PRESENT LAW AND BACKGROUND RELATING TO THE FUNDING RULES FOR EMPLOYER-SPONSORED DEFINED BENEFIT PLANS AND THE FINANCIAL POSITION OF THE PENSION BENEFIT GUARANTY CORPORATION ("PBGC")

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on April 30, 2003

Prepared by the Staff
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CONTENTS

Page

INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for April 30, 2003, on challenges facing pension plan funding. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background relating to the funding rules for defined benefit plans. Part I of the document discusses the present-law rules relating to qualified plans generally and special rules applicable to defined benefit plans. Part II of the document describes the present-law funding and deduction rules applicable to defined benefit plans. Part III discusses the pension insurance system and the financial status of the PBGC. Part IV contains data relating to qualified retirement plans. Part V of the document provides a discussion of general issues relating to defined benefit plans and retirement security.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to the Funding Rules for Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation ("PBGC")* (JCX-39-03), April 29, 2003.

I. OVERVIEW OF PRESENT LAW RELATING TO DEFINED BENEFIT PLANS[2]

A. Rules Relating to Qualified Retirement Plans Generally

1. In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a "qualified retirement plan") is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. An employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions (e.g., employee elective deferrals to a qualified cash or deferred arrangement, i.e., a 401(k) plan) are generally treated the same as employer contributions for tax purposes.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.[3] One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In particular, a qualified retirement plan must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries (the "exclusive benefit rule").

In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.[4] Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees;[5] (2) the plan benefits a percentage of nonhighly

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[2] Except as otherwise indicated, this discussion refers to rules in the Internal Revenue Code. The Employee Retirement Income Security Act of 1974 ("ERISA") also contains rules relating to qualified plans, including defined benefit plans. Some, but not all, of the ERISA provisions are described here.

[3] *See* sec. 401(a). In some cases, special provisions apply to qualified retirement plans maintained by State and local governments. This document discusses the rules applicable to qualified retirement plans without regard to such special provisions, except as specifically mentioned.

[4] Sec. 410.

[5] Under present law, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2003) or (b) at the election of the employer, had compensation for the preceding year in excess of $90,000 (for

compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test that compares the benefits received by highly compensated employees and nonhighly compensated employees. Present law also contains a general nondiscrimination requirement which provides that a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits. Special rules apply to plans that primarily benefit key employees (called "top-heavy plans").

The plan qualification standards also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified retirement plans. A limit of $200,000 (for 2003) applies to the amount of a participant's compensation that may be taken into account for qualified retirement plan purposes.[6] Limits apply also to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.[7]

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from qualified retirement plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans, including defined benefit plans, is restricted.

Qualified retirement plans are also subject to regulation under ERISA. The ERISA rules generally relate to the rights of plan participants, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Internal Revenue Code and ERISA applicable to qualified retirement plans are identical or very similar. For example, both the Internal Revenue Code and ERISA impose minimum participation and vesting requirements.

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. The qualification requirements under the Internal Revenue Code are enforced by the Internal Revenue Service ("IRS"). If a plan fails to meet the qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. The IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.

2003) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee.

[6] Sec. 401(a)(17).

[7] Secs. 415, 402(g), and 404. See the discussion in Part I.B.6., below. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The EGTRRA provisions generally do not apply for years beginning after December 31, 2010.

Certain of the Internal Revenue Code rules relating to qualified plans are enforced through an excise tax rather than through disqualification. For example, a failure to satisfy the minimum funding requirements for defined benefit plans, discussed below, does not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Internal Revenue Code. ERISA's requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

2. Types of qualified retirement plans

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

Employer contributions to a defined benefit plan are subject to minimum funding requirements under the Internal Revenue Code and ERISA to ensure that plan assets are sufficient to pay the benefits under the plan. An employer is generally subject to an excise tax for a failure to make required contributions. Benefits under a defined benefit plan are guaranteed (within limits) by the PBGC.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (commonly called "401(k) plans" after the section of the Internal Revenue Code regulating such plans) are examples of defined contribution plans.

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance.

3. Taxation of qualified retirement plan contributions and distributions[8]

Employer contributions and employee pre-tax contributions to a qualified retirement plan are not includible in an employee's income at the time of contribution.

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[8] Secs. 72, 402.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply in certain cases, e.g., in the case of distributions rolled over to another employer-sponsored retirement plan or IRA, and distributions of employer securities.

Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax.[9] That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income.

Distributions from a qualified retirement plan are required to begin no later than the participant's required beginning date.[10] The required beginning date is April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2, or (2) the calendar year in which the employee retires. In the case of an employee who is a five-percent owner, the required beginning date is April 1 of the calendar year following the calendar year the employee attains age 70-1/2. Distributions after the participant's death also must meet certain minimum distribution requirements.

The sanction for failure to make a minimum required distribution to an employee (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed.[11] The tax is imposed on the individual required to take the distribution. However, the qualification requirements also require that a plan must expressly provide that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

4. Qualified retirement plan reporting and disclosure requirements

<u>Annual report</u>

A qualified retirement plan is subject to annual reporting requirements under both the Internal Revenue Code and ERISA. The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan. This report is made as a single submission to the Department of Labor on the Form 5500, which forwards copies of the report to the IRS and the PBGC. The plan administrator must automatically provide participants with a summary of the annual report described above. In addition, on written request, a participant must be provided with a copy of the full annual report.

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[9] Sec. 72(t).

[10] Sec. 401(a)(9).

[11] Sec. 4974.

Annual registration statement

A plan administrator is required to file an annual registration statement with the IRS with respect to any participant who (1) separates from service during the year, (2) is entitled to a deferred vested benefit under the plan as of the end of the plan year, and (3) whose benefits were not paid during the year. The annual registration statement is filed by means of Schedule SSA of the Form 5500 for the year following the year in which the employee separates from service. The plan administrator must also furnish an individual statement to each participant who separates from service and is listed in the annual registration statement described above. The individual statement must set forth the nature, amount and form of the deferred vested benefit to which the participant is entitled.

Summary plan description

ERISA requires that a plan administrator furnish participants with a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan.[12] The summary plan description must be furnished within 90 days after the participant first becomes a participant in the plan. In addition, if plan amendments are made, the plan administrator must furnish each participant every fifth year with an updated summary plan description that includes all the plan amendments made within the five-year period (or, if there have been no amendments, a new summary plan description every tenth year). A participant may also obtain a copy of the summary plan description on request.

The plan administrator must also furnish participants with a summary of any material modification in the terms of the plan and any change in the information required in the summary plan description within 210 days after the end of the plan year in which the modification or change occurs.

These documents must be written in a manner calculated to be understood by the average plan participant and must reasonably apprise participants of their rights and obligations under the plan.

Benefit statements

ERISA provides that a plan administrator must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. This requirement applies in the case of any plan that is subject to ERISA, including defined contribution and defined benefit plans. The benefit statement must indicate, on the basis of the latest available information, (1) the participant's or beneficiary's total accrued benefit, and (2) the participant's or beneficiary's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than one benefit statement during any 12-month period.

[12] The summary plan description must also be furnished to the Department of Labor on request.

Special requirements for defined benefit plans

Defined benefit plans must provide certain reports or notices if the plan is underfunded, if a plan amendment significantly reduces the rate of future benefit accrual, or if plan assets are transferred to health benefit accounts.

