Pension Funding Relief – Beware of the Excess Compensation Adjustment

As readers may know, pension funding relief, in the form of the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (Funding Relief), is now law. So far, most of the analysis of this law has been positive, with a focus on the cash management opportunities afforded to plan sponsors.

While there is some cash flow “relief” for plan sponsors in the new law, some of the adjustments could have a more detrimental effect than many have realized. In this article, we focus on the adjustments to required contributions regarding excess compensation.

Background

Generally, Funding Relief allows plan sponsors to elect an alternative shortfall amortization schedule with respect to any two of three plan years (a very limited number of sponsors also have access for the 2008 plan year) beginning in 2009, 2010, and 2011.

As we discussed in our initial article on Funding Relief, the benefit is that instead of using the standard, 7-year amortization schedule of shortfall amortization bases, Funding Relief would let plan sponsors choose a 15-year amortization schedule or a schedule under which they pay interest only for 2 years and then amortize the outstanding balance over the next 7 years.

Funding Relief requires sponsors to increase those amortization amounts in three specific circumstances:
- payment of extraordinary dividends,
- stock redemptions, or
- excess compensation.

Excess Compensation Increase

The sum of these increases, should they occur, is known as an installment acceleration amount. Each acceleration amount would increase the relief amortization amount by an amount not to exceed the cumulative reduction due to application of either the 15-year schedule or the “2+7” schedule.

As the law is written, though, a company may – pending IRS interpretation – have to match excess compensation twice. For example, suppose a company elects alternative amortization schedules for the 2010 and 2011 plan years, and the company pays excess compensation of $1 in 2012. The amount of excess compensation attributable to 2012 will result in a $1 increase to the amortization payments with respect to both the 2010 and 2011 plan years, or a $2 increase to the required contribution for each $1 of excess compensation.

Initially, observers of the new law thought that excess compensation would not be a troublesome provision, because companies can control what they pay their employees. But more careful examination shows that this may not be the case.
Pension Funding Relief – Beware of the Excess Compensation Adjustment

Funding Relief specifies that excess compensation, oversimplified a bit, is compensation paid to an employee during a calendar year. For this purpose, compensation is defined in Code Chapter 1 – in other words, (virtually all) taxable income. So, presumably, this would include various types of imputed income.

More troubling, however, is that it would include income from equity compensation (with a few exceptions), making the amount of compensation dependent on systemic market fluctuations, etc.

Let’s look at the magnitude of this potential increase in required installment. As we understand it, a plan sponsor considers all of its employees with U.S. taxable income. For any employees for which that amount exceeds $1 million (excluding income for services rendered before March 1, 2010, certain amounts subject to a binding written agreement in place before March 1, 2010, and any amounts in the nature of commissions), the excess contributes to the installment acceleration amount.

Additionally, amounts set aside in trusts to fund nonqualified deferred compensation, such as rabbi trusts, are considered income for this purpose. The amount of the increase in the required installment is equal to the sum of the excess compensation with respect to all employees, subject to the cap mentioned earlier. Any amounts not included in an increase for the year (because they exceed the cap) are carried over to the next year.

Problematic Situations

A few situations might be particularly problematic. First, consider a company that pays its Chairman $1 million in base pay in 2012, but also awards him or her a bonus of $10 million in restricted stock. The Chairman makes a so-called 83(b) election to pay taxes on that restricted stock immediately in order to avoid the taxes on appreciation in the share value. Then, for 2012, the Chairman has $10 million in excess compensation for 2012. In our second scenario, a plan sponsor compensates employees who are eligible for a long-term incentive plan with annual grants of stock options. In 2013, the company stock appreciates significantly, and most of the highest-paid employees exercise all of their vested options. In this case, the income from all of those options (with a few exceptions) will be considered in determining whether there is excess compensation and what the magnitude of that excess compensation would be.

Reports indicated that bill sponsors felt that when a company was doing well enough to pay excess compensation to its employees, it was doing well enough to fund its pension plan closer to PPA rules. But in the scenario above, the excess compensation may not result from sudden cash availability, but rather from some external forces over which the sponsor may not have control.

Similar scenarios may come to mind that are a concern under this new Funding Relief regime. For planning purposes, though, all raise potential problems from the standpoint of cash management.
Pension Funding Relief – Beware of the Excess Compensation Adjustment

How Sponsors Can Plan

Proper evaluation of the effects of funding relief elections entails more than evaluating the two alternative schedules. One should also consider the potential adjustments or increases, particularly due to excess compensation. Such a study should look at the effects of variations in stock price and exercise behaviors.

Involvement of both the Finance and Human Resource functions will be important in analyzing the situation. As a leading provider of both equity compensation valuation services and defined benefit actuarial services, Aon is well positioned to help. Plan sponsors should contact their Aon consultant to discuss next steps.

For more on retirement plan strategies, contact John Lowell at 404.264.3088