

Professional Perspective

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Harold Ashner and Elliot Raff, Keightley & Ashner LLP

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Single-Employer Pension Plan Funding Relief: An Explanation for Non-Actuaries

Contributed by [Harold Ashner](#) and [Elliot Raff](#), Keightley & Ashner LLP

On March 11, 2021, President Biden signed into law the [American Rescue Plan Act of 2021](#), which, among many other things, provides much-needed funding relief for employers maintaining single-employer defined benefit pension plans. This article will explain the relief in context, equipping legal, human resources, and finance staff to have more productive discussions with their actuaries and leading to better informed strategic decisions.

ARPA provides two forms of general funding relief: enhanced interest rate stabilization and extended amortization of funding shortfalls. This will provide many employers with flexibility to smooth out funding obligations over longer time periods—flexibility that may be needed to avoid disruptive cost-cutting measures and, for some employers, to ensure the very survival of both the employer and the pension plan.

Enhanced Interest Rate Stabilization

The minimum required contribution (MRC) for a plan year is based to a significant extent on the interest rates used by the plan actuary to determine the present value of payments expected to be made in the future, as of the plan's annual valuation date (which is required to be the first day of the plan year, except for small plans). Higher interest rates lead to lower present values and, in general, lower MRCs, and vice versa. The historically low interest rates prevailing in recent years have led to ever-increasing MRCs for many employers.

Pre-ARPA Interest Rate Stabilization

Prior versions of funding relief were designed to provide interest rate smoothing by stabilizing the historically low interest rates so as to reflect interest rates over a 25-year period.

Both before and after the prior versions of funding relief were in effect, the rules called for determining an interest rate based on the average yield of high-quality corporate bonds over a recent 24-month period for each of three segments: a first segment rate based on corporate bonds maturing during the five-year period starting with the applicable month, a second segment rate based on corporate bonds maturing during the following 15 years, and a third segment rate based on corporate bonds maturing thereafter. Note that sponsors can also choose to use a traditional yield curve, but those sponsors don't benefit from interest-rate stabilization.

Funding relief stabilizes these three segment rates by increasing or decreasing each of them to come within a corridor surrounding the 25-year averages of those same corporate bond yields. The corridor was at 10% from the 2012 plan year (when these rules first went into effect) through the 2020 plan year, and was set to widen by 5% per year thereafter until reaching 30% for the 2024 plan year and thereafter.

Example 1: Assume that: (1) the first, second, and third segment rates based on the 24-month averages are 2%, 3%, and 4%, respectively; (2) the corresponding 25-year average rates for these three segments are 5%, 6%, and 7%, respectively; and (3) a 10% corridor applies. The three segment rates are each increased to 90% of the corresponding 25-year average rates, *i.e.*, to 4.5%, 5.4%, and 6.3%, respectively, to bring them within the 10% corridor.

Example 2: Assume the same facts as in Example 1, except that a 30% corridor applies. The three segment rates based on the 24-month averages are each increased to 70% of the corresponding 25-year average rates, *i.e.*, to 3.5%, 4.2%, and 4.9%, respectively, to bring them within the 30% corridor.

These examples show that when current rates are lower than historical rates, widening the corridor lowers interest rates, which generally pushes MRCs higher.

This structure led to significant funding challenges for many employers due to persistent historically low interest rates. The 25-year average has continued to drop each year as a high-rate year drops out from the back of the tail and a current low-rate year is added. This has reduced the effect of the stabilization rules on the segment rates every year, with that effect on

the verge of phasing out completely over the next few years in light of the scheduled widening of the interest rate corridor. As a result, many employers were facing much higher contributions at the same time they were grappling with the economic consequences of the COVID-19 pandemic.

ARPA Changes

ARPA addresses these issues by enhancing the interest rate stabilization structure already in effect in three ways.

- *Initial Narrowing of Corridor:* For the 2020 plan year, the 10% corridor is narrowed to a 5% corridor thus increasing interest rates.
- *Five-Year Deferral of Widening of Corridor:* The corridor will not begin to widen until the 2026 plan year, at which time it will widen to 10% and thereafter widen further by 5% per year until reaching 30% for the 2030 plan year and thereafter.
- *Establishment of 5% Floor on 25-year Average Rates:* Each of the 25-year average segment rates will be subject to a floor of 5%.

Example 3: Assume that: (1) the unadjusted first segment rate based on the 24-month average is 2%; (2) the corresponding 25-year average first segment rate is 3%; and (3) a 5% corridor applies. Without the 5% floor, the first segment rate would have increased from 2% to 2.85% (95% of 3%), but with the 5% floor, the first segment rate will increase from 2% to 4.75% (95% of 5%).

