FASTEN YOUR SEAT BELT. WE ARE ENCOUNTERING PENSION TURBULENCE.

An Analysis of Proposed Pension Legislation for Airlines

By

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The airline industry continues to struggle. In addition to their other woes, the mainline carriers are saddled with tremendous unfunded pension liabilities. Earlier this year the Pension Benefit Guaranty Corporation ("PBGC") took over USAirways' pension plans.[1] Then a few weeks ago, a bankruptcy court approved the termination of United Airlines' pension plans. Combined these unfunded liabilities totaled $12.3 billion, according to PBGC.

Investors question how the remaining mainline carriers will deal with their unfunded pension liabilities. Significantly, the cash contributions required to fund these ongoing pension plans in the near term may push one or more of these carriers to the brink.

Airlines	**2005 Required Cash[2]**	**2002-2004 Operating Loss**
Delta Airlines	$285 million	($5.4 billion)
Northwest Airlines	$420 million	($1.6 billion)
Continental Airlines	$266 million	($338 million)
American Airlines	$310 million	($4.3 billion)

If these carriers are unable to continue their pension plans, PBGC, as the Federal agency which insurers company-sponsored defined benefit pension plans, must step in and assume the plans. This is not a good solution for anyone:

- PBGC reported a $23.3 billion deficit as of September 30, 2004. Congress has questioned how many more liabilities PBGC can absorb before it needs a taxpayer bailout.

- The airlines' employees and retirees lose because PBGC limits the amount of pension benefits participants can receive. For plans terminating in 2005, the maximum annual benefit PBGC will pay a plan participant retiring at age 65 is $45,614.[3] For employees who retire earlier, the maximum pension is reduced. This is particularly pronounced for pilots who, under Federal law, must retire at age 60. That pension benefit is $29,649 annually.

- Companies lose since the typical method for terminating a pension plan occurs in the bankruptcy arena, which is an expensive and time consuming endeavor. And they have to deal with PBGC's claim for the plan's underfunding. This could involve litigation all the way to the Supreme Court.

While the Administration has acknowledged that the defined benefit pension system is broken and needs an overhaul, their proposed solutions appear to exacerbate many of the existing flaws in the current system.

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[1] PBGC previously became trustee of the US Airways' pilots pension plan in 2003.
[2] The companies expect 2006 required contributions to exceed 2005 amounts.
[3] PBGC's guarantee covers basic pension benefits only. Additionally, PBGC does not pay lump sums in excess of $5,000.

Problems with the airline industry and their underfunded pension plans are not new. Congress previously enacted the Pension Funding Equity Act of 2004, which among other pension changes, provided certain relief to the pension plans sponsored by commercial passenger airlines for up to two years.[4] However, this legislation is scheduled to expire.[5]

Against this backdrop, on April 20, 2005, Senators Johnny Isakson (R-GA) and John Rockefeller (D-WV) introduced legislation, S. 861 the "Employee Pension Preservation Act of 2005", which would permit commercial passenger airlines to stretch out payment of certain pension liabilities over 25 years.

Some argue that special exemptions for industries are protectionism and interfere with the natural order of the capital markets. Others point to the long-term nature of pension promises and the stunning $13 billion of underfunding[6] and contend that some breathing room is necessary for an industry under siege.

This article will discuss how S.861, if enacted, will operate.

Generally speaking, the annual amount of cash required to be contributed to a pension plan consists of normal cost (the cost of the benefits earned during the year), an amortization payment of past service liabilities, and interest.

Past service liabilities arise when benefits are credited retroactively for service before the plan was created and retroactive benefit enhancements added by plan amendments.

The last significant pension legislation, the Retirement Protection Act of 1994 ("RPA"), accelerated the funding of past service liabilities if a plan was not well funded. These accelerated funding payments are called deficit reduction contributions ("DRC").[7]

RPA designed a funding test to determine if a plan would be subject to the DRC. If a pension plan's fair market value of assets to current liabilities ratio is at least 90%, no DRC payment is required. If the ratio of plan assets to current liabilities is less than 90%, there is a three year look back period. If this ratio is at least 80% for any two consecutive years in the look back period, no DRC payment is required. Otherwise, there is a DRC payment.