5. Investment of qualified retirement plan assets

Risk of investment loss

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan.

In a defined benefit plan, plan benefits are funded with the general assets of the plan, which are invested by plan fiduciaries in accordance with plan terms. Investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits. The minimum funding rules also require periodic valuation of defined benefit plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.[13]

Benefits under defined benefit plans are guaranteed (within limits) by the PBGC. In the event a plan terminates with assets insufficient to pay promised benefits, the PBGC pays benefits up to the maximum guaranteed amount. For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.[14]

In a defined contribution plan, the benefit the participant is entitled to is the account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Because the benefits due to participants in the event of a termination of a defined contribution plan are based on the assets held by the plan, defined contribution plans are not insured by the PBGC.

Fiduciary rules

ERISA contains general fiduciary standards that apply to all fiduciary actions, including the investment of plan assets held by a defined benefit plan. ERISA requires that a plan fiduciary must discharge its duties solely in the interests of participants and beneficiaries and:

- for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration;
- with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

[13] The funding rules are discussed further in Part II.A., below.

[14] The PBGC insurance program is discussed further in Part III, below.

- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with plan documents insofar as they are consistent with ERISA.[15]

Violations of the fiduciary rules under ERISA are subject to enforcement through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

ERISA generally provides that a person is a plan fiduciary to the extent the fiduciary exercises any discretionary authority or control over management of the plan or exercises authority or control over management or disposition of its assets, renders investment advice for a fee or other compensation, or has any discretionary authority or responsibility in the administration of the plan. As a result, a person who makes investment decisions with respect to a qualified retirement plan is generally a plan fiduciary and investment decisions are fiduciary actions.[16]

Generally, the plan trustee has exclusive authority and responsibility for managing and controlling plan assets and is thus responsible for investing plan assets. However, the plan may make the trustee subject to the direction of a named fiduciary, or the authority for managing plan assets may be delegated to an investment manager. An investment manager is a registered investment advisor, bank, trust company, or insurance company that is appointed by a named fiduciary of the plan with the power to manage, acquire, or dispose of plan assets. The investment manager must acknowledge in writing its status as a fiduciary.

Plan investment decisions that violate the fiduciary requirements of ERISA may in some cases violate the exclusive benefit rule under the Internal Revenue Code. However, not all fiduciary violations relating to plan investments are violations of the exclusive benefit rule.

Limits on investments in employer securities and real property

ERISA imposes restrictions on the investment of qualified retirement plan assets in employer securities or employer real property. A qualified retirement plan may hold only a "qualifying" employer security and only "qualifying" employer real property. In addition, ERISA prohibits defined benefit plans from acquiring qualifying employer securities or real property if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities and real property. Most defined contribution plans, other than a type of defined contribution plan known as money purchase pension plans, are not subject to these limits.

[15] ERISA sec. 404.

[16] Under a special ERISA provision, if a participant in a defined contribution plan exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's exercise of control.

Any stock issued by the employer or an affiliate of the employer is a qualifying employer security. In the case of a defined benefit plan (and money purchase pension plans other than certain pre-ERISA plans), in order for stock to be a qualifying employer security, the plan cannot hold more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class, and at least 50 percent of the aggregate amount of that stock must be held by persons independent of the issuer. Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness).

Qualifying employer real property means parcels of employer real property (1) if a substantial number of the parcels are dispersed geographically, (2) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use, (3) even if all of the real property is leased to one lessee (which may be an employer, or an affiliate of an employer), and (4) if the acquisition and retention of such property generally comply with the fiduciary rules of ERISA (with certain specified exceptions).

Prohibited transactions

Both the Internal Revenue Code and ERISA contain prohibited transaction rules that prohibit the employer, plan fiduciaries, and other persons with a close relationship to a qualified retirement plan from engaging in transactions with the plan.[17] These rules are not targeted toward particular types of investments, but rather seek to prevent self-dealing transactions.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Certain transactions are exempt from prohibited transaction treatment. In addition, the Department of Labor may grant administrative exemptions in particular circumstances.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

[17] Code sec. 4975; ERISA secs. 406-408.

B. Rules Relating to Defined Benefit Plans

1. Common defined benefit plan designs

In general

Subject to the applicable qualification rules, the employer (and, in the case of collectively bargained plans, employee representatives) determines the benefit formula under a defined benefit plan, as well as other plan features. Thus the benefits under such plans vary from employer to employer. Some common types of plan design are discussed below.

Final average pay plans

Under a final average pay plan, an employee's benefit is based on the average of the employee's compensation for a certain number of years (e.g., three or five years). Generally, the years taken into account are the most recent years (e.g., the three or five most recent years) or, if applicable, an earlier period of years in which the employee's average compensation is the highest (sometimes referred to as "average annual compensation").

The formula used to determine an employee's normal retirement benefit under a final average pay plan may be a unit credit formula or a flat benefit formula.[18] A unit credit formula provides a specified rate of benefit for each year of service, often with a limit on the years of service taken into account. For example, a plan may provide a normal retirement benefit of 1.5 percent of final average pay for each year of service up to 30 years.[19] A flat benefit formula provides a normal retirement benefit of a specified percentage without regard to years of service, for example, 50 percent of final average pay.

Because the normal retirement benefit under a final average pay plan is based on an employee's most recent or highest pay, increases in an employee's pay are reflected in the employee's entire benefit. As a result, under a unit credit benefit formula, for an employee with a long period of service, compensation increases generally result in significant benefit increases because the compensation increase is reflected in the benefit attributable to all years of service. In addition, in the case of an employee who works for the employer until retirement, the retirement benefit is based on the employee's most recent or highest pay at the time of retirement.

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[18] The benefit formula describes the benefit payable under the plan at normal retirement age. However, the benefit payable to an employee in the case of termination of employment (or termination of the plan) before normal retirement age depends on the portion of the normal retirement benefit that has accrued, which is determined under the plan's accrual method, as discussed below. In addition, the amount of the accrued benefit payable to the employee depends on the extent to which the employee's right to the accrued benefit is vested.

[19] A unit credit formula may provide different benefit rates for different years of service (e.g., 1 percent of final average pay for each year of service up to 15 years and 1.25 percent of final average pay for each year of service from 16 to 30 years), subject to the accrual rules discussed below.

Career average plans

Under a career average pay plan, an employee's normal retirement benefit consists of the sum of separate benefits determined for each year of service, based on compensation for the year of service. For example, a career average plan may provide a benefit of 1.5 percent of compensation for each year of service, with the total normal retirement benefit consisting of the sum of the separate benefits determined for each year of service. This plan design is also referred to sometimes as an "accumulation" plan. Under a career average plan, an increase in an employee's compensation does not affect the portion of the employee's normal retirement benefit attributable to previous years of service.[20]

Permitted disparity

The permitted disparity rules allow a defined benefit plan to provide a higher rate of benefit with respect to compensation above a certain amount without violating the prohibition on discrimination in favor of highly compensated employees.[21]

The rationale for permitted disparity lies in the design of the Social Security system, under which an employer pays Social Security taxes on an employee's compensation and, as a result, is considered to provide a portion of the employee's Social Security benefits.[22] Because Social Security benefits are based on an employee's compensation only up to the wage base, permitted disparity allows the employer to provide higher (that is, disparate) benefits with respect to the portion of an employee's compensation that is not taken into account under the Social Security system.[23] The amount of disparity that is permitted under a defined benefit plan is based roughly on the rate at which Social Security benefits replace earnings.