Example 4: Assume the same facts as in Example 3, except that the corridor is 70%. Without the 5% floor, the first segment rate would have increased from 2% to 2.1% (70% of 3%), but with the 5% floor, the first segment rate will increase from 2% to 3.5% (70% of 5%).

Effective Date and Employer Options

These provisions are generally effective starting with the 2020 plan year. However, a plan sponsor can elect to have these provisions *not* apply to any pre-2022 plan year, either for all purposes or solely for the purpose of determining the plan's funding level under the rules governing benefit restrictions.

- *What is clear:* Plan sponsors can elect to have these provisions not apply for any purpose for the 2020 and 2021 plan year, or apply for minimum funding but not benefit restriction purposes for both the 2020 and 2021 plan years.
- *What is not clear:* It is not clear whether a plan sponsor can elect to have these provisions: (1) not apply for the 2020 plan year and then apply for the 2021 plan year; (2) apply for the 2020 plan year and then not apply for the 2021 plan year; or (3) apply for different purposes for the 2020 and 2021 plan years.

Electing to apply the ARPA provisions for a plan year for MRC but not benefit restriction purposes will be helpful for plan sponsors that want the minimum funding relief for the applicable plan year but do not want to try to reverse benefit restrictions previously imposed for that year under pre-ARPA law.

Extended Amortization of Funding Shortfalls

The MRC for a plan year generally consists of the sum of: (1) the plan's "target normal cost" for the plan year (generally, the present value of benefits expected to accrue or to be earned during the plan year and the amount of plan-related expenses expected to be paid from plan assets during the plan year); and (2) the plan's "shortfall amortization charge" for the plan year. For most plans, and particularly for frozen plans, the shortfall amortization charge represents the lion's share of the MRC.

Pre-ARPA Shortfall Amortization Charge

Pre-ARPA law generally calls for amortization of funding shortfalls over seven years, with the rules leading to the development of the above shortfall amortization charge, as briefly explained below (the following assumes that the plan has a funding shortfall at all relevant times).

- The *Shortfall Amortization Base* for a plan year is, in effect, the funding shortfall in the plan that remains after accounting for the unamortized portion of prior shortfalls, *i.e.*, the current year's base is the total shortfall reduced by the present value of the outstanding amortization installments from prior plan years.
- The *Shortfall Amortization Installments* are the annual amounts needed to amortize the shortfall amortization base for a plan year over seven plan years, with each of those installments becoming part of the MRC for that plan year and the following six plan years.
- The *Shortfall Amortization Charge* for a plan year consists of the sum of all shortfall amortization installments that apply to that plan year (generally, the installments needed to amortize the shortfall amortization bases for that plan year and for each of the preceding six plan years).

ARPA Changes

ARPA calls for significant changes to the rules governing the determination of the shortfall amortization charge, as follows (again, assuming the plan has a funding shortfall at all relevant times).

- *Fresh Start*: For the first plan year these ARPA provisions apply (see below), all pre-ARPA shortfall amortization bases are reduced to zero, thereby eliminating all of the related shortfall amortization installments.
- *ARPA Full Funding Shortfall*: The plan actuary determines the initial shortfall amortization base (the total funding shortfall for the plan) as of the valuation date for that first plan year.
- *Initial 15-Year Amortization*: That shortfall amortization base is amortized through 15 (not just seven) annual shortfall amortization installments that apply to that first plan year and the following 14 plan years. The first installment becomes the shortfall amortization charge for that first plan year.

For all later plan years, the pre-ARPA rules continue to apply, but with the amortization schedule (as it does for the first plan year these ARPA provisions apply) calling for 15-year amortization rather than just seven-year amortization. The use of 15-year amortization schedules under ARPA in lieu of the pre-ARPA seven-year amortization schedules will result in far less volatile (and lower) minimum funding requirements.

Effective Date and Employer Options

The ARPA changes to how funding shortfalls will be amortized go into effect starting with the 2022 plan year. However, a plan sponsor can elect to have these new rules start instead with the 2019, 2020, or 2021 plan year. This flexibility may be helpful to plan sponsors in various circumstances, including where an election to start 15-year amortization for a pre-2022 plan year reduces MRCs for a current or prior plan year, or where the plan had no MRC with or without 15-year amortization for a prior plan year and leaving that plan year as is obviates the need to redo one or more old valuations.