A DRC payment accelerates the funding of past service liabilities by adjusting the amortization period from 30 years to as few as 7 years. Consequently, a plan subject to the

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[4] In addition to commercial passenger airlines, the relief is also applicable to certain companies in the steel/iron ore industries. Generally, the legislation provided companies with the option to fund just 20% of their deficit reduction contribution amounts in exchange for restrictions on benefit increases.

[5] The legislation is applicable for any plan year beginning after December 27, 2003 and before December 28, 2005.

[6] These amounts for American, Delta, Northwest, and Continental were calculated in accordance with generally accepted accounting principles. PBGC computes the funded status of a pension plan on a termination basis, which results in significantly greater underfunding amounts.

[7] While the DRC existed in previous legislation, RPA substantially strengthened the DRC funding required for certain pension plans.

DRC will require significantly more cash contributions than a plan not subject to these accelerated payments. It is these DRC payments that the airline industry is struggling with.

S. 861 provides for an alternative calculation of minimum funding to assist commercial passenger airlines in managing their pension liabilities through the creation of a new subjection "o" of the Internal Revenue Code ("IRC") § 412 and a "transition" funding standard account.[8]

The pension plans of commercial passenger airlines have the option to elect to be subject to IRC § 412(o) on a plan by plan basis. Additionally, a plan can choose when it will become subject to these new funding rules. Once the plan sponsor makes the election, it is irrevocable.

As of the first applicable plan year, the plan must cease accruals and remain frozen. Participants may not earn credit for subsequent service or compensation earned.[9]

How will IRC § 412(o) work?

Funding

As of the first applicable plan year, the existing amortization bases and credit balance, if any, will be reduced to zero. Annually, the plan will compute the amount of unfunded accrued liability determined as of the first day of the plan year. For purposes of this calculation, assets shall be measured at their fair market value.[10] Liabilities shall be computed using the unit credit funding method.[11] The difference between the assets and the liabilities is the amount subject to the 25-year amortization. The transition funding standard account will be charged with the amount necessary to amortize this underfunded amount in equal annual installments over the 25-year amortization period.

In each subsequent plan year, the unfunded accrued liability is recalculated as of the first day of that plan year, that recalculated unfunded liability is amortized in equal annual payments over the remaining number of years of the 25-year period and the amount attributable to the current year is the current plan year charge to the transitional funding standard account for that plan year.

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[8] The funding standard account is the account through which the various pension credits and debits are charged. Netting these credits and debits determines the amount of required minimum funding.

[9] The legislation also includes an "anti-gaming" provision that prohibits plan amendments which increase liabilities due to increasing benefits, changing the rate of benefit accruals, or changing the rate benefits become nonforfeitable between the time the legislation is enacted and first applicable plan year. This is designed to prohibit plan sponsors from trying to "beat the clock" by providing additional benefits and then electing this special funding methodology. One exception is included in the legislation. A plan may otherwise increase benefits provided the transition funding standard account is charged with the entire amount of the expected increase in accrued liability for benefits accruing during the plan year attributable to the increased benefits. For purposes of valuing the accrued liability, the unit credit funding method must be used.

[10] The transition funding standard account shall be credited with amounts considered contributed by the employer (i.e. receiveables).

[11] Under the unit credit funding method, contributions are due as benefits accrue (i.e. a "pay as you go" system).

No Full-funding Limitation
The legislation excludes the full-funding limitation section, IRC § 412(c)(7), from transition funding standard accounts.

A plan which is at the full-funding limitation is, in theory, considered well funded. Consequently, such a plan is not subject to the deficit reduction contribution. Additionally, a plan sponsor is curtailed in contributing additional funds into the plan. Under certain circumstances, the plan sponsor can contribute non-deductible contributions, but these are limited.

In practice, a plan can be subject to the full-funding limitation even if it is not particularly well funded due to the plan's actuarial assumptions, methods, and market interest rates.

Removing this limitation from applicability ensures that the pension plans of commercial passenger airlines receive the necessary and important pension contributions.