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[20] An employer maintaining a career average plan may periodically amend the plan to provide a one-time benefit adjustment under which the employee's benefit is the greater of (1) the benefit determined under the career average formula for the employee's completed years of service, and (2) the benefit determined under a final average pay formula, based on final average compensation as of the year in which the amendment applies and the employee's completed years of service. For subsequent years (i.e., years after the year in which the amendment applies), the employee's benefit consists of the sum of (1) the benefit determined under the amendment and (2) the benefit determined under the career average formula for years of service in subsequent years.

[21] Secs. 401(a)(5)(C) and 401(l). The permitted disparity rules also allow a defined contribution plan to provide a higher rate of contribution with respect to compensation above a certain amount.

[22] The employee also pays Social Security taxes on his or her compensation, at the same rate as the employer.

[23] Before 1989, the methods by which contributions or benefits under a qualified retirement plan were integrated with the Social Security system were provided in Rev. Rul. 71-446, 1971-2 C.B. 187. Permitted disparity is sometimes referred to as "Social Security integration," and a plan that uses permitted disparity is referred to as an "integrated" plan.

Two methods may be used for applying permitted disparity under a defined benefit plan: the excess benefit method and the offset method. Under the excess benefit method, the plan provides one rate of benefit with respect to compensation up to a specified amount (i.e., the "integration level") and a higher rate of benefit with respect to compensation in excess of the integration level. Under the offset method, the plan provides the same rate of benefit with respect to all compensation (the "gross benefit") and offsets the gross benefit by a specified percentage of compensation up to the integration level or by a portion of the employee's estimated benefits under the Social Security program.[24]

<u>Cash balance plans</u>

A cash balance plan is a defined benefit plan under which benefits are defined by reference to a hypothetical account balance. An employee's hypothetical account is determined by reference to hypothetical annual allocations to the account (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account. Depending on the design of the cash balance plan, an employee who receives a hypothetical allocation to his or her account for a year may be automatically entitled to future hypothetical earnings on that allocation, or the right to future hypothetical earnings on the allocation (or the amount of the earnings) may depend on whether the employee continues employment with the employer maintaining the plan.

Hypothetical earnings on the account may be determined in the form of hypothetical interest on the account at a rate specified in the plan or based on a specified market index, such as the rate of interest on certain Treasury securities. Alternatively, hypothetical earnings on the account may be based on hypothetical assets held in the account, similar to earnings on an account under a defined contribution plan, which are based on the assets held in the account. In that case, the plan may permit the employee to designate the hypothetical assets on which hypothetical earnings are based or permit the employee to choose from hypothetical investment options.[25]

Under defined benefit plans generally, normal retirement benefits are payable in the form of an annual benefit commencing at normal retirement age. Under a cash balance plan, the annual benefit payable to an employee at normal retirement age is generally determined as the actuarial equivalent of the amount of the employee's hypothetical account balance at normal retirement age, using actuarial factors specified in the plan. In addition, cash balance plans generally provide for lump sum distributions based on the employee's hypothetical account balance at the time the distribution is made.

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[24] The term for the Social Security benefit payable to an individual at Social Security retirement age is the individual's primary insurance amount or "PIA." A defined benefit plan that bases the offset on estimated Social Security benefits is referred to as a "PIA offset" plan.

[25] The assets of the cash balance plan may or may not include the assets or investments on which hypothetical earnings are based. As in the case of other defined benefit plans, a plan fiduciary would be responsible for making investment decisions with respect to cash balance plan assets.

Contributory defined benefit plans

In general

Some defined benefit plans provide for employee contributions. Such a plan is referred to as a "contributory" defined benefit plan. Contributory defined benefit plans are fairly common among governmental defined benefit plans, but not among plans maintained by private employers.

Generally, employee contributions to a defined benefit plan are made on an after-tax basis.[26] However, under a special rule, employee contributions to a plan maintained by a State or local government employer may be "picked up" by the employer and made on a pre-tax basis. Pre-tax treatment applies even if the employee's salary is reduced by the amount of the contributions picked up by the employer.

Types of employee contributions

A defined benefit plan may be designed to provide for mandatory or voluntary employee contributions.

In the case of mandatory contributions, an employee must make the contributions in order to be covered by the defined benefit plan and receive employer-provided benefits under the plan. Depending on the plan design chosen by the employer, an employee may be given the choice (generally at the start of employment or after completing a year of service) of whether to make mandatory contributions and participate in the plan, so that employee contributions are a condition of participation in the plan. Alternatively, employee contributions may be required as a condition of employment, i.e., all employees must make contributions and participate in the plan.[27]

In the case of voluntary employee contributions to a defined benefit plan, an employee has the option of making contributions and receiving additional benefits based on those contributions. A plan may be designed so that a separate account is maintained for voluntary employee contributions, to which income, expenses, gains, and losses are allocated, and benefits attributable to the employee contributions are based on the balance of the separate account. In that case, the separate account is treated as a defined contribution plan for certain purposes.

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[26] Employee elective deferrals under a qualified cash or deferred arrangement (i.e., a 401(k) plan) are made on a pre-tax basis. Under a qualified cash or deferred arrangement, benefits (other than employer matching contributions) must not be contingent on the employee's election to make deferrals. This rule prevents employee contributions to a defined benefit plan, even if voluntary, from being treated as pre-tax elective deferrals because benefits under a contributory defined benefit plan depend in part on employee contributions.

[27] Employee contributions required as a condition of employment are a common feature in governmental defined benefit plans.

Vesting rules for employee contributions[28]

Under a qualified retirement plan, an employee must be fully vested in the benefits under the plan that are attributable to employee contributions. The method for determining the amount of benefits attributable to employee contributions depends on whether the employee contributions are mandatory or voluntary and, in the case of voluntary employee contributions, whether the contributions are maintained in a separate account.

The amount of benefits attributable to mandatory employee contributions under a defined benefit plan is determined as the amount of the employee's "accumulated contributions," converted to an actuarially equivalent annuity payable at normal retirement age, using a statutory interest rate (i.e., the interest rate on 30-year Treasury securities). "Accumulated contributions" means the total of all mandatory contributions made by the employee plus interest thereon, projected to the employee's normal retirement age using a specified rate and annual compounding.[29] The fact that the amount of mandatory employee contributions must be accounted for and credited with interest does not cause the employee contributions to be maintained in a separate account that is treated as a defined contribution plan, as described above.

If voluntary employee contributions are maintained in a separate account that is treated as a defined contribution plan, as described above, the amount of benefits attributable to employee contributions is the account balance. If voluntary employee contributions are not maintained in a separate account, the amount of benefits attributable to employee contributions is determined by multiplying the amount of the employee's total benefits under the plan by the ratio of (1) the total of the employee's contributions to the plan to (2) the sum of the employee's contributions and the employer contributions made to the plan on behalf of the employee.

Cost-of-living adjustments

Generally the amount of an employee's annual retirement benefit from a defined contribution plan is determined at retirement and does not change. However, some defined benefit plans provide for post-retirement benefit increases based on cost-of-living adjustments ("COLAs"). A COLA may be provided automatically as part of the normal retirement benefit under the plan (an "automatic" COLA) or may be provided by a plan amendment made at the time (or times) the employer deems a COLA to be appropriate (an "ad hoc" COLA).

