



CCH Tax Briefing: PENSION FUNDING EQUITY ACT OF 2004

Special Report

April 13 , 2004

Significant Impact

- ✓ \$80 Billion Pension Contributions at Stake
- ✓ \$1.6 Billion DRC Relief for Special Industries
- ✓ 45 Million Employee/Participants Affected
- ✓ Higher Interest Rate Assumptions
- ✓ 23 Internal Revenue Code Amendments
- ✓ 17 Amendments to ERISA
- ✓ Numerous Effective Dates and Special Rules

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Pension Funding Relief Enacted; Immediate Impact On April 15th Deadline

Congress has passed the Pension Funding Equity Act of 2004 that offers important temporary relief for many pension plans. After the House approved the conference bill by a vote of 336 to 69 on April 2, there was some question whether the agreement would hold up long enough to pass in the Senate. At the eleventh hour before the mid-April recess, however, the Senate approved the bill on April 8 by a vote of 78 to 19. President Bush signed the bill into law on April 10, 2004. Over a year in the making, the Pension Funding Equity Act of 2004 (P.L. 108-218) was enacted just in time to provide some immediate relief to employers.

Impact *A sluggish economy along with unusually low interest rates and generous pension benefits agreed to in better times have combined to make required plan funding suddenly too burdensome for many businesses. With an April 15 deadline looming for the next round of defined benefit plan contributions, the Pension Funding Equity Act allows employers—both pension plan sponsors across the board as well as those in specifically-targeted industries—to lower the amount of their required contributions immediately.*

OVERVIEW

The new law will:

- Replace, for two years, the 30-year Treasury bond rate used to calculate employers' contributions to pension plans with a long-term corporate bond rate;
- Provide partial, temporary relief from deficit reduction contributions; and
- Target relief to multiemployer plans.

Temporary relief only. The legislation is only a temporary fix, covering 2004 and 2005. It is designed to get businesses over their immediate crisis until a long-term solution can be crafted. Many companies are being required to make substantial contributions when they can least afford them. Pension plan benefits promised to employees remain the same, with the defined benefit plan expected to have the cash on hand when those obligations arise. Benefits, for the most part, are guaranteed by the Pension Benefit Guaranty Corporation (PBGC).

Impact *The legislation also helps to keep the PBGC solvent. Congress has been concerned about the potential liabilities facing the PBGC. The PBGC estimates that the total underfunding in multiemployer pension plans is \$100 billion and in single-employer plans is \$400 billion.*

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Scope of the crisis. Single-employer pension plans cover nearly 35 million workers and retirees. Multiemployer plans cover an additional 10 million. In total, one in five workers participates in a defined benefit plan. More telling, in terms of one reason behind the current crisis, in 1980 there were four active workers for every one retiree in a multiemployer plan; in 2002, there was only one active worker for every one retiree. Trends also show a significant decline in the use of defined benefit pension plans, with only one quarter as many companies providing defined benefit plans today as they did 20 years ago.

INTEREST RATE FIX

The new law replaces the current standard that employers must use to determine their pension liabilities under Code Sec. 412—the 30-year Treasury bond interest rate—with a rate within a permissible range of the weighted average of the rates of interest on amounts invested in long-term corporate investment-grade bonds (to be determined by the Treasury Secretary) for two years through December 31, 2005. Although contributions to satisfy the minimum funding requirements are due within 8½ months of the plan year, plans with funded current liabilities of less than 100 percent must estimate quarterly payments for the plan year. Failure to make required payments subjects the employer to excise tax under Code Sec. 4971.

Companies currently use from 90 percent to 120 percent of the average interest rate for 30-year Treasury bonds maturing in 2031 when calculating their pension liabilities. The 30-year Treasury bond interest rate has been historically low. Low interest rates have caused projected future pension plan payouts to require higher present contributions since growth of those contributions is projected to be slower.

Impact *The U.S. Treasury 30-Year T-Bond yield (approximately 4.75 percentage) currently is about 0.75*

percentage points lower than AAA corporate bond yields (Moody's).

The IRS immediately responded to the enactment of the legislation by issuing Notice 2004-34 on April 12. The notice provides guidance for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the additional funding requirements under Code Sec. 412(l) and the minimum full funding limitation of Code Sec. 412(c)(7)(E).

“...the Pension Funding Equity Act will allow employers—both pension plan sponsors across the board as well as those in specifically-targeted industries—to lower the amount of their required contributions immediately.”

RELIEF FROM DEFICIT REDUCTION CONTRIBUTIONS (DRCs)

The new law gives special relief to airlines, steel companies, and the Transportation Communications Union pension plan. An applicable plan year must begin after December 27, 2003, and before December 28, 2005. They can reduce contributions by 80 percent, for two years only. However, the bill does not contain provisions that provide deficit reduction contributions (DRC) waivers for all other single employer plans.

