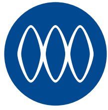

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Multiemployer Review

Update on Issues Affecting Taft-Hartley Plans

DECEMBER 2006

To-Do's for Trustees:
Addressing a Plan's Funded Status Today to Face the Challenges of Tomorrow

Although the Pension Protection Act's (PPA) new requirements for pension plans in *endangered* or *critical* status do not become effective until the 2008 plan year, actions taken by Trustees now can go a long way toward positioning their defined benefit plans to avoid some of the law's harshest consequences. To comply with the law's strict requirements, the plan's actuary must estimate the plan's funding status as of the beginning of the 2008 plan year and project the funding standard account through the 2014 plan year. If the plan's current or projected status shows the plan to be endangered or critical, the actuary must notify the Trustees within 90 days of the beginning of the 2008 plan year, and they in turn must notify federal agencies and affected parties within 30 days, and then adopt a program to meet the special funding standards and transmit it to the bargaining parties before the end of the 2008 plan year.

This issue of *Multiemployer Review* suggests key steps for Trustees to take immediately and issues to consider in the near term if the plan confronts the consequences of endangered or critical status; fortunately, most plans will not fall into either category.

What's the Rush?

Trustees and bargaining parties should act now to prepare for or to avoid the PPA's requirements for financially troubled plans. The determination of whether a plan is endangered or critical will be based on a projection of the 2007 actuarial valuation or the latest valuation available, whichever is most recent. Thus, actions taken today can affect a plan's status for the 2008 actuarial certification. Also, the PPA's reduced amortization period (15 years instead of 30) for changes in actuarial assumptions means that changes in assumptions adopted in 2007 that would create an actuarial loss (e.g., an updated mortality table) will have a less negative impact on the plan's funding standard account than if the changes are adopted in a later plan year. Finally, the PPA requires the IRS, beginning with the 2008 plan year, to grant a plan's request for an amortization period extension if the plan's actuary certifies that certain conditions are satisfied.

Projecting the Plan's Funding Status

Milliman has been projecting the future status of many of its Taft-Hartley clients for several years. Using the latest actuarial report, the plan's actuary can project the plan's funding status through the 2014 plan year and beyond. The results of this projection will show whether a plan could be in endangered or critical status in 2008 or subsequent years.

The PPA requires the actuary to use reasonable assumptions in projecting a plan's liabilities and gives the actuary a choice about future contributions to the plan. The actuary may either assume that the contributions in the last plan year continue, or use the contribution rates contained in existing collective bargaining agreements and project future covered service using the Trustees' estimates of covered work. The value of assets is determined as of the beginning of the plan year being tested using any actuarial method contained in existing regulations. Thus, a plan's actual funding status as of the beginning of its 2008 plan year will depend on the results shown in the 2007 actuarial valuation and the actuarial value of assets as of the 2008 valuation date.

Actions to Consider

Plans that are projected to be in endangered or critical status in 2008 can take several steps. Trustees, bargaining parties, and plan actuaries should consider:

- Combining or offsetting amortization bases in the funding standard account;
- Restarting the "asset smoothing" method to capture recent investment gains;
- Adjusting plan benefits by reducing: the rate of future accruals; early retirement or supplemental benefits prospectively; and/or ancillary benefits such as disability and plan-paid death benefits;
- Increasing contributions;
- Applying for an automatic extension of the amortization period for the 2008 plan year;
- Applying for an extension of the amortization period now; and/or
- Changing the funding method.

The effectiveness of these actions depends on which test a plan is projected to fail and the individual characteristics of the plan. For example, one of the tests for endangered status is based on the plan projected to have an accumulated funding deficiency by the end of the 2014 plan year. Any of the above actions taken either alone or in combination may be sufficient to avoid failing this test. In particular, the automatic extension of the amortization period by itself will allow many plans to avoid endangered status, assuming the IRS allows the actuary to take the extension into account if the application is filed before the actuarial certification is due. Whether the IRS will accept applications before the 2008 plan year or allow the plan actuary to assume the automatic extension remains an unanswered question. The IRS might not provide guidance, leaving the determination of reasonableness to general actuarial principles if the plan actuary determines that the plan qualifies for the extension and the Trustees have authorized the application request.

In some cases, a change from the *Entry Age Normal* funding method to the *Unit Credit* funding method can help the plan avoid endangered status because of a projected funding deficiency, as illustrated by Charts 1 and 2 below, which provide an example of a fund's projected credit balance in its funding standard account.

Another test for endangered status is that the plan's funded percentage is less than 80%. While correcting this by prospective changes in contributions or accruals presents difficulties, a plan that is currently better than 80% funded but projected in 2008 to fall short by up to 2 percentage points may be able to increase its funded status sufficiently by: changing its asset valuation method to capture recent gains; eliminating ancillary benefits; and/or cutting back subsidized early retirement benefits for future accruals and/or decreasing future accruals.