Insurance contract plans

An insurance contract plan is a defined benefit plan that meets the following requirements: (1) the plan is funded exclusively by the purchase of individual insurance

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[28] Governmental plans are not subject to the vesting requirements.

[29] The specified rate is (1) 120 percent of the Federal midterm rate for the period from the time the contribution is made to the time the determination is made, and (2) the statutory interest rate (i.e., the interest rate on 30-year Treasury securities) for the period from the time the determination is made to the time the employee would reach normal retirement age.

contracts,[30] (2) the contracts are paid for by level annual premiums over the period of the individual's participation in the plan, (3) benefits under the plan equal the benefits provided under the contracts at normal retirement age under the plan and are guaranteed by the insurance carrier, (4) premiums payable for the plan year, and all prior plan years, have been paid, (5) no rights under the contracts have been subject to a security interest at any time during the plan year, and (6) no policy loans are outstanding at any time during the plan year. Special accrual and funding rules apply to insurance contract plans.

2. Benefit accrual requirements[31]

In general

Several of the requirements that apply to a qualified retirement plan relate to a participant's accrued benefit. For example, the vesting requirements apply with respect to a participant's accrued benefit. In addition, as discussed below, a plan amendment may not have the effect of reducing a participant's accrued benefit.

In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan. In the case of a defined benefit plan, a participant's accrued benefit is the portion of the normal retirement benefit (i.e., the annuity payable at normal retirement age under the plan's benefit formula, based on the participant's compensation and years of service) that has accrued under the accrual method provided under the plan. For example, if a participant terminates employment before reaching normal retirement age, the benefit to which the participant is entitled is the accrued benefit. The accrual method under a defined benefit plan must satisfy one of three accrual methods provided under the Code.

Permissible accrual methods

The three permissible accrual methods are (1) the 133-1/3 percent method, (2) the fractional method, and (3) the three-percent method. Most defined benefit plans use the 133-1/3 percent method or the fractional method.

Under the 133-1/3 percent method, (1) the accrued benefit payable at normal retirement age must equal the normal retirement benefit under the plan, and (2) the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age for any plan year cannot be more than 133-1/3 percent of the annual rate at which he or she can accrue benefits for any earlier plan year. For example, if the plan provides that a participant accrues a benefit of 1.5 percent of compensation for each year of service up to 20 and 2 percent of compensation for each year of service in excess of 20, the plan satisfies the requirements of the 133-1/3 percent method. However, a benefit that accrues at the rate of one percent of compensation for each year of service up to 20 and 1.5 percent of compensation for each year of service in excess of 20 does not satisfy the requirements of the 133-1/3 percent method.

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[30] Group insurance contracts may be used if certain requirements are met.

[31] Sec. 411. Governmental plans are not subject to the accrual requirements.

Under the fractional method, the accrued benefit to which a participant is entitled at any time must equal or exceed the participant's "fractional rule benefit," multiplied by a fraction (not exceeding one), the numerator of which is the participant's total years of participation in the plan, and the denominator of which is the total number of years of plan participation the participant would have if he or she separated from service at normal retirement age. A participant's "fractional rule benefit" is the normal retirement benefit to which the participant would be entitled under the plan if the participant attained normal retirement age on the date the benefit is being determined (i.e., based on the participant's current amount of compensation and years of service).

The fractional method is illustrated by the following example. Suppose a plan provides a normal retirement benefit at age 65 of two percent of compensation for each year of service up to 30 years, so that a participant with 15 years of service has a fractional rule benefit of 30 percent of compensation (determined as if the participant attained normal retirement age on the date the benefit is being determined). For a participant who began participation in the plan at age 21 and is now age 36, the participant's accrued benefit under the fractional method is the participant's fractional rule benefit (30 percent of compensation), multiplied by the fraction 15/44 (i.e., the participant's 15 years of participation over the participant's projected years of plan participation at normal retirement age of 65) or 10.23 percent of compensation. For a participant who began participation in the plan at age 35 and is now age 50, the participant's accrued benefit under the fractional method is the participant's fractional rule benefit (30 percent of compensation), multiplied by the fraction 15/30 (i.e., the participant's 15 years of participation over the participant's projected years of plan participation at normal retirement age of 65) or 15 percent of compensation.

Under the three-percent method, the accrued benefit to which each participant is entitled (computed as if the participant separated from the service as of the end of the plan year) must be at least three percent of the "three-percent method benefit," multiplied by the participant's years of plan participation as of the end of the year (but not more than 33-1/3 years). A participant's "three-percent method benefit" is the normal retirement benefit to which the participant would be entitled if he or she began participation at the earliest age possible under the plan and participated in the plan continuously until the earlier of age 65 or the normal retirement age under the plan.

The fractional method and the three-percent method provide the minimum rate at which a participant's benefit must accrue. Therefore, a plan may use an accrual method under which participants' accrued benefits exceed the minimum, provided that no participant's accrued benefit can be less than the minimum.

Notice of reduction in future rate of accrual[32]

If an amendment to a defined benefit plan provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy, the plan administrator must furnish a written notice concerning the

[32] Sec. 4980F.

amendment. The plan administrator is required to provide in this notice, in a manner calculated to be understood by the average plan participant, sufficient information (as defined in Treasury regulations) to allow participants to understand the effect of the amendment.

The plan administrator is required to provide this notice to each affected participant, each affected alternate payee, and each employee organization representing affected participants. An affected participant or alternate payee is a participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment. The plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment.

3. Optional forms of benefit

Accrued benefits under a defined benefit plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form.[33] Under an exception, if a participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's vested accrued benefit without the consent of the participant, if the present value of the benefit does not exceed $5,000.[34]

Defined benefit plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.[35]

A defined benefit plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

In addition, statutory actuarial assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.[36] That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to

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[33] Governmental plans are not subject to this requirement. See below for a discussion of the spousal protection rules (including spousal consent) for distributions in the case of a married participant.

[34] The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested accrued benefit.

[35] In some cases, an optional form of benefit may be "subsidized," i.e., more valuable on an actuarial basis than the life annuity payable to the participant.

[36] The statutory actuarial assumptions must be used also in determining whether the present value of the benefit exceeds $5,000.

the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the Internal Revenue Service) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of a time that is permitted under regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

4. Prohibition on reductions in accrued benefits[37]

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[38] This prohibition applies to benefits that have already accrued. An amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, notice is provided as discussed above.

For purposes of the prohibition on reductions in accrued benefits, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

5. Spousal protections[39]

Defined benefit plans are required to provide benefits in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. In the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity ("QPSA"), which must provide the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these requirements include providing the

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[37] Sec. 411(d)(6).

[38] This restriction is sometimes referred to as the "anticutback" rule.

[39] Secs. 401(a)(11) and 417. These requirements also apply to money purchase pension plans, but not to other defined contribution plans if the participant does not elect an annuity as the form of payment, the surviving spouse is the participant's beneficiary (unless the spouse consents to the designation of another beneficiary), and, with respect to the participant, the plan has not received a transfer from a plan to which the QJSA and QPSA requirements applied (or separately accounts for the transferred assets).

participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver.

6. Limits on benefits[40]

Annual benefits payable under a defined benefit plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $160,000 (for 2003). All defined benefit plans of the employer are aggregated for purposes of this limit. The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan. The compensation limit is reduced proportionately for individuals with less than 10 years of service.