Limitations on Deductibility
For a variety of reasons, including the example discussed above, a plan sponsor may be unable to make tax deductible contributions into its pension plan. This legislation ensures that all amounts needed to be contributed to these commercial passenger airline pension plans will be tax deductible. This is accomplished by adding a clause (v) to IRC § 404(a)(1)(D) which states that the maximum amount deductible shall be the amount paid into the plan.

Additionally, deductibility may be limited when a sponsor maintains one or more defined benefit pension plans and one or more defined contribution plans. In these situations, the total amount deductible in a taxable year to all plans is generally limited to 25% of compensation paid or accrued to the plan participants. The legislation ensures that this 25% threshold does not artificially impede necessary funds from being contributed into these significantly underfunded pension plans. This is achieved by disregarding these contributions when determining the 25% threshold test pursuant to a new clause (iii) added to IRC § 404(a)(7)(C).

Interest on Underpayments
If a plan operating under IRC § 412(o) experiences a pension underpayment, the proposed legislation is unclear as to the interest rate charged on this missed amount. Generally, IRC § 412(m)(1) governs this issue[12] and provides that if a plan fails to pay the full amount of an installment payment, the rate at which interest accrues on this missed amount is the greater of 175% of the Federal mid-term rate or the rate used under the plan in determining costs (which is the IRC § 412(b) rate).[13]

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[12] This subsection is applicable to plans which have a funded current liability ratio of less than 100% as measured as of the preceding plan year.
[13] The interest rate established in IRC §412(b) is the rate within the "permissible range" used to value plan liabilities. Currently the "permissible range" is any interest rate which is not above or 10% below the 4-year weighted average long term investment grade corporate bond portfolio. In today's markets, the "permissible range" is 5.38% -5.97%; while the § 412(m) rate is 6% for the calendar quarter April 1, 2005-June 30, 2005.

The uncertainly arises as the proposed legislation states that interest on underpayments should be charged at the rate determined under IRC § 412(b), which seems to imply that IRC § 412(m)(1) does not govern for plans operating under this special legislation. However, the legislation does not exclude IRC § 412(m) from applicability, which is vital given that it details the timing and amounts of installment payments as well as liquidity shortfall payments.

If IRC § 412(m)(1) continues to be binding, there is no change to how interest penalties are calculated. On the other hand, if the rates used under IRC § 412(b) control, the legislation does not enumerate why a commercial passenger airline being provided with unique pension flexibility should also benefit from lower interest rates on missed pension payments.

Successor Plans

To ensure that a plan sponsor does not unfairly take advantage of this special pension funding while providing additional pension benefits to its plan participants via one or more other defined benefit plans, the legislation allows the Secretary of the Treasury to disqualify the pension trusts of the other pension plans unless all benefit obligations of the plan subject to this legislation have been satisfied. This is accomplished by adding a new paragraph (35) to IRC § 401(a).

Specifically, the proposed language prohibits an employer from utilizing one or more other defined benefit plans that in combination provide benefit accruals to any substantial number of successor employees. A "successor employee" is an employee who is/was covered by a plan subject to this legislation and an employee who performs substantially the same type of work with respect to the same business operations as an employee covered by the plan subject to this legislation.

This seems fair. If a company is taking advantage of these special funding rules, it should not be able to create additional liabilities. In other words, it should pay off what it owes first.

Notice

If a plan amendment is necessary in order to comply with the provisions of this legislation (e.g. freezing the plan), any participant notice required under ERISA § 204(h), Notice of Significant Reduction in Benefit Accruals, needs to be provided to participants at least 15 days before the effective date, provided the plan is maintained pursuant to one or more collective bargaining agreements.[14]

The IRS issues the 4-year corporate bond weighted average interest rate and the "permissible range" monthly. PBGC issues the interest rate used to compute underpayments quarterly.

[14] This legislation reduces the amount of notice time required for plans subject to collective bargaining agreements. The standard time required under ERISA § 204(h) for a notice to participants for plans (other than small plans and multiemployer plans) is 45 days before the effective date.