Under current pension funding rules, companies that offer defined benefit pension plans are required to make additional contributions when they are less than 90 percent funded. A plan's

funding level is set by comparing the plan's current assets to its promised benefits. DRC rules require companies to close an underfunded gap on an accelerated basis. DRCs can force companies to seek bankruptcy protection.

Impact *This provision provides temporary, two-year relief from some of the cashflow burdens imposed by DRCs. During this period, companies are still required to make their normal required pension contributions. Companies that receive DRC relief will be required to contribute at least the amount necessary to fund the expected increase in current liability that results from benefits that have accrued during the year.*

Impact *Proponents of the legislation point out this relief aids companies that had well-funded pension plans as recently as 2000, but due to economic turmoil, including 9-11, are now on shaky financial footing. Many members of Congress agree that this is only a short-term fix to a long-term problem, caused by an overall flawed system of funding that should be reviewed and reformed.*

The IRS released Announcement 2004-38 on April 12, which sets forth the procedure for electing an alternative DRC for the industries targeted for relief by the Act.

TARGETED MULTIEMPLOYER PLAN RELIEF

The new law also targets relief to multiemployer plans, especially those plans “most in need.” These plans have experienced significant losses as a result of low interest rates, sizable market investment losses and an expanding number of retirees. To qualify for relief, plans would have to meet specific thresholds and make a special election.

Under current law, if a multiemployer plan has a net experience loss for a plan year, the plan's funding standard account is charged with the amount needed to amortize the net experience loss over 15 years. The conference agreement allows certain multiemployer plans to defer amortization of up to 80 percent of 2002 net experience losses for two plan years.

Multiemployer plans would qualify for relief only if they meet the following requirements:

- The plan had a net investment loss of 10 percent or more of the average fair market value of assets for 2002.
- The plan's actuary certifies that the plan is expected to have a funding deficiency for any plan year beginning after June 30, 2003, and before July 1, 2006. The certification must be based on the same actuarial assumptions used in the 2003 plan year.
- The plan must not have failed to timely pay any excise tax imposed by the IRS.
- The plan must not have had a funding holiday for contributions in excess of 10 cents per hour.
- The plan must not have previously received a funding waiver from the IRS.

Under the conference bill, multiemployer plans could not be amended to increase benefits during the deferral period unless:

- The plan's enrolled actuary certifies that the contributions to the plan will exceed the annual charges to the plan's account which were attributable to the change, or
- The amendment is required by a collective bargaining agreement in effect on the date of enactment.

Impact *The funding provisions were a main bone of contention and they delayed passage of the entire bill. Many lawmakers wanted much broader funding relief. Critics, such as Sen. Edward Kennedy, D-Mass., contended that the bill would benefit less than four per-*

cent of the nation's approximately 1,600 multiemployer plans. Multiemployer plans are usually found in unionized industries spread among many smaller businesses.

The new law also extends the date by which plans can make "qualified transfers" of excess pension assets to retiree health accounts under Code Sec. 420 from December 31, 2005, to December 31, 2013.

MULTIEMPLOYER PLAN FUNDING NOTICES

The conference agreement requires multiemployer plans to give an annual plan funding notice to each participant and beneficiary, to each labor organization representing participants and beneficiaries, to each employer that has an obligation to contribute under the plan, and to the Pension Benefit Guaranty

Corporation (PBGC). This requirement would apply to plan years beginning after December 31, 2004.

Plans will have to provide the name, address, and phone number of the plan administrator, the plan's principal administrative officer, and each sponsor's employer identification and plan number.

They also will have to set forth:

- A statement as to whether the plan's funded current liability percentage for the plan year is at least 100 percent (and if not, what the actual percentage is);
 - A statement as to the value of the plan's assets, the amount of benefit payments, and the ratio of assets to payments for the plan year;
 - A summary of the rules governing insolvent multiemployer plans; and
 - A general description of the benefits guaranteed by the PBGC.
- All of this information will have to be provided no later than two months after

Winners and Losers

Who wins? The legislation impacts 45 million Americans. It temporarily helps employers out of a funding dilemma. By assisting employers, Congress believes that rank-and-file employees also benefit by keeping jobs that would not be there if the business fails. All taxpayers also benefit since PBGC bailout money is not as likely to be required and more workers will stay employed and on the tax rolls. In addition, employees with pension benefits negotiated above guaranteed amounts (for example, airline pilot union members) benefit from their employers remaining solvent and in business. Employees participating in multiemployer plans also benefit. This group includes workers in key areas of economic growth, such as construction.