The dollar limit on annual benefits is reduced if benefits under the plan begin before age 62. If benefits under a defined benefit plan begin after age 65, the dollar limit is increased so that it is the actuarial equivalent of a benefit beginning at age 65 in the amount of the dollar limit.

The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning at age 65. If a benefit is payable in another form, the benefit must be adjusted to be actuarially equivalent to a straight life annuity that does not exceed the dollar limit. If the other form of benefit must be determined using the 30-year Treasury interest rate discussed above (e.g., a lump sum benefit), that interest rate must be used also in making the adjustment.

Under a special rule, a minimum benefit can be paid even if the benefit exceeds the normally applicable benefit limitations. Thus, the overall limits on benefits are deemed to be satisfied if the retirement benefit of a participant under all defined benefit pension plans of the employer does not exceed $10,000 for a year or any prior year, and the participant has not participated in a defined contribution plan of the employer. The $10,000 limit is reduced for participants with less than 10 years of service with the employer.

7. Reversions

<u>In general</u>

Defined benefit plan assets generally may not revert to an employer before termination of the plan and the satisfaction of all plan liabilities. In addition, the plan must provide for the reversion. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax.[41] The excise tax rate is generally 20 percent, but increases to 50 percent if the employer does not maintain a

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[40] Sec. 415(b).

[41] Sec. 4980.

replacement plan or make certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be fully vested.

Use of excess plan assets for retiree health benefits[42]

A qualified transfer of excess assets of a defined benefit plan may be made to a separate account within the plan in order to fund retiree health benefits. Excess assets generally means the excess, if any, of the value of the plan's assets[43] over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003),[44] or (2) 125 percent of the plan's current liability.

Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. Amounts transferred in a qualified transfer are not includible in the gross income of the employer and are not subject to the excise tax on reversions of assets in a defined benefit plan. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation). In addition, at least 60 days before the date of a qualified transfer, the plan administrator must notify each participant and beneficiary under the plan of such transfer.[45] The notice must include information with respect to the amount of excess pension assets, the portion to be transferred, the amount of health benefits liabilities expected to be provided with the assets transferred, and the amount of pension benefits of the participant that will be vested immediately after the transfer. The employer maintaining the plan must also provide advance notice of the transfer to the Department of Labor and the Department of Treasury, and any employee organization representing participants in the plan. A copy of this notice must be available for inspection in the principal office of the administrator.

No qualified transfer may be made after December 31, 2005.

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[42] Sec. 420.

[43] The value of plan assets is the lesser of fair market value or actuarial value.

[44] The current liability full funding limit is repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

[45] ERISA sec. 101(e).

II. PRESENT-LAW PENSION FUNDING REQUIREMENTS

A. Funding Rules for Defined Benefit Plans

1. In general

Defined benefit plans are subject to minimum funding requirements.[46] The minimum funding requirements are designed to ensure that plan assets are sufficient to pay plan benefits when due. The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required in the case of certain plans.

In general, plan contributions required to satisfy the funding rules must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such date, the contribution is treated as if it were made on the last day of the plan year. However, a plan subject to the additional contributions requirements (described below) may be required to make quarterly contributions.

An employer sponsoring a defined benefit plan generally may deduct amounts contributed to satisfy the minimum funding requirements for a plan year. No contribution is required under the minimum funding rules in excess of the full funding limit (described below). In addition, contributions in excess of the full funding limit generally are not deductible. Special deduction limits apply in the event an employer maintains both a defined contribution plan and defined benefit plan. Nondeductible contributions are subject to a 10-percent excise tax, unless an exception applies.[47]

The minimum required or maximum permitted contribution that can be made to a defined benefit plan depends on the funding method used by the plan and the actuarial assumptions used by the plan actuary. As a result, subject to the minimum funding requirements and the limits on deductible contributions, plan sponsors have flexibility to determine the amount of a contribution to make with respect to any plan year. Thus, for example, plan sponsors may vary the amount of the contributions based on the business cycle of the employer.

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[46] Sec. 412.

[47] Sec. 4972.

2. General minimum funding rules[48]

Funding standard account

As an administrative aid in the application of the funding requirements, a defined benefit plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (as described below), including credits for contributions to the plan, are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is generally treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

Funding methods

In general

A defined benefit plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as (1) normal cost, and (2) supplemental cost.

Normal cost

The normal cost for a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

Supplemental cost

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common

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[48] Governmental plans are not subject to the minimum funding rules.

supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized over a specified number of years.

Acceptable methods

Normal cost and supplemental cost are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under one of a number of permissible actuarial cost methods. Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually.

Charges and credits to the funding standard account

In general

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

Normal cost

Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit. For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability

There are three separate charges to the funding standard account, one or more of which may apply as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account over a specified period of years, generally 30 years for the first two types of past service liabilities and 40 years for the third type of past service liability.[49] Assuming that there are no other credits in the account to offset a charge for past service liability, an employer contribution will be required for the year to avoid an accumulated funding deficiency.

For example, assume that a plan uses the calendar year as the plan year. Further assume that during 1987 the plan was amended to increase benefits and that the net result of plan amendments for 1987 was an increase in the past service liability under the plan of $500,000. In addition, the plan's actuary uses an interest rate of eight percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.[50] Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid an accumulated funding deficiency unless the plan becomes fully funded.

Gains and losses from changes in assumptions

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of ten years, resulting in credits or charges to the funding standard account.

Experience gains and losses

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable, as discussed below. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than those anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those

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[49] In the case of certain multiemployer plans, special amortization periods may apply to credits and charges related to certain past service liabilities. Sec. 412(b)(6).

[50] This amount, $44,414, when paid annually over a 30-year period, has a present value of $500,000 when discounted using an eight percent interest rate.

anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized over a five-year period.[51]

Waived funding deficiencies

Under the funding standard, the amount of a waived funding deficiency is amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

Reasonableness of actuarial assumptions

All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

3. Special rules for multiemployer plans[52]

Certain modifications to the funding rules apply to multiemployer plans that experience financial difficulties, referred to as "reorganization status." A plan is in reorganization status for a year if the contribution needed to balance the charges and credits to its funding standard account exceeds its "vested benefits charge." The plan's vested benefits charge is generally the amount needed to amortize, in equal annual installments, unfunded vested benefits under the plan, over (1) 10 years in the case of obligations attributable to participants in pay status, and (2) 25 years in the case of obligations attributable to other participants. A plan in reorganization status is eligible for a special funding credit. In addition, a cap on year-to-year contribution increases and other relief is available to employers that continue to contribute to the plan.

Subject to certain requirements, a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC.[53] In order for accrued benefits to be reduced, at least six months

[51] In the case of certain multiemployer plans, special amortization periods may apply to credits and charges related to certain experience gains or losses. Sec. 412(b)(6).

[52] Secs. 418-418D. A multiemployer plan is a plan (1) maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, (2) to which more than one employer is required to contribute, and (3) that satisfies other requirements prescribed by the Secretary of Labor.

[53] The rules applicable to qualified retirement plans generally prohibit a plan amendment that reduces participants' accrued benefits.

before the beginning of the plan year in which the amendment is adopted, notice must be given that the plan is in reorganization status and that, if contributions to the plan are not increased, accrued benefits will be reduced or an excise tax will be imposed on employers obligated to contribute to the plan. The notice must be provided to plan participants and beneficiaries, any employer who has an obligation to contribute to the plan, and any employee organization representing employees in the plan.

