Sibson Consulting

Spotlight™

Strategic HR Consulting

January 2014

PBGC Premium Rates Increase Again: What Plan Sponsors Can Do to Minimize PBGC Premium Payments

The Bipartisan Budget Act of 2013 that was signed into law on December 26, 2013 significantly increases both the flat-rate and variable-rate single-employer Pension Benefit Guaranty Corporation (PBGC) premiums.* Those increases are in addition to the premium increases introduced as part of 2012's Moving Ahead for Progress in the 21st Century Act (MAP-21). PBGC premiums, unlike contributions to a pension plan, do not fund plan benefits or improve the plan's funded status. As a result, similar to taking steps to avoid taxes, plan sponsors generally want to take steps to minimize the premiums payable. This *Spotlight* discusses some strategies to minimize the amount paid for PBGC premiums.

What Can Be Done to Minimize Variable-Rate Premiums?

This year, the PBGC variable-rate premium is 1.4 percent of a plan's unfunded vested liability, going up to at least 2.4 percent in 2015 and 2.9 percent in 2016, with indexing thereafter. For an underfunded plan, increasing pension plan contributions above amounts previously contemplated is the surest way to reduce the amount of the PBGC variable-rate premium payment.

In addition to reducing the PBGC variable-rate premium, making additional pension contributions generally provides a tax deduction and tax-free accumulation of investment earnings. At the new high levels of PBGC premiums, even organizations that do not have the available cash to make significant pension contributions may decide that it is advantageous to borrow cash in order to fund additional contributions to their pension plans. Of course, the viability of increasing contributions depends on the availability and the cost of debt capital, as well as other options for investing the capital.

Some organizations with frozen pension plans are wary of making additional pension contributions even if their plans are currently underfunded on a PBGC premium basis. Those organizations believe there is a possibility that the plan could become overfunded if interest rates and/or investment returns turn out to be higher than the rates used for the variable-rate premium calculation. If that were to happen, additional contributions may become unnecessary. Moreover, in the case of a for-profit organization, any remaining overfunding that reverts to the plan sponsor upon plan termination would be subject to an excise tax equal to 50 percent of the reversion as well as subjecting the employer to ordinary income tax on the amount of the reversion. However, while the possibility of overfunding should be considered, sponsors may not need to be overly concerned with this issue. Even a frozen plan that is anticipated to terminate will likely need assets significantly more than the PBGC vested liability to purchase the annuities needed to terminate the plan. In addition, a sponsor that might be subject to the reversion excise and income taxes can avoid some of the excise and income taxes by transferring a portion of the surplus to a defined contribution plan

---

* The increases are described in Sibson Consulting's January 7, 2014 *Compliance Alert*: http://www.sibson.com/publications-and-resources/compliance-alert/archives/?id=2481

covering the same employees. Finally, any concern about *the possibility of* overfunding must be balanced against the *certainty* of paying additional variable-rate premiums now.

Organizations that do not wish to increase their level of contributions may be able to reduce their premiums by accelerating the timing of contributions. In this regard, note that while PBGC premiums for each plan year reflect the market value of assets as of the last day of the prior plan year, contributions can be reflected (at a discounted amount) for premium purposes in many cases if they are paid within 8½ months after the plan year. Thus, for calendar-year plans, this could allow the inclusion of contributions paid as late as September 15, 2014 in determining the 2014 premium. So, for example, if a contribution that is otherwise due on October 15, 2014 is accelerated by 30 days, it would be counted in the computation of the unfunded liability for PBGC premium purposes. However, before deciding upon this course of action, plan sponsors should consult with their actuary to be sure there are no unintended consequences of this acceleration.

What Can Be Done to Minimize Flat-Rate Premiums?

This year, the PBGC flat-rate premium will be $49 per participant, going up to $57 in 2015 and $64 in 2016, with indexing thereafter. As a result, the present value of future PBGC flat-rate premiums for a participant could now be a significant percentage of the present value of that participant's benefit payments. For example, the present value of future PBGC flat-rate premiums would be about $1,800 for a 40-year old participant, assuming 5 percent interest and 3 percent inflation indexing. At this level of premiums, plan sponsors will be looking for ways to reduce their participant counts. One way to reduce participant count is by offering a lump-sum window to terminated vested participants. The box below provides some background on the considerations involved in offering a lump-sum window.

Lump-Sum Windows

By law, a plan cannot require a terminated participant to take a distribution as a lump sum if the amount of the lump sum exceeds $5,000. Rather, a lump sum can be available only as an optional form of payment that is offered with an alternative annuity payable at the same time, and only with spousal consent if the participant is married. Although DB plan sponsors can offer lump sums as a standard option, it has become more popular to offer lump sums only during a one-time window period. This avoids creating a protected right to the lump-sum option in the future, and may produce a higher acceptance rate than an option that is a permanent plan feature.

Cashing out terminated vested participants involves many considerations besides PBGC premiums. One must compare the financial implications of the cash-out to that of continuing to maintain the obligation to pay monthly benefits upon retirement, as these two alternatives involve calculations that are based on different assumptions. Typically, lump-sum cash-outs are based on legally mandated assumptions, while the value of the benefit payments would be measured each year under the accounting rules. A cash-out also has a "de-risking" effect by finalizing the cost and eliminating future volatility.

Another major consideration for some organizations is whether a cash-out is significant enough to reach the threshold for "settlement" treatment under the accounting rules. (A typical accounting policy is to only reflect a settlement if the total amount cashed out — along with any other settlements during the year — exceeds the "service cost" and "interest cost" components of the annual expense for the plan.) If the threshold is met, cash-outs are

Continued on next page

Lump-Sum Windows (continued)

considered to be a partial settlement of the liabilities. This would require that a portion of any outstanding losses being deferred must be immediately reflected in the current year's income statement.

An organization can choose to limit the size of the group to which it offers a lump-sum window, subject to applicable nondiscrimination rules. For example, the window might be limited to terminations during a specified period. Alternatively, the window might be offered only to those with lump sums under a specified amount. Limiting the window to small lump sums targets participants who tend to have higher future PBGC flat-rate premiums as a percentage of the present value of their benefit payments and may offer the best bang for the buck.

For a more detailed discussion of lump-sum windows, see Sibson's May 2012 *Spotlight*: http://www.sibson.com/publications/spotlight/may2012lsw.pdf

Other Considerations

Plan sponsors should also note that the interest rates used to determine the PBGC variable-rate premiums can vary depending on their elections. The plan sponsor can generally choose whether to use the rates for the month prior to the plan year, or to use the average rates for the 24 months prior to the plan year, but an election cannot be revoked for five years. A plan sponsor that has been using the 24-month average rates for the past five years may be able to switch to the spot rates for 2014. For a calendar-year plan, this could typically result in increasing the effective interest rate by approximately 50 basis points, which may significantly reduce the 2014 underfunding for PBGC variable-rate premium purposes.

Conclusion

Reducing or avoiding PBGC premiums is an important consideration in determining a pension plan's policies. With the recent additional increases in the PBGC premium rates, now is the time for plan sponsors to focus on this issue.

■ ■ ■

To discuss the tradeoffs and strategies involved in minimizing PBGC premiums, contact your Sibson consultant or the nearest Sibson office. (For a list of Sibson offices, click on the second link in the box below.)