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AMERICAN RESCUE PLAN ACT OF 2021 – SINGLE EMPLOYER PENSION FUNDING PROVISIONS

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The American Rescue Plan Act of 2021 ("Act") provides funding relief for single employer pension plans in the form of interest rate stabilization and extending the period for amortizing funding shortfalls.

Extension of Amortization Period for Funding Shortfalls

The "shortfall amortization charge" oftentimes represents a significant portion of the annual minimum required contribution ("MRC") that is required to be made to a single employer pension plan. The shortfall amortization charge is a function of the "shortfall amortization installments" and the "shortfall amortization base." The shortfall amortization base for a plan year is generally equal to the plan's funding shortfall, minus the present value of any outstanding amortization installments for prior plan years. Meanwhile, the shortfall amortization installments represent the amount necessary to amortize the shortfall amortization base for any plan year in level installments over seven years – in other words, the shortfall amortization base for the current plan year becomes a part of the MRC for that plan year and for each of succeeding six plan years.

The Act provides for significant changes to the development of the shortfall amortization charge. It provides for a fresh start, where shortfall amortization bases for plan years preceding the 2022 plan year (or, at the election of the plan sponsor, the 2019, 2020 or 2021 plan years) are reduced to zero. Thus, a plan's actuary will determine an initial shortfall amortization base for the 2022 plan year (or such earlier year elected by the plan sponsor). The newly determined shortfall amortization base will then be amortized over 15 years, rather than over seven years as provided for under pre-Act law.

Accordingly, the changes made by the Act have the effect of lengthening the period for amortizing the shortfall amortization base and, therefore, resulting in lower MRC's.

Interest Rate Stabilization

The MRC for a plan year is highly dependent on the interest rates used by the plan's actuary. The lower the interest rate, the higher the MRC. Historically low interest rates in recent years have resulted in plan sponsors facing seemingly endless increases in their MRC's.

In developing the interest rate, the plan's actuary looks at average yields on high-quality corporate bonds over a 24-month period for three segments. The first segment rate applies to benefits reasonably determined to be payable during the next five years and is based on corporate bonds maturing during the five-year period. The second segment rate applies to benefits reasonably determined to be payable during the following 15 years and is based on corporate bonds maturing during this 15-year period. Lastly, the third segment rate applies to benefits reasonably determined to be payable following the end of the 15-year period and is based on corporate bonds maturing after the end of the 15-year period.

Pre-Act rules were intended to smooth interest rates by applying a corridor to average interest rates on high-quality corporate bond yields over a 25-year period. These rules stabilized the segment rates by increasing or decreasing those rates to be within a corridor of the 25-year averages. Through the end of the 2020 plan year, the corridor was set at 10%, but was then set to widen by 5% per year until reaching 30% for the 2024 plan year. Because current interest rates are lower than 25-year average interest rates, the widening of the corridor would cause MRC's to increase.

The Act modifies the interest rate stabilization rules in several respects. The corridor for the 2020 plan year and continuing through the 2025 plan year is set at 5%. Beginning for the 2026 plan year, the corridor will increase by 5% each plan year, until it reaches 30% for the 2030 plan year. In addition, the Act provides for an interest rate floor of 5% on the average 25-year rates.

The Act provisions are generally effective for the 2020 plan year, though a plan sponsor may elect not to apply the rules for any plan year preceding the 2022 plan year, either for all purposes or solely for purposes of the benefit restriction rules under Section 436 of the Internal Revenue Code.