Multiemployer plans are also exempt from the additional funding requirements (described below) and the statutory interest and mortality assumptions required to be used for that purpose.

4. Additional funding requirements for certain plans[54]

In general

Additional contributions may be required under a special funding rule for certain single-employer defined benefit pension plans.[55] These additional funding requirements were enacted in 1987 and amended in 1994 to address demands on the PBGC insurance system as a result of terminations of underfunded plans.

Under the special funding rule, additional contributions are generally required if the value of the plan assets is less than 90 percent of the plan's current liability.[56] The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage." In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present value basis.

The minimum required contribution under the special rule is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the deficit reduction contribution, plus the amount required with respect to benefits that are contingent on unpredictable events. The deficit reduction contribution is the sum of (1) the unfunded old liability amount, (2) the unfunded new liability amount, (3) the expected increase in current liability due to benefits accruing during the plan year, and (4) the amount needed to amortize increases in current liability due to certain future changes in the mortality table required to be used in determining current liability. The amount of additional contributions required under the

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[54] Sec. 412(l).

[55] Single-employer plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

[56] Under an alternative test, a plan is not subject to the special rule if (1) the value of the plan assets is at least 80 percent of current liability and (2) the value of the plan assets was at least 90 percent of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years.

special funding rule cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

Unfunded old liability amount

The unfunded old liability amount is the sum of two amounts. The first amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years, beginning with the first plan year beginning after December 31, 1988. The "unfunded old liability" with respect to a plan is generally the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to certain collective bargaining agreements). The second amount is, in general, the amount needed to amortize the additional old unfunded liability over a period of 12 years, beginning with the first plan year beginning after December 31, 1994. The "additional old unfunded liability" is the increase in the unfunded old liability resulting from statutory changes made in the interest rate and mortality assumptions used to determine current liability for plan years beginning after December 31, 1994.

Unfunded new liability amount

The unfunded new liability amount for a plan year is the applicable percentage of the plan's unfunded new liability. "Unfunded new liability" means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability amount, any unfunded mortality increases, and certain unfunded liabilities under a collectively bargained plan, and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 60 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent.

Unpredictable contingent event benefits

The value of any unpredictable contingent event benefit is not considered until the event has occurred. In the case of a plan that is subject to the additional funding requirements, if the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event has occurred), then an additional contribution (over and above the minimum funding contribution otherwise due) is required.

Unpredictable contingent event benefits include benefits that depend on contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably predictable. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

The amount of the additional contribution is generally equal to the greatest of the following three amounts: (1) the unfunded portion of the unpredictable contingent event benefits paid during the plan year, including (except as provided by the Secretary) any payment for the purchase of an annuity contract for a participant with respect to unpredictable contingent event benefits; (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over seven years, beginning with the plan year in which the event occurs; and (3) the additional contribution that would be required if the unpredictable contingent event benefit liabilities were included in the calculation of the plan's unfunded new liability for the plan year. In addition, the present value of the additional funding contribution with respect to one event is limited to the unpredictable contingent event benefit liabilities attributable to that event.

Required interest rate

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[57] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.[58] The permissible range is generally from 90 percent to 105 percent.[59] The IRS publishes the applicable rate on a monthly basis. The Department of the Treasury does not currently issue 30-year Treasury securities.[60] As of March 2002, the IRS publishes the average yield on the 30-year Treasury bond maturing in February 2031 as a substitute.

Section 405 of the Job Creation and Worker Assistance Act of 2002,[61] provides a special interest rate rule applicable in determining the amount of additional contributions for plan years beginning after December 31, 2001, and before January 1, 2004 (the "applicable plan years"). The special rule expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements for the

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[57] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period.

[58] The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan. Sec. 412(b)(5)(B)(iii)(II).

[59] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

[60] As discussed elsewhere in this document, the interest rate on 30-year Treasury securities is used for other purposes also, including determination of certain optional forms of benefits (e.g., a lump sum), application of the dollar limit on benefits to certain forms of benefit, determination of benefits attributable to mandatory employee contributions, and determination of additional PBGC premiums.

[61] Pub. L. No. 107-147.

applicable plan years. The permissible range is from 90 percent to 120 percent for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

Quarterly contributions requirement

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is generally 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[62] Quarterly installments for a plan year are generally due on April 15, July 15, October 15 of the plan year and January 15 of the following year.

The amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall"). In general, a plan has a liquidity shortfall for a quarter if the plan's liquid assets are less than the base amount for the quarter. For this purpose liquid assets include cash, marketable securities, and other assets specified by the Secretary of the Treasury. The base amount for a quarter is generally three times the adjusted disbursements from the plan for the 12-month period ending on the last day of the month preceding the quarterly installment due date. A plan's adjusted disbursements means the amount of all disbursements from the plan's trust and administrative expenses, reduced by the product of the plan's funded current liability percentage and the sum of certain disbursements. The amount of the liquidity shortfall for a quarter must be paid in liquid assets. The amount of any liquidity shortfall payment, when added to prior installments for the plan year, cannot exceed the amount necessary to increase the funded current liability percentage of the plan to 100 percent, taking into account the expected increase in the plan's current liability due to benefits accruing in the plan year.

[62] In connection with the expanded interest rate range available for 2002 and 2003, special rules apply in determining current liability for the preceding plan year for plans years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions, and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

5. Failure to make required contributions

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[63] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than three waivers may be granted within any period of 15 consecutive plan years (five of any 15 years in the case of multiemployer plan consecutive plan years).

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Excise tax and notice to employees

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[64] The excise tax is 10 percent of the amount of the funding deficiency (five percent in the case of a multiemployer plan). In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period. If an employer maintaining a plan (other than a multiemployer plan) fails to make minimum required contributions and fails to obtain a waiver, the employer must notify participants of the failure.[65]

6. Full funding limit

No contributions are required under the minimum funding rules in excess of the full funding limit and such contributions, if made, generally are not deductible.[66] The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent (for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets (i.e., the average fair market value over a period of

[63] Sec. 412(d).

[64] Sec. 4971.

[65] ERISA sec. 101(d).

[66] Sec. 412(c)(6) and (c)(7). The 10-percent excise tax on nondeductible contributions generally applies only to contributions in excess of the accrued liability full funding limit.

years).[67] However, the full funding limit may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limit may be based on projected future benefits, including future salary increases.

The full funding limit based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. Thus, in 2004 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets, as described above.[68]

7. Security for plan amendments

Under the Code and ERISA, if a plan amendment increasing current liability is adopted, the contributing sponsor and members of the controlled group of the contributing sponsor must provide security in favor of the plan equal to the excess of (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) $10 million.[69] The amendment is not effective until the security is provided.

The security must be in the form of a bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. The security is released after the funded liability of the plan reaches 60 percent.

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[67] In determining current liability for this purpose, the permissible range interest rate range is from 90 percent to 110 percent of the weighted average of the interest rates on 30-year Treasury securities for the preceding four-year period. In addition, certain service that is generally disregarded in determining current liability is taken into account for purposes of the full funding limit.

[68] The full funding limit based on 170 percent of current liability is reinstated pursuant to the general sunset provision of EGTRRA for years beginning after 2010.

[69] Sec. 401(a)(29).

