the first plan year beginning after December 31, 2009).
 - ♦ For the 15-year rule, it is the 5-year period beginning with the plan year of election (or, if later, the first plan year beginning after December 31, 2009).

Excess Employee Compensation. Excess employee compensation is defined as the excess, if any, over \$1 million (or such amount as indexed), of each employee's taxable income for remuneration during the calendar year in which the plan year begins for services performed by the employee (regardless of whether the employee performed such services during the calendar year) plus amounts set aside for deferred compensation. **Note: As some benefits practitioners have noted, it is not clear whether the compensation of former employees or nonresident aliens subject to U.S. income tax is counted.**

- Excess employee compensation includes:
 - ♦ W-2 compensation - amounts paid to an employee in a relevant year, generally including:
 - Salary,
 - Bonus, and
 - Equity compensation and deferred compensation realized as income in that year.
 - ♦ Funding for Deferred Compensation - also included is any amount set aside or reserved (directly or indirectly) during a calendar year in a trust (or other arrangement determined by the Secretary of Treasury) or transferred to such a trust or arrangement by a plan sponsor for purposes of paying nonqualified deferred compensation (as defined in IRC 409A) to the employee. **Note: it appears that the use of a so-called Rabbi trust (or other funding mechanism designed to not trigger constructive receipt) would fall under this provision. To the extent that it does apply, the Act does not provide guidance as to how amounts contributed to a Rabbi trust would be allocated amongst participating employees. Treasury regulations are expected to clarify these issues.**
- Exemptions from Excess Employee Compensation. The following types of income are not part of this calculation:
 - ♦ Compensation attributable to services performed before March 1, 2010, including:
 - Salary through that date, and annual bonuses for 2009 but paid in 2010;

- Nonqualified deferred compensation, restricted stock, stock options or SARs payable or granted under a written binding contract that was in effect on March 1, 2010, and which was not modified in any material respect before payment of such remuneration.

- ♦ Amounts includible in income with respect to restricted stock granted after February 28, 2010, that is subject to a substantial risk of forfeiture (as defined under IRC 83(c)(1)) for at least 5 years from the grant date.
- ♦ Commissions based solely on income directly generated by an employee's individual performance.

Extraordinary Dividends and Redemptions.

- Definition. This is defined as the excess, if any, of
- The sum of:
 - ♦ (i) dividends declared during the plan year by the plan sponsor, but only those dividends declared on or after March 1, 2010; plus
 - ♦ (ii) the aggregate amount paid for the redemption of stock of the plan sponsor during the plan year, but only those redemptions occurring on or after March 1, 2010.
- ♦ Over the greater of:
 - (x) the plan sponsor's EBITDA; or
 - (y) in the case of a plan sponsor that has determined and declared dividends in the same manner for at least 5 consecutive years immediately preceding the plan year, the aggregate amount of dividends determined and declared for such plan year using such manner. **Note: for these purposes, just as with excess aggregate compensation, the "plan sponsor" includes the entire controlled group.**
- Exception. The following dividends and redemptions are not included:
 - ♦ Dividends paid by one member of a controlled group to another member of such group;

- ◆ Redemptions that are made pursuant to a plan maintained with respect to employees or made on account of death, disability or termination of employment; and
- ◆ Dividends and redemptions of applicable preferred stock, which is preferred stock that was issued before March 1, 2010 (or is held by an employee benefit plan), if dividends accrue at a specified rate in all events and without regard to the plan sponsor's income, and interest accrues on unpaid dividends.

Other Important Points: The Act contains a number of restrictions on the relief it affords, as well as limits to the relief "add-backs." Some of the more important (and comprehensible) rules include:

- Installment acceleration amounts for a given year cannot cause a situation where the total amortization payments for the relief period elected exceed what the total amortization payments would have been if the plan sponsor had not elected any relief. **Thus, by electing relief under the Act, you won't end up having to contribute more than if you had not made an election under the Act.**

- To the extent an installment acceleration amount is limited by an applicable limitation, the excess amount is carried over to the following year, but will only extend for a limited period beyond the applicable restricted period.

Treasury will promulgate rules:

- For the application of restrictions relating to dividends, redemptions and compensation to plan sponsors that elect funding relief for multiple plans; and
- For the application of these restrictions in cases where the plan sponsor is involved in a merger or acquisition.

CONCLUSION

As noted above, the relief provided by the Act is only available for a limited time. A plan sponsor, in consultation with its board of directors and applicable committees, will need to analyze funding relief along with the impact, if any, the company's compensation practices and dividend and stock buyback policies may have on such relief.

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