Who loses? Competitors of airline and steel companies specifically targeted for relief will face revitalized

businesses. Pension underfunding is concentrated in mature industries. Indirectly, "newer" industries such as high-tech, that have opted for defined contribution plans (401(k) plans, etc.) instead of traditional pension plans, won't share in \$80 billion that pension sponsors are estimated to save under the new law. The plight of smaller businesses that are required to continue to make DRCs while airline and steel companies are cut a break, is largely ignored. Unions representing employees in these "forgotten" industries have lost clout in not having more employees included in this "bail-out." Employees who would prefer to participate in a defined pension plan also generally lose since current circumstances serve as one more example to employers of how precarious a business's financial future can become as the result of being locked into required pension plan contributions.

the deadline, including extensions, for filing the plan's annual report for the plan year to which the notice relates.

PENDING TAX LEGISLATION

The coming presidential election is diverting lawmakers from completing work on several pending tax bills. President Bush, almost daily, calls on Congress to extend the tax cuts in the three big tax bills passed so far during his administration. His presumptive Democratic challenger, Sen. John Kerry of Massachusetts, is just as adamant that the Bush tax cuts have hurt, rather than helped, the economy. Against this backdrop, lawmakers haven't rushed to enact any new tax cuts.

FSC/ETI REPEAL, CORPORATE TAX CUTS AND BUSINESS EXPENSING

The U.S. is risking billions of dollars in trade sanctions unless it repeals the Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) regime, which the World Trade Organization has declared an illegal export subsidy. In its place, Congress has been considering tax cuts for manufacturers. House and Senate Republicans have tried to use FSC/ETI legislation as an election-year vehicle for other tax-related measures. So far, they have failed.

In its latest reincarnation in the Senate, the *Jumpstart Our Business Strength (JOBS) Bill* (S. 1637), includes not only FSC/ETI reform but enhanced expensing of business expenditures, tax shelter curbs, reform of Sales In, Lease Out (SILO) arrangements, and extensions of expiring tax provisions. Republican leaders are trying to attach about \$13 billion in energy tax incentives to the FSC/ETI bill in the hopes of passing both measures in one piece of legislation. Democrats, on the other hand, are trying to use the FSC/ETI bill to block the Labor Department from implementing new rules about overtime pay.

FSC/ETI repeal and foreign taxes. JOBS would repeal the FSC/ETI provisions of the Code and substitute tax incentives for manufacturers. Taxpayers would be eligible for a deduction equal to nine percent of income from qualified production activities. The deduction would be phased-in between 2004 and 2008. "Qualified production activities income," the bill explains, is an amount equal to the portion of the taxpayer's modified taxable income attributable to domestic production.

The bill also enhances the carryback and carryover of excess foreign tax paid. Code Sec. 904(c) would be amended to allow an up to 20-year foreign tax credit carryover.

International tax rules. JOBS would repeal the foreign personal holding company and foreign investment company rules. Foreign personal holding income would not include qualified income from the leasing or rental of any aircraft or vessel. It would also modify exceptions under Subpart F for active financing. Withholding tax on dividends from certain foreign corporations and the special capital gains tax on aliens present in the United States for 183 days or more would be repealed.

Business provisions. JOBS would expand the qualified small-issue bond program and enhance expensing of broadband internet access. Another key provision would modify the definition of active business interest under Code Sec. 355. Section 179 expensing would be increased and the five-year carryback of net operating losses enhanced.

The research credit, which is set to expire on June 30, 2004, would get an 18-month lease on life. The bill would extend the research credit through December 31, 2005. Taxpayers engaged in the production of films and television programs and manufacturing relating to timber would be eligible for enhanced expensing.

ENERGY TAX INCENTIVES

Last December, Congress came very close to passing a comprehensive energy bill with \$26 billion in tax cuts. A smaller ver-

sion of the energy bill gathered some bipartisan support early this year after Republicans agreed to eliminate some controversial provisions. It would cost about half of the original bill and include limited tax incentives for energy efficient homes and improvements. Energy producers would also receive some tax relief. Like FSC/ETI repeal, the energy bill seemed to lose steam early in the year over disputes about liability protection for makers of the fuel additive MTBE, which has been linked to cancer. While the chances of moving this bill forward looked slim only a month ago, the dramatic spike in gasoline prices may put a renewed sense of urgency back into the bill.