B. Deduction Rules for Defined Benefit Plans

<u>In general</u>

Employer contributions to qualified retirement plans are deductible subject to certain limits.[70] In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. In order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program. Contributions in excess of the full funding limit[71] are generally not deductible.

If an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees, the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

<u>Excise tax on nondeductible contributions</u>

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.[72] In determining the amount of nondeductible contributions for this purpose, the employer is permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit are not subject to the excise tax on nondeductible contributions.

[70] Sec. 404.

[71] The full funding limit is described above in Part II.A.

[72] Sec. 4972.

III. THE PBGC PENSION INSURANCE PROGRAM

A. Present Law

1. In general

As enacted in ERISA, as well as under present law, the minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation ("PBGC"), a corporation within the Department of Labor, was created in 1974 under ERISA to provide an insurance program for benefits under most defined benefit plans maintained by private employers.[73] According to the PBGC's latest annual report (for fiscal year 2002), the PBGC currently insures about 44 million participants in more than 32,700 defined benefit plans. Of these, about 34.4 million participants are covered by approximately 31,050 single-employer pension plans, and about 9.5 million are covered by approximately 1,650 multiemployer plans.

2. Termination of single-employer defined benefit plans

<u>In general</u>

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination.[74] The participants and the PBGC must be notified of the termination. The PBGC may also involuntarily terminate a plan.

<u>Standard terminations</u>

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.[75] Generally, benefit liabilities equal all benefits earned to date by plan participants, including vested and nonvested benefits (which automatically become vested at the time of termination), and including certain early retirement supplements and subsidies.[76] Benefit liabilities may also include certain contingent benefits (for example, plant shutdown benefits). If assets are sufficient to cover benefit liabilities (and other termination requirements, such as notice to employees, have not been violated), the plan distributes benefits to participants. The plan provides for the benefit payments it owes by purchasing annuity contracts from an insurance company, or otherwise providing for the payment of benefits, for example, by providing the benefits in lump sum distributions.

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[73] The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

[74] ERISA sec. 4041.

[75] *Id.*

[76] ERISA sec. 4001(a)(16).

If certain requirements are satisfied, and the plan so provides, assets in excess of the amounts necessary to cover benefit liabilities may be recovered by the employer in an asset reversion. Reversions are subject to an excise tax, described in Part I.B.7., above.

Distress terminations and involuntary terminations by the PBGC

Distress terminations

If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer meets one of four criteria necessary for a ''distress'' termination:

- The contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings;
- The contributing sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding;
- The PBGC determines that termination is necessary to allow the employer to pay its debts when due; or
- The PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.[77]

These requirements, added by the Single Employer Pension Plan Amendments Act of 1986[78] and modified by the Pension Protection Act of 1987[79] and the Retirement Protection Act of 1994,[80] are designed to ensure that the liabilities of an underfunded plan remain the responsibility of the employer, rather than of the PBGC, unless the employer meets strict standards of financial need indicating genuine inability to continue funding the plan.

Involuntary terminations by the PBGC

In order to terminate a plan involuntarily, the PBGC must obtain a court order.[81] The PBGC may institute court proceedings only if the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded nonforfeitable benefits, or may reasonably be expected to increase PBGC's long-run loss unreasonably. The PBGC must terminate a plan if the plan is unable to pay benefits that are currently due. A court may order termination of the plan in order to protect the interests of

[77] ERISA sec. 4041.

[78] Pub. L. No. 99-272.

[79] Pub. L. No. 100-203.

[80] Pub. L. No. 103-465.

[81] ERISA sec. 4042.

participants, to avoid unreasonable deterioration of the plan's financial condition, or to avoid an unreasonable increase in the PBGC's long-run loss.

Asset allocation

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates.[82] Plan assets available to pay for benefits under a terminating plan include all plan assets remaining after subtracting all liabilities, other than liabilities for future benefit payments, paid or payable from plan assets under the provisions of the plan. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories.[83] If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next lower priority category. This process is repeated until all benefits in the priority category are provided or until all available plan assets have been allocated.[84]

Payment of benefits

When a plan terminates in a distress termination and assets are sufficient to pay guaranteed benefits, the plan pays out benefits. When an underfunded plan terminates in a distress or involuntary termination and benefits are insufficient to pay guaranteed benefits, the plan effectively goes into PBGC receivership.[85] The PBGC becomes the trustee of the plan, takes control of any plan assets, and assumes responsibility for liabilities under the plan. The PBGC makes payments for benefit liabilities promised under the plan with assets received from two sources: assets in the plan before termination, and assets recovered from the employer. The balance, if any, of guaranteed benefits owed to beneficiaries is paid from the PBGC's revolving funds.

Employer liability to the PBGC

Additionally, following a distress or involuntary termination, the plan's contributing sponsor and every member of that sponsor's controlled group is liable to the PBGC for the excess of the value of the plan's liabilities as of the date of plan termination over the fair market value of the plan's assets on the date of termination.[86] The liability is joint and several, meaning that each member of the controlled group can be held responsible for the entire liability. Generally, the obligation is payable in cash or negotiable securities to the PBGC on the date of termination. Failure to pay this amount upon demand by the PBGC may trigger a lien on the

[82] ERISA sec. 4044(a).

[83] *Id.*

[84] The asset allocation rules also apply in standard terminations.

[85] ERISA sec. 4042(b).

[86] ERISA sec. 4062.

property of the contributing employer's controlled group for up to 30 percent of its net worth. Obligations in excess of this amount are to be paid on commercially reasonable terms acceptable to the PBGC.

Restoration of a terminated plan

ERISA authorizes the PBGC to restore a terminated pension plan to its sponsoring employer if the PBGC determines that restoration is appropriate and consistent with its duties under ERISA.[87] The PBGC has restored pension plans only once, in the case of an employer that set up new plans (called "follow-on plans") to provide employees with the benefits under the original plans that were not guaranteed by the PBGC.[88] After the restoration of those plans, Treasury regulations were issued to establish a special funding method (the "restoration method") to apply to restored plans.[89]

Under the restoration method, a special amortization base (the "initial restoration amortization base") is established, consisting of the unfunded liability of the plan (i.e., the amount by which liabilities exceed assets) as of the first valuation date after the restoration, based upon the assets and liabilities restored by the PBGC. The PBGC establishes a schedule of restoration payments to be made by the employer, over a period of no more than 30 years, to amortize the initial restoration amortization base. The restoration method generally applies only to the initial restoration amortization base, i.e., the usual funding rules generally apply to plan costs, gains and losses for periods after the plan is restored.

Subject to limitations, the PBGC may grant a deferral of the required restoration payments for a year in order to avoid temporary substantial business hardship of the plan sponsor. The PBGC may also modify the restoration payment schedule; however, any modification must comply with the requirements of the restoration method, including the requirement that the 30-year period not be extended.

3. Multiemployer plans

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. Accordingly, a multiemployer plan need not be terminated to qualify for PBGC financial assistance, but must be found to be insolvent. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to

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[87] ERISA sec. 4047.

[88] *See Pension Benefit Guaranty Corporation v. LTV Corporation*, 496 U.S. 633 (1990). The opinion notes that the PBGC views follow-on plans as an abuse of the PBGC insurance program, under which the PBGC is responsible for benefits under a terminated plan. The establishment of a follow-up plan for benefits not covered by the terminated plan means that, in effect, the insurance program is being used to subsidize an ongoing retirement program.

