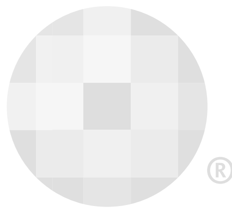
Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

Pension Funding Relief Brings with It Increased PBGC Premiums



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On July 6, 2012, the President signed the Moving Ahead for Progress in the 21st Century Act, often referred to as the Highway Bill (H.R. 4348), as it provides funding for federal highway and surface transportation. This Act contains four provisions that impact defined benefit plans, some of the provisions for the better and some not (as they fall into the category of key revenue raisers). These provisions include (1) pension funding stabilization, (2) PBGC premiums, (3) improvements of PBGC, and (4) transfers of excess pension assets, which are summarized below, along with a general background on the current minimum funding rules.

Background

Defined benefit plans generally are subject to minimum funding rules that require the sponsoring employer generally to make a contribution for each plan year to fund plan benefits. Parallel rules apply under the Employee Retirement Income Security Act of 1974 (ERISA), which is generally under the jurisdiction of the Department of Labor. The minimum funding rules for single-employer defined benefit plans were substantially revised by the Pension Protection Act of 2006 (PPA).

In general, the minimum required contribution for a plan year for a single-employer defined benefit plan depends on a comparison of the value of the plan's assets, reduced by any prefunding balance or funding standard carryover balance ("net value of plan assets"), with the plan's funding target and target normal cost. The plan's funding target for a plan year

is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is generally the present value of benefits expected to accrue or to be earned during the plan year.

If the net value of plan assets is less than the plan's funding target, then the plan has a funding shortfall, and the minimum required contribution is the sum of the plan's target normal cost and the "shortfall amortization charge" for the plan year. The shortfall amortization charge for a plan year is the sum of the annual shortfall amortization installments attributable to the shortfall bases for that plan year and the six previous plan years. Generally, if a plan has a funding shortfall for the plan year, a shortfall amortization base must be established for the plan year. A plan's funding shortfall is the amount by which the plan's funding target exceeds the net value of plan assets. The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases for the six previous plan years. The shortfall amortization base is amortized in level annual installments ("shortfall amortization installments") over a seven-year period beginning with the current plan year and using the segment interest rates.

The shortfall amortization base for a plan year may be positive or negative, depending on whether the present value of remaining installments with respect to amortization bases for previous years is more or less than the plan's funding shortfall. If the shortfall amortization base is positive (that is, the funding shortfall exceeds the present value of the remaining installments), the related shortfall amortization installments are positive. If the shortfall amortization base is negative, the related shortfall amortization installments are negative. The positive and negative shortfall amortization installments for a particular plan year are netted when adding them up in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero (*i.e.,* negative amortization installments may not offset normal cost).

Alternatively, if the net value of plan assets is equal to or exceeds the plan's funding target, the minimum required contribution is the plan's target normal cost, reduced by the amount, if any, by which the net value of plan assets exceeds the plan's funding target. And any shortfall amortization bases and related shortfall amortization installments are eliminated.

Lastly, it is important to understand the interest rate assumptions to be used for determining the present value of benefits for purposes of a plan's target normal cost and funding target. Present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury ("Secretary") on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. The IRS publishes the segment rates each month. The present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the employer, any of the four months preceding the month that includes the valuation date.

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month

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preceding the month in which the plan year begins (*i.e.,* without regard to the 24-month averaging described above) ("monthly yield curve"). If an election to use a monthly yield curve is made, it cannot be revoked without IRS approval.[1]

Funding Relief Provisions

The New Rules

The Act provides for much needed funding relief for single-employer defined benefit plans. Changes were made to the PPA's minimum funding rules under Code Sec. 430, briefly described above, and funding-based benefit restrictions provisions under Code Sec. 436 to adjust for periods of abnormally low or extremely high interest rates so as to remove the distortions caused by the current low interest rate environment. In sum, the Act increases the interest rates at which the minimum funding rules and related actuarial certifications are determined, resulting in much-needed decreases to these liabilities and providing plan sponsor with more flexibility in terms of plan contributions. Specifically, the Act adjusts the relevant interest rates under these Code provisions for any period to the extent that the rate for that period is not within a specified range of the average "segment" rates for the preceding 25-year period. If a segment rate for an applicable month under the PPA rules is less than the applicable minimum percentage, the segment rate is adjusted upward to match that percentage. If a segment rate for an applicable month under the PPA rules is more than the applicable maximum percentage, the segment rate is adjusted downward to match that percentage. The following ranges would apply. For this purpose, the average segment rate is the average of the segment rates determined under the regular rules for the 25-year period ending September 30 of the calendar year preceding the calendar year in which the plan year begins. The Secretary is to determine average segment rates on an annual basis and may prescribe equivalent rates for any years in the 25-year period for which segment rates determined under the regular rules are not available. The Secretary is directed to publish the average segment rates each month, which has not yet been released.

The applicable minimum percentage and the applicable maximum percentage depend on the calendar year in which the plan year begins as shown by Table 1.

For example, if the first segment rate determined for an applicable month under the regular rules for the 2012 plan year is less than 90 percent of the average segment rate, then the segment rate is adjusted to 90 percent of the average segment rate.