The energy provisions impact three major areas:

- (1) **Conservation.** The proposed law would be felt most directly by the majority of Americans through a handful of conservation tax incentives. These are aimed at encouraging the design and improvement of energy-efficient homes and green vehicles. The average business would benefit not only by selling these products to consumers but also by being rewarded for implementing energy conservation measures themselves through efficiencies in facilities and equipment.
- (2) **"Black out" prevention.** The unprecedented power blackout last August was the major reason Congress could muster the consensus to move ahead so quickly in an area filled with so many conflicting interests. The proposed legislation contains enhanced depreciation recovery, capital cost expensing, small refiner credits and other tax incentives to ensure development of more robust and reliable power grids.
- (3) **Energy production.** Individual and business taxpayers would also be expected to benefit from the tax incentives given directly to the fossil fuel industry and those who invest in its future. These tax provisions result in a hefty amount of

“required reading” for practitioners with clients in the oil, gas or coal industries. They focus not only on enhanced credits, but also on faster percentage depletion, alternative minimum tax protection, and extension of the nonconventional fuels credit.

The energy incentives proposed this year mirror almost identically the incentives in last year’s failed comprehensive energy bill. Many of the effective dates have been moved up to January 1, 2005. Some inflation adjustments have been eliminated and AMT relief has been restricted.

TAX SHELTERS

Proponents of tightening the rules to combat abusive tax shelters have been unsuccessful in passing stand-alone legislation. The latest version of the JOBS bill contains numerous provisions all targeted at tightening the registration and disclosure rules for tax shelter transactions.

The bill significantly increases penalties for failing to register and disclose tax shelters. Failure to include reportable transaction information with a taxpayer’s return or statement could result in a fine of up to \$100,000 if the transaction is on the IRS’s roster of “listed transactions.” Penalties would be enhanced for large entities, with gross receipts in excess of \$10 million, and high net worth individuals, whose net worth exceeds \$2 million. An accuracy-related penalty for reportable transaction understatements would also be imposed. It would equal 20 percent of the understatement. Taxpayers could avoid the penalty if they can show a reasonable cause for the understatement and they acted in good faith. If the transaction lacks economic substance, taxpayers would risk a 40 percent penalty. To raise revenue, the JOBS bill would place restrictions on SILOs.

In a controversial move, the JOBS bill would also statutorily de-

fine the economic substance doctrine. A transaction would have economic substance only if it changes in meaningful way (apart from federal tax effects) the taxpayer’s economic position and the taxpayer has a substantial non-tax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing the purpose. More specific rules would apply when the taxpayer relies on profit potential.

EXTENDERS

Some tax incentives have been around for so long they seem permanent, but they aren’t. When 2003 came to an end, a number of popular, but temporary, tax cuts expired. Others will expire in 2004. Lawmakers have tried to attach these expiring incentives to several bills. However, their efforts were unsuccessful generally because of opposition to the bills to which they were attached. Now, the extenders have been attached to the JOBS bill.

The following tax incentives would be extended, enhanced or expanded:

- Qualified zone academy improvement bonds;
- Professional educators’ classroom expense deduction;
- Environmental remediation expensing;
- Corporate donations of scientific property and computer technology;
- New York Liberty Zone benefits;
- District of Columbia homebuyers credit;
- Native American employment;
- Deductions for mutual life insurance;
- Cover over of tax on distilled spirits;
- Allowance of nonrefundable personal credits against AMT;
- Oil and gas from marginal wells;
- Business property on Native American reservations;
- Transfers of excess pension assets to retiree health accounts;
- Qualified electric vehicle credit; and
- Clean-fuel vehicle deduction.

The JOBS bill would also consolidate the Work Opportunity Credit with the Welfare-to-Work credit.

HIGHWAY BILL

About \$12 billion in tax incentives have been added to the House’s federal highway spending bill (H.R. 3550). House Republicans included the tax incentives, largely aimed at small businesses, to win support from Democrats for the bill. The House passed its version, including the tax incentives, on April 2. The Senate passed its version of a highway authorization bill in February. The House and Senate must reconcile their differing bills in a conference. Congress must pass a highway bill before April 30 or extend current authorization.

Targeting business taxpayers, H.R. 3550 would extend the increase in Section 179 expensing from the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (JGTRRA) two more years. JGTRRA increased small business expensing from \$25,000 to \$100,000 for property placed in service after 2002 and before 2006.

H.R. 3550 also impacts the AMT. The AMT exemption for business taxpayers would be boosted from \$7.5 million to \$20.5 million of annual gross receipts. According to lawmakers, expanding the AMT exemption would benefit more than 90 percent of businesses. Additionally, business taxpayers would be able to offset their AMT liability with net operating losses and foreign tax credits.

President Bush has indicated his displeasure with the cost of both the House and the Senate versions of the highway bill. Democrats are adamant that Congress pass a highway bill before the April 30 deadline. The fate of the highway bill, and the tax cuts, will depend on how well Democrats and Republicans can cooperate in a conference. Many Democrats are still upset that they were excluded from conference deliberations over last year’s energy bill and other bills.