PBGC

So far we've discussed how this proposed legislation may impact employers and plan participants. How will PBGC fare? Is this approach fair to the overall pension system or will it require healthy companies with ongoing pension plans to subsidize their faltering airline counterparts?

Importantly, PBGC's guarantee is limited by S. 861 so that PBGC is not incrementally exposed during this amortization period. ERISA § 4022 sets out the road map for how PBGC computes plan participants' guaranteed benefits when a plan terminates. The proposed legislation would add paragraph (8) to ERISA § 4022(b) which states that ERISA § 4022(b)(1), (3), and (7) are applied as if the plan terminated on the *first day of the first applicable plan year.*

ERISA § 4022(b)(1) explains that benefit increases provided by a plan which have been in effect for less than 60 months at the time the plan terminates and any increase in the amount of benefits resulting from a plan amendment within 60 months before the plan is terminated shall not be guaranteed. Instead, ERISA § 4022(b)(7) provides a phase-in schedule for benefits in effect for less than 60 months prior to termination.

The amount of the guarantee for these types of benefits is the greater of $20 per month or 20% of the benefit times the number of years in existence. (For example, a plan amendment in place 3 full years prior to termination would be phased-in 60%, 20% times 3).

This provision in the legislation disregards any passage of time between the first day of the first applicable plan year and the day when the plan terminates, if any, when calculating the guaranteed benefits.

ERISA § 4022(b)(3) pertains to the maximum annual benefit PBGC will pay a plan participant and is based on the year the plan terminates.[15] This maximum is adjusted annually due to changes in the Social Security contribution and benefit base.

By requiring PBGC to compute its guarantee based on the first day of the first applicable plan year, the legislation is removing the incremental indexed amounts from the maximum benefit.

These limitations, in effect, remove the risk to PBGC of the plan remaining ongoing.

Lump Sum Payments and Annuity Purchases

There are two considerations not addressed in S. 861 which could be significant to neutralizing PBGC's risk, namely the payment of lump sum benefits and the purchase of annuities.

Assume the relief provided by this legislation is insufficient and the plan terminates at some date after the first day of the first applicable plan year. If, during this time period, the plan

[15] As previously mentioned, for plans terminating in 2005, the current annual benefit for a participant retiring at age 65 is $45,614.

paid out lump sum benefits, then participants may have received significant amounts of non-guaranteed benefits. This is a particularly realistic scenario for pilot participants because pilots' pensions are generally well in excess of PBGC's guaranteed amount. Of course, participants would also receive non-guaranteed benefits if they receive their pensions via monthly annuities; however, the amounts paid monthly in excess of PBGC guarantees is significantly less.

If a plan continued to pay participants lump sums and the plan subsequently terminated, PBGC could argue that it was harmed because too many plan assets were used to pay non-guaranteed benefits.

A similar analogy occurs with the purchase irrevocable commitments (i.e. annuities). If a plan were to purchase annuities for certain participants, they would receive both guaranteed and non-guaranteed benefits. The plan assets would be reduced, perhaps significantly. If the plan subsequently terminated, PBGC could again argue that it was harmed because too many plan assets were used for purchasing non-guaranteed benefits.

A potential solution, albeit perhaps not a popular one with plan participants, is to require plans which elect to participate under S. 861 funding to pay benefits in the form of annuities paid monthly from the plan and to prohibit the purchase of full or partial annuities.

Given PBGC's experience with United Airlines and USAirways, it is likely that, absence a significant and immediate improvement in airline economics, one or more mainline carriers will be unable to afford their pension liabilities and PBGC will assume them.

Instead, if a plan remains ongoing under S. 861, no additional liabilities will be created but additional funds will be added to the plan. Absent a decline in the market value of plan assets, the amount of underfunding should decline and the plan should become better funded.

What if the worst case occurs and the company is unable to continue the plan after a few years? PBGC's guarantee reverts back to the date the plan adopted S. 861, meanwhile the plan has fewer liabilities and greater assets. PBGC suffers a smaller loss. To the extent that PBGC absorbs a smaller loss in the future, rather than a larger loss in the near term, its financial position improves and this benefits all plan sponsors.

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