

COVID-19: A look at minimum required contributions for single employer defined benefit plans

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COVID-19 has precipitated short- and long-term economic responses that will continue to unfold, but in the meantime, employers have questions regarding IRS minimum required contributions (MRCs) for their defined benefit (DB) plans. These questions include:

- What if a significant number of active participants are terminated?
- What if plan amendments are adopted to freeze benefit accruals?
- What if participants have to work longer because they cannot afford to retire?
- What will happen if asset returns are much lower than expected?
- What will be the impact if interest rates remain historically low?
- What relief is available for funding the MRC?

This article first summarizes the components that feed into the MRC calculation and then addresses these questions.

What comprises the MRC (IRS Code Section 430)?

Normal cost is equal to:

- The present value of all benefits expected to accrue or be earned during the plan year plus
- Administrative expenses expected to be paid out of the plan during the plan year

One component of the MRC accommodates how asset performance and liability experience in the prior year deviated from

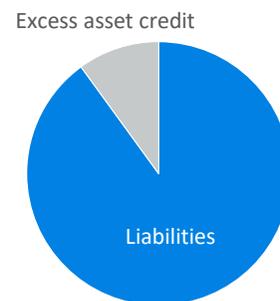
Normal cost
+ Shortfall amortization charge
- Excess asset credit
Minimum required contribution

expected results. The plan's funding shortfall is equal to the excess of liabilities over plan assets. In any given year, changes in the funding shortfall are amortized over seven years. The total shortfall amortization charge is the sum of any outstanding previous amortizations plus the shortfall amortization for the current year.

Excess asset credit is the excess of assets over liabilities.

If the plan's funded percentage (i.e., the ratio of plan assets to liabilities) is greater than 80%, an employer may elect to satisfy the MRC by using credit balances (prefunding balance or carryover balance) instead of making cash contributions. A credit balance is any contribution in excess of the MRC accumulated with interest. Excess contributions do not automatically increase the credit balance. For any given plan year with an excess, an employer needs to elect to add such excess to any credit balance that may have existed from prior plan years.

FIGURE 1: TOTAL ASSETS



How will COVID-19 affect MRC?

While we cannot predict with certainty, we can consider how possible changes may offset each other to some extent in calculating the MRC.

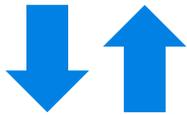
ACTIVE PARTICIPANT POPULATION



If a significant number of active participants become **non-vested or vested terminated participants** without being replaced by new hires, we can expect the normal cost to possibly decrease. Each year, normal cost is equal to benefits accrued by active participants plus administrative expenses. When active participants terminate employment, their portion of the normal cost is eliminated. This may reduce total normal cost and the MRC, depending on the benefit accrual basis and which participants terminate. If accruals are based on hours or compensation and the remaining population of participants is biased towards those with higher hours or compensation, the normal cost might not decrease. Note that if the MRC is reduced, but active participant counts increase again in future years, so will the MRC.



If more than 20% of the active population is laid off, a DB plan has to examine if the reduction meets the metrics of a **partial plan termination** (IRS Revenue Ruling 2007-43). IRC Section 411(d)(3) provides that in the event of a partial plan termination, non-vested or partially vested participants who terminate during the plan year of partial termination are automatically 100% vested in their accrued benefit regardless of the plan's vesting schedule, to the extent they are funded when valued on a termination basis. The effects will be similar to those outlined above.



A certain percentage of actives that were expected to retire may choose to continue working and **defer retirement** until they have experienced some level of financial recovery.

This could translate into an increase in normal cost during the recovery period because benefit accruals are higher for participants who are older and closer to retirement. However, the additional benefits accrued might be offset by unclaimed early retirement subsidies if they are included in the plan provisions.

PLAN AMENDMENTS



Plan amendments to soft or hard freeze benefit accruals might need to be adopted to assist employers in managing the financial effects of COVID-19. A soft freeze will not result in immediate reductions in the MRC, while a hard freeze will immediately reduce or eliminate the normal cost portion of the MRC, depending on the timing of the amendment. A soft freeze will limit future accruals to current active participants, not allowing new entrants into the plan. In this case, the normal cost will gradually decrease over time as participants terminate employment or retire from the plan. A hard freeze of benefits eliminates future benefit accruals for all participants.

ASSETS



Adverse investment performance as a result of COVID-19 will result in an increase in MRC. For single employer plans, asset returns that are less than expected will increase the funding shortfall for the following plan year. As a result, the shortfall amortization and resulting MRC will increase.

LIABILITIES



When interest rates decrease, liabilities for fixed future benefit payments will increase, thus causing a liability loss. So far, COVID-19 has caused interest rates to plummet to historical lows. Barring legislative relief, this will cause higher liabilities and an increase in MRC.

Funding relief

The CARES Act, signed into law on March 27, 2020, allows for the deferral of MRCs until January 1, 2021, increased with interest. While this addresses possible challenges with cash flow during the 2020 plan year, it does not provide any relief for the amount that is due to be paid. Some other portions of the law that affect DB plans have to do with delayed filing deadlines.

In May 2020, proposed legislation was included in the HEROES Act that may provide some relief for plan sponsors with a high legacy cost in that it eliminates all prior shortfall bases and increases the amortization period for shortfall from seven years to 15 years. This would be somewhat similar to the relief provided in response to the 2008 global financial crisis. However, the 2008 relief provision did not include the fresh start approach for the shortfall amortization bases and limited the use of the 15 year amortization to the subsequent two plan years. The proposed legislation takes into consideration some of the items requested by the American Benefits Council in a letter sent to the House of Representatives on April 7, 2020. As of the date of this publication, the HEROES Act was passed by the House and is awaiting discussion in the Senate.

Conclusion

While we cannot predict the implications of COVID-19 for employers and their DB plan MRCs, we can consider how potential consequences may trickle down into the MRC calculation for current and future plan years. The effects of COVID-19 may increase or decrease MRCs. If the excess asset credit or prefunding balance are greater than the sum of normal cost and shortfall amortization charge, the above fluctuations will only occur behind the scenes and not translate into contributions required to be paid by the employer.

In response to the intense economic (and personal) hardships brought about by COVID-19, we have seen a flood of new legislation, both proposed and already signed into law. The enacted CARES Act and proposed HEROES Act include some relief for employers as they face a possibly long period of economic recovery. What will be the overall impact of COVID-19 on MRCs? Only time will tell.

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