Certain additional information is required to be included in the annual funding notice of an applicable plan year, and the DOL is directed to modify the model funding notice to reflect this information. Specifically, for an "applicable plan year," the funding notice should include the following:

- A statement that the Act modified the method for determining the interest rates used to determine the actuarial value of benefits earned under the plan, providing for a 25-year average of interest rates to be taken into account in addition to a two-year average
- A statement that, as a result of the Act, the plan sponsor may contribute less money to the plan when interest rates are at historic lows
- A table that shows (determined both with and without regard to the Act) the funding target attainment percentage, the funding shortfall, and the minimum required contribution for the applicable plan year and each of the two preceding plan years (For pre-2012 plan years, the table will show only amounts determined without regard to the Act.)

For this purpose, the "applicable plan year" means for any plan year beginning after December 31, 2011, and before January 1, 2015, for which (1) the funding target is less than 95 percent of such funding target determined without regard to the Act, (2) the plan has a funding shortfall (determined without regard to the Act) greater than $500,000, and (3) the plan had 50 or more participants (following the aggregation rules) on any day during the preceding plan year.

Table 1.

If the calendar year is	The applicable minimum percentage is	The applicable maximum percentage is
2012	90 percent	110 percent
2013	85 percent	115 percent
2014	80 percent	120 percent
2015	75 percent	125 percent
2016 or later	70 percent	130 percent

Rules That Did Not Change

Importantly, these funding changes do not apply to a variety of related areas. For example, the Act changes have no impact on the following rules:

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- The maximum interest rates used for calculating lump-sum (and other nonannuity) payouts under Code Sec. 417(e)
- The interest rate used for calculating maximum lump-sum (and other nonannuity) payouts under Code Sec. 415(b)
- The limits on deductible employer contributions under Code Sec. 404
- ERISA §4006—calculation of variable rate PBGC premiums
- ERISA §4010—PBGC reporting (*e.g.,* the $15M underfunding provisions and 80-percent test)

Effective Date

These new rules apply for plan years beginning after December 31, 2011, *i.e.,* the 2012 plan year. Importantly, a plan sponsor can elect to defer these rules until the 2013 (presumably, pending IRS guidance will inform us how to make the election), and such an election comes with anti-cutback protection. The employer can either elect to defer (1) all these Act rules until the 2013 plan year, or (2) only the Act's rules regarding the Code Sec. 436 provisions—*i.e.,* defer solely for purposes of determining the plan's adjusted funding target attainment percentage used in applying the funding-based benefit restrictions in Code Sec. 436/ERISA §206(g), and have the Act rules regarding minimum funding contributions under Code Sec. 430 to apply.

In addition, the Act permits plan sponsors to revoke a previous election (without IRS consent) to use a monthly yield curve to determine minimum required contribution, but such an election must be made within one year of the date of enactment (which was July 6, 2012), and this election will not prevent a plan sponsor from later switching back to the monthly yield curve.

PBGC Premium Increases

The Act also substantially increases the PBGC premiums for single-employer plans, with a more modest increase for multiemployer plans, beginning in 2013. The rate changes are summarized below, which may cause plan sponsors to reconsider terminating frozen plans. Historically, the per-participant rate for flat-rate premium ranged from $31 in 2007 to $35 in 2012 for single employer plans, and $8 in 2007 to $9 in 2012 for multiemployer plans.

- Single-employer plans (please refer to Table 2)
- Multiemployer plans: Flat-rate premiums will increase from $9 to $12 per participant for plan years beginning in 2013 and will be indexed to inflation thereafter.

PBGC Structural Changes

The Act will also impose new governance requirements on the PBGC, including (1) changes to the make-up of the PBGC's board of directors; (2) mandatory independent review of PBGC's governance structure; and (3) the addition of a Participant and Plan Sponsor Advocate to provide additional protections to the governmental agency and the covered plans.

Code Sec. 420 Changes

Lastly, the Act extends the current rules under Code Sec. 420 that allow transfers of surplus pension assets to provide retiree health benefits through Decem-

Table 2.

	Old Flat Rate	New Flat Rate	Old Variable Rate (per $1,000 unfunded vested benefits)	New Variable Rate (per $1,000 unfunded vested benefits)
2012—no change	$35 ($30, indexed for inflation)	$35	$9	$9
2013	$30, indexed for inflation	$42	$9	$9, indexed for inflation (cap $400)
2014	$30, indexed for inflation	$49	$9	$9, indexed for inflation, plus $4 (cap $400, indexed)
2015—forward	$30, indexed for inflation	$49, indexed for inflation	$9	$9, indexed for inflation, plus $9—indexed for inflation beyond 2015 (cap $400, indexed)

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ber 31, 2021, as the provisions were set to expire on December 31, 2013. The Act also extends (and generally applies, with modifications in certain areas such as the maintenance of cost rules) the Code Sec. 420 rules to allow the use of surplus pension assets to provide up to $50,000 in group-term life insurance (as defined under Code Sec. 79) on eligible retirees, with special provisions for collectively bargained plans. This provision is effective for transfer made after July 6, 2012.

ENDNOTES

[1] *See* H.R. CONF. REP. NO. 112-557.

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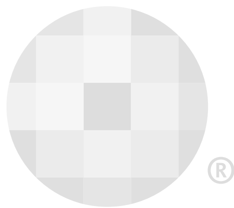

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