ISLER DARE RAY RADCLIFFE & CONNOLLY, P.C.

EMPLOYEE BENEFITS UPDATE

July 2012

Key Pension Provisions of the Surface Transportation Extension Act of 2012 and Recent IRS Guidance Affecting Defined Benefit Plans

Last week was an unusually busy week for defined benefit pension plans. At the beginning of the week, on July 2nd, the IRS announced new guidance about notice obligations that affect underfunded defined benefit pension plans. Capping off the week, on July 6th, President Obama signed into law the Surface Transportation Extension Act of 2012 (known informally as the "2012 Highway Investment Act"). In addition to highly-publicized provisions affecting transportation projects and student loan interest rates, the new law contains some important new changes that will affect defined benefit pension plans.

Executive Summary

- Beginning with the 2012 plan year, pension liabilities can now be calculated using average interest rates over a 25 year (not 2 year) period. This should improve plan funding levels and reduce the amount of required contributions, which, in turn, may eliminate restrictions on benefits and distribution options that are imposed when a plan's funding drops below certain limits.
- PBGC premiums are scheduled to increase beginning in 2013.
- Overfunded plans may create planning opportunities for the use of excess pension assets to help fund retiree health benefits and certain retiree group-term life insurance.
- Plans with an adjusted funding target attainment percentage (AFTAP) of less than 80% that are subject to benefit and distribution limitations must notify participants of these restrictions by following new guidance announced by the IRS.

What You Should Do if You Maintain a Defined Benefit Pension Plan

- Contact your plan's actuarial consultant and have them run projected calculations using the new interest rate rules, so that you can evaluate the impact of these changes on your plan's funding levels, required minimum contributions, and any benefit and payment restrictions that may be in place.
- Depending on your plan terms regarding distributions, take appropriate action to encourage terminated participants to receive their benefits, in order to mitigate the impact of the PBGC premium increases that will take effect in 2013.
- If your plan is (or becomes) subject to funding-related restrictions on benefits and payment options, develop appropriate notification to your plan participants, based on the new model notice and guidance issued by the IRS.

Smoothing of Interest Rates for Funding Purposes

- The new law changes the interest rates that must be used to calculate defined benefit plan funding levels and the amount that companies must contribute to their plans annually in order to keep them adequately funded.

- Because interest rates directly affect pension liabilities (with lower interest rates creating greater pension liabilities), the new law's changes are designed to give corporations some relief from the historically low interest rate environment of the last few years. These low rates, combined with market volatility and the performance of plan investment portfolios, have converged to require companies to make larger than-expected contributions to their defined benefit plans. In some cases, restrictions have been imposed on benefit increases and lump-sum distributions, because a plan's adjusted funding target attainment percentage has dropped below 80%.

- Currently, for purposes of determining a defined benefit plan's short-term, mid-term and long-term liabilities, the plan is required to use interest rates (sometimes called "segment rates") equal to the two-year average paid on AA-rated corporate bonds. Under the new law, effective for the 2012 plan year, a plan will be able to use interest rates that are determined according to a corridor of the 25-year average of those corporate bond rates—a change that should smooth out the impact of interest rate fluctuations and the extremely low rates of recent years.

  - Under the new law, plans will be able to use interest rates that are within 10% of the 25-year average interest rates for corporate bonds; by 2016, this interest rate corridor will widen, and plans will be able to use interest rates that are within 30% of the 25-year average interest rates for corporate bonds.

  - This change will be implemented by using a table that establishes the interest rate corridor between an "applicable minimum percentage" and an "applicable maximum percentage" of the 25-year average interest rates.

  - Assuming that a company does not opt out of these interest rate changes, they are likely to have the following impact:

    - A plan's adjusted funding target attainment percentage may increase, and if the increase is of a sufficient level, any benefit and payment restrictions that are currently in place due to low funding levels in recent years could be lifted;

    - The amount of a company's required contributions to a plan could decrease;

    - The limit on deductible contributions that a company can make is not likely to be impacted, since those calculations are not impacted by the new interest rate smoothing rules for funding computations; and

- The present value calculations of benefit payments, for lump-sum or cash-out distributions, are not likely to be impacted, since those calculations are not impacted by the new interest rate smoothing rules for funding purposes.

Changes to Annual Funding Notice

- Pension plans are required to provide their participants with an "annual funding notice" each year. Under the new law, pension plans with 50 or more participants that have a funding shortfall (as determined under current law) exceeding $500,000 must provide additional information in the annual funding notice if the effect of the 25-year smoothing provision causes the plan's funding target, determined using the new interest rules, to be less than 95 percent of the funding target determined under the prior rules.

- However, this additional information will only be required for plan years between 12/31/11 and 1/1/15, and it is expected that the Department of Labor will modify its model notice so that the notice includes the new required information in a prominent manner.

Increase in PBGC Premiums Starting in 2013

- To help pay for some of the pension-funding relief, PBGC premiums will increase, beginning in 2013. Therefore, to mitigate the cost impact of this increase, companies may wish to step up their communication and outreach efforts to terminated participants and encourage them to take a distribution of their benefits, especially if any lump-sum payment restrictions are removed with the implementation of the 25-year interest rate smoothing changes.

- Flat premiums will increase from the current level of $35 per participant to $42 per participant in 2013 and $49 in 2014; thereafter, they will be indexed for inflation.

- Variable premiums, which are currently equal to $9 per $1,000 in underfunding, will be adjusted for inflation and will increase by $4 in 2014 and $5 in 2015, with the maximum variable premium being $400 per participant (indexed for inflation) beginning in 2013.

Transfer of Excess Pension Assets

- Should a plan have excess assets (over 125% of the plan's funding target), they will be permitted to transfer those assets to a retiree medical account, or to a retiree group-term life insurance account, within the plan, as long as the transfer is made by December 31, 2021 and certain use, vesting, minimum cost, and notice requirements are met. By so doing, the excess assets would not be subject to income tax or a penalty excise tax.

New Guidance on Notice Requirements for Plans Subject to IRC §436 Restrictions

- Defined benefit plans with funding levels below 80%, which are subject to the benefit accrual and payment restrictions of Internal Revenue Code Section 436, are required to provide notice of these restrictions to plan participants and beneficiaries. Recently, the IRS issued Notice 2012-46, which provides helpful guidance about determining the date that these restrictions apply, describing the content of the required notice that must be provided, and identifying which participants and beneficiaries should receive the notice. The IRS guidance also provides a model notice with sample language that can be used.

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If you have any questions about these new developments in particular, or about your benefit plans in general, please let us know.

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