WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: President Signs Highway Act Extending Use of 25-Year Pension Smoothing

MARKET TREND: Congress's search for new sources of income to fund government spending, combined with continuing economic challenges for businesses, means that retirement plans have again become a target for changes to placate employers and to finance such spending. This law allows for much lower funding for businesses sponsoring defined benefit pension plans, potentially increasing the businesses' taxable revenue.

SYNOPSIS: In August, the President signed into law the Highway and Transportation Funding Act of 2014 ("HATFA"), which in part, pays for transportation projects by extending the use of 25-year pension smoothing for defined benefit pension plan funding purposes. Pension smoothing reduces the minimum required level of tax-deductible contributions to single-employer defined benefit pension plans by allowing employers to use higher historic interest rates in their funding calculations. This law results in both: (1) lower required contributions and (2) increased taxable business income due to the lower contribution expense (and, correspondingly, potential increased tax revenue). While these changes may assist employers in the short run by reducing required contributions, the ultimate long-term liability remains and future obligations will need to be satisfied, either by employers or the Pension Benefit Guaranty Corporation (the government-provided safety net).

TAKE AWAYS: Under the new law, employers can put less money into their pension plans by using calculations that allow them to value liabilities using historic interest rates that are higher than the prevailing low rates. Interest rate smoothing could result in a shift away from liability-driven investing because of the deemed greater funding level and extended funding period. The current trend toward providing pension funding relief may lead to a reevaluation of risk when setting pension investment policies and an interest by plan sponsors in reformulating a plan investment policy away from fixed income investments and toward riskier investments like equity and alternative investments.

MAJOR REFERENCES: *Highway and Transportation Funding Act of 2014 (P.L. 113-159), IRS Notice 2014-53, Moving Ahead for Progress in the 21st Century Act (P.L. 112-141).*

The recently-enacted HATFA implements 25-year pension smoothing for single-employer defined benefit pension plans, which effectively allows employers to put less money into their pension plans by calculating the value of liabilities using historic interest rates that are higher than the prevailing low rates. Reductions in required contributions should leave plan sponsors with more capital for other business purposes, like employee incentives and expansion, and may impact pension investment policies.

LAW

The interest rates used to estimate pension liabilities and determine employer contributions have been based statutorily on the two-year average of interest rates, which have been kept artificially low by the Federal Reserve. These averages will be adjusted so that they are based on the average of interest rates for the 25-year period preceding the current year. This change effectively raises the interest rates used and improves projected plan funding levels.

Enacted in 2012, the Moving Ahead for Progress in the 21st Century Act of 2012 ("**MAP-21**") initially provided for use of a 25-year interest rate corridor over which a plan's applicable interest rate could be determined. Effective for plan years beginning on or after January 1, 2012, the first, second, and third segment rates, as described in Internal Revenue Code ("**Code**") §430(h)(2)(C), are adjusted as necessary to fall within a specified range that is determined based on an average of the corresponding segment rates for the 25-year period ending on September 30 of the calendar year preceding the first day of that plan year.

HATFA modifies the pension-smoothing corridors under MAP-21. Under HATFA, for plan years beginning in 2012 through 2017, the segment rates of interest for certain pension purposes are adjusted so that they are at least 90% and no more than 110% of the corresponding 25-year average segment rate. This range gradually increases until the segment rates for plan years beginning after 2020 are no less than 70% and no more than 130% of the corresponding 25-year average segment rates. Thus, HATFA extends the period for which the narrowest range around the 25-year average segment rates apply in determining the segment rates that are used for the Code §430 minimum funding requirements and the Code §436 limits on benefit accrual and payment for underfunded plans.

APPLICATION

Interest rates and minimum required contributions are inversely related because if an employer is obliged to assume that pension contributions accumulate more interest and grow in value faster, it is allowed to contribute less. The pension smoothing provisions weaken the link between historically low short-term interest rates and minimum required contributions. It creates a corridor of minimum and maximum interest rates along a broader 25-year moving average that reflects interest rates' higher historical levels. The corridor gradually widens with the lower bound falling to accommodate interest rates' expected rise to historical norms. As an example, if the 24-month moving average interest rate for 2012 (0.1%) were below the product of the 25-year moving average (1.5%) and 90% (0.9), that second, pension smoothing corridor (1.35%) would be used to calculate minimum required contributions.

AVAILABLE & DEEMED ELECTIONS

A plan sponsor may elect not to have HATFA segment rates apply to a plan year beginning in 2013, either for all purposes or solely for determining the plan's Adjusted Funding Target Attainment Percentage ("**AFTAP**") for that plan year (which is used to apply the benefit restrictions under Code §436). A plan sponsor makes the election to defer the use of the HATFA segment rates until the first plan year beginning on or after January 1, 2014, by providing written notice to the plan's enrolled actuary and to the plan administrator. The notice must specify the name of the plan, employer identification number and plan number, and whether the use of HATFA segment rates is deferred for all purpose or only for determining the plan's AFTAP. This election is irrevocable, and must be made by the later of: (1) the deadline for filing the Form 5500, Form 5500-SF or Form 5500-EZ (including extensions) for the plan year beginning in 2013; or (2) December 31, 2014.

For a plan year beginning in 2013, if, on or before December 31, 2014, a plan's Form 5500, Form 5500-SF or Form 5500-EZ is filed, and the Schedule SB used the prior-law MAP-21 segment rates, then an election is deemed made to defer use of the HATFA segment rates until the first plan year beginning on or after January 1, 2014, for purposes of *both* Code §430 and Code §436. This deemed election may be revoked by filing an amended Form 5500, Form 5500-SF, or Form 5500-EZ for the plan year, with a revised Schedule SB that reflects the use of HATFA segment rates. These reports must be filed no later than December 31, 2014.

TAKE AWAYS

- Interest rate smoothing under HATFA provides opportunities for defined benefit plan sponsors to reduce plan contributions and use those contribution amounts for other corporate purposes.

- It also may impact investment considerations for such plans.

- Advisors assisting clients with corporate planning should make sure the client is aware of the opportunities and the risks presented by the new law, and assist with taking full advantage of techniques to benefit from this limited window, such as reducing contributions to pension plans and utilizing the savings for other purposes, like employee incentive and retention programs and capital improvements.

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