Critical Status

A plan will be in critical status if it fails any one of four tests. The most likely test a plan will fail is the one in which a plan is

CHART 1

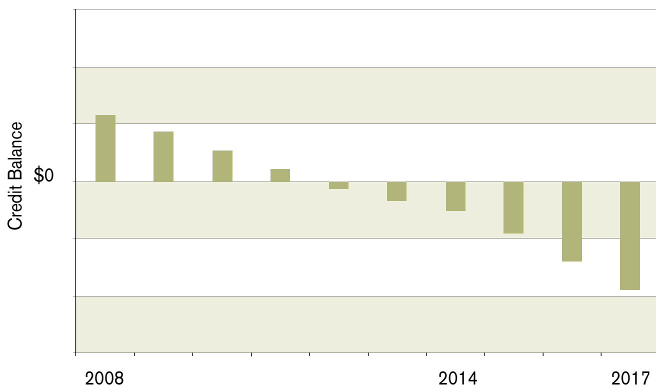
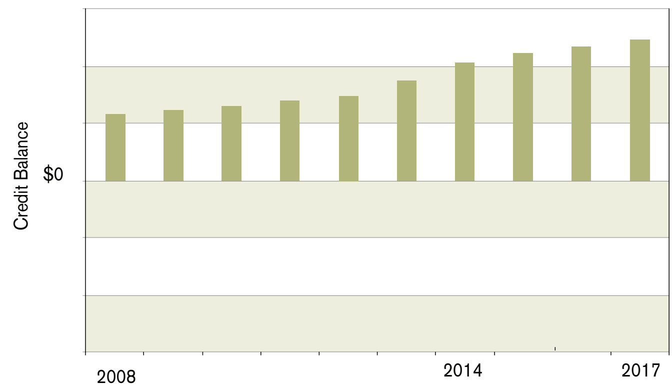


CHART 2



projected to have a funding deficiency by the end of the third succeeding plan year. Unlike the test for endangered status based on a projected funding deficiency, the critical status tests do not allow the actuary to take amortization extensions into account. Thus, such extensions will not help the plan avoid critical status, but as illustrated in the above example, a change in the funding method can help the plan avoid critical status for those tests that are based on projected funding deficiencies.

If the projection shows that the plan will be in critical status in the 2008 plan year, the actuary should so notify the Trustees as soon as possible. The Trustees have the option of providing the required notice to the affected parties (participants and beneficiaries, the Secretary of Labor, and the Pension Benefit Guaranty Corporation) up to 120 days after the beginning of the 2008 plan year. The notice must include a statement that *adjustable benefits* may be reduced for participants and beneficiaries whose benefit commencement date is after the notice date. Adjustable benefits include: early retirement subsidies; subsidized retirement payment options; supplemental benefits; and benefit increases that have been in effect for less than 60 months as of the start of the 2008 plan year.

Providing the notice will permit the plan to be amended after 2008 to reduce or eliminate adjustable benefits for participants who have not retired before the date of the notice. Also, once the actuary gives notice of critical status to the Trustees, the plan is prohibited from paying benefits other than in the form of a life annuity, paying lump sums in excess of $5,000, or purchasing annuities. Thus, early notice of a plan's projected critical status can be used to prevent a *run on the bank* in a plan with highly subsidized early retirement benefits or lump-sum options. Early notice does not change the date (November 25, 2008, for calendar year plans) for adoption of a rehabilitation plan, but will give the bargaining parties additional time to try to avoid critical status or minimize the actions that will be needed. Providing early notification does not appear to move up the date for actually reducing adjustable benefits; doing so simply warns nonretired participants that if they retire early or begin receiving supplemental benefits after the date of the notice, their benefits may be adjusted after the beginning of the 2008 plan year.

Other Items to Consider Now

Other issues Trustees should consider now include:

- *Withdrawal Liability in General*—Changes to the withdrawal liability rules generally do not require plan amendments, but Trustees should check with plan counsel to determine the extent to which changes in the plan's procedures for identifying and assessing withdrawal liability are needed, including in some circumstances an amendment of the plan. These rules include: the limit based on net sales proceeds for withdrawals due to a sale of all an employer's assets; the right to decline making interim payments for a withdrawal based on a determination that the purpose of a transaction was to avoid or evade withdrawal liability; and the new partial withdrawal rule for contracting out covered work to another employer owned or controlled by the contracting employer.

- *Withdrawal Liability for the Construction Industry*—Trustees of construction industry plans should consider whether they want to adopt the *free-look* rule (under ERISA section 4210), which becomes effective for withdrawals occurring in 2007. They also should consult with fund counsel about whether to restart the presumptive method if the plan's unfunded vested benefits are zero for 2005.

- *Extension of Notice Period from 90 to 180 days*—Effective for plan years beginning in 2007, a plan has 180 days before the start of a distribution date to provide the participant the required notice to elect an optional form of payment or to waive a joint-and-survivor annuity (J&SA). Participants may make their election within the 180 days prior to the distribution date.

- *New Notice Requirements for Early Distributions*—The PPA requires the Treasury Department to modify the distribution notice requirements to include a description of the effect of failing to defer a distribution, such as taking early retirement or a lump sum. Plans will need to make a good-faith attempt to comply with the regulation within 90 days of its publication.

- *75% J&SA*—A plan must offer both a 50% J&SA and a 75% J&SA, designating one as the normal form of benefit and the other—a "qualified optional survivor annuity"—as an elective benefit, beginning with the 2008 or 2009 plan year. (The effective date depends on when collective bargaining agreements in effect on August 17, 2006, expire.) The plan need not subsidize the additional optional J&SA and might be able to eliminate the existing subsidy on the 50% J&SA. Trustees should consider this issue in the course of examining plan design and amendments, along with communications and other administrative items.

Conclusion

The most urgent concern facing Trustees today is the prospect of their plans falling into endangered or critical status in the 2008 plan year. The tools to gain such knowledge are readily available. With the capacity to perform sensitivity testing of a change in investment return, retirement patterns, mortality assumptions, and other factors, the projection models and other tools can help Trustees to map out appropriate courses of action for their plans' finances.

Trustees also will have to change their plans' operating and administrative procedures and may have to consider plan amendments and communications. Addressing such issues early and in a comprehensive, integrated manner can facilitate a plan's readiness to meet the challenges of the PPA.

Multiemployer Review: Update on Issues Affecting Taft-Hartley Plans is intended to provide information and analysis of a general nature. Application to specific circumstances should rely on separate professional guidance.

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