[89] Treas. Reg. sec. 1.412(c)(1)-3.

pay benefits that come due in the next plan year. If it appears that available resources will not support the payment of benefits at the guaranteed level, the PBGC will provide the additional resources needed as a loan. The PBGC may provide loans to the plan year after year. If the plan recovers from insolvency, it must begin repaying loans on reasonable terms in accordance with regulations.

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the withdrawal liability.[90] In general, "complete withdrawal" means the employer has permanently ceased operations under the plan, has permanently ceased to have an obligation to contribute.[91] A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.[92] When an employer withdraws from a multiemployer plan, the plan sponsor is required to determine the amount of the employer's withdrawal liability, notify the employer of the amount of the withdrawal liability, and collect the amount of the withdrawal liability from the employer.[93] The employer's withdrawal liability generally is based on the extent of the plan's unfunded vested benefits for the plan years preceding the withdrawal.[94]

4. Guaranteed benefits

In general

Single-employer plans

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depend on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. Within certain limits, the PBGC guarantees any retirement benefit that was vested on the date of plan termination (other than benefits that vest solely on account of the termination), and any death, survivor or disability benefit that was owed or was in payment status at the date of plan termination. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump sum benefits payable to encourage early retirement) is guaranteed.[95]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee such as that before the date the plan terminates, the

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[90] ERISA sec. 4201.

[91] ERISA sec. 4203.

[92] ERISA sec. 4205.

[93] ERISA sec. 4202.

[94] ERISA secs. 4209, 4211.

[95] ERISA sec. 4022(b) and (c).

participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, early retirement benefits provided only if a plant shuts down) are guaranteed only if the triggering event occurs before plan termination.

For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.[96] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65, and does not apply to certain types of ancillary benefits. In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.

Multiemployer plans

The PBGC guarantees benefits under a multiemployer plan of the same type as those guaranteed under a single-employer plan, but a different guarantee ceiling applies. The limit for multiemployer plans is the sum of 100 percent of the first $11 of monthly benefits and 75 percent of the next $33 of monthly benefits for each year of service.[97]

5. Sources of PBGC funding

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings.

Single-employer plans

All covered single-employer plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional variable premium based on the level of underfunding.

As initially enacted in ERISA, covered plans were required to pay a flat premium to the PBGC of $1 per plan participant. The flat-rate per-participant premium has been increased several times since the enactment of ERISA and is $19 per participant.[98]

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[96] Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plans whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who (1) owns the entire interest in an unincorporated trade or business, (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership, (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation, or (4) at any time within the preceding 60 months was a substantial owner under the plan. ERISA sec. 4022(b)(5).

[97] ERISA sec. 4022A(c).

[98] ERISA sec. 4006(a).

In the case of an underfunded plan, additional PBGC premiums are required in the amount of $9 per $1,000 of unfunded vested benefits (the amount which would be the unfunded current liability if only vested benefits were taken into account and if benefits were valued at the variable premium interest rate). These premiums are referred to as "variable rate premiums."[99] No variable-rate premium is imposed for a year if contributions to the plan for the prior year were at least equal to the full funding limit for that year. In determining the amount of unfunded vested benefits, the interest rate used is generally 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins. Under section 405 of the Job Creation and Worker Assistance Act of 2002, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes for 2002 and 2003 is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the applicable plan year begins.

Multiemployer plans

The rules under ERISA governing terminations of multiemployer defined benefit plans also require employers to pay plan termination insurance premiums to the PBGC. The PBGC premium rate for multiemployer plans is $2.60 per participant per plan year.[100] This flat-rate per-participants premium is the only premium paid to the PBGC for multiemployer plans.

[99] If variable rate premiums are required to be paid, the plan administrator generally must provide notice to plan participants of the plan's funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.

[100] ERISA sec. 4006(a)(3).

B. Financial Status of the PBGC

In general

As of September 30, 2002, the PBGC reported a total deficit of $3.48 billion.[101] At the end of the prior fiscal year, a $7.85 billion surplus was reported. The single-employer program reported a loss of $11.37 billion for fiscal year 2002, which, according to the PBGC, was the largest loss in its 28-year history. The multiemployer program reported net income of $42 million for fiscal year 2002.

The single-employer program loss resulted in the PBGC's first deficit position since fiscal year 1995. The PBGC was in a deficit for the first 21 years of its existence. From 1996 though 2001, a surplus was reported. According to the PBGC, the record terminations of underfunded pension plans and financial weakness among many plan sponsors contributed to the decline in its financial position and increased exposure to future claims. In addition, poor returns and interest rate drop worsened its financial position.

As of September 30, 2002, the value of the PBGC's assets in the single-employer and multiemployer programs was approximately $26 billion. This is an increase from approximately $23 billion as of September 30, 2001. The PBGC had an overall rate of return on investment for fiscal year 2002 of 2.1 percent compared with a negative 3.3 percent in 2001.

Table 1 and Table 2, below, summarize the PBGC's financial position and net income for fiscal year 2001 and fiscal year 2002.

Table 1.– Summary of PBGC Financial Position (millions)

	Fiscal year 2001	Fiscal year 2002
Single-employer program surplus/(deficit)[102]	$7,732	($3,638)
Multiemployer program surplus/(deficit)	$116	$158
Combined surplus/(deficit)	$7,848	($3,480)

[101] Information on the financial status of the PBGC was obtained from the Pension Benefit Guaranty Corporation 2002 Annual Report, released January 30, 2003.

[102] The program's surplus is its assets less liabilities.

Table 2.–PBGC Net Income/(Loss)
(millions)

	Fiscal year 2001	Fiscal year 2002
Single-employer program income/(loss)	($1,972)	($11,370)
Multiemployer program income/(loss)	($151)	$42
Combined income/(loss)	($2,123)	($11,328)

Single-employer program

The single-employer program reported a $3.64 billion deficit at the end of fiscal year 2002 and a $7.73 billion surplus at the end of fiscal year 2001. The single-employer program loss of $11.37 billion for fiscal year 2002 was an increase from the loss of $1.97 billion in fiscal year 2001. According to the PBGC, the single-employer program loss in fiscal year 2002 principally resulted from completed and probable terminations of underfunded pension plans. In fiscal year 2002, the PBGC experienced the largest plan termination in its history with the termination and trusteeship of the four LTV Steel pension plans, which resulted in a loss of $1.9 billion. According to the PBGC, another $396 million in losses was absorbed from the pension plans of other steel companies. The PBGC's losses from completed and probable plan terminations increased from a loss of $705 million in fiscal year 2001 to a loss of $9.31 billion in fiscal year 2002. The PBGC states that future losses remain unpredictable as the PBGC's loss experience is highly sensitive to losses from large claims. According to the PBGC, the decline in interest rates increased the PBGC's liabilities by $1.65 billion. The single-employer program reported an investment gain of $170 million for fiscal year 2002.

According to the PBGC, premium revenues for 2002 fell to their lowest level in 11 years, while the benefit payments exceeded $1.5 billion for the first time in the PBGC's history.

Under generally accepted accounting principles, the PBGC recognizes both actual and probable pension plan terminations as losses. The PBGC reports that during fiscal year 2002, $5.91 billion of the $9.31 billion in losses were probable. Since the close of the 2002 fiscal year, the PBGC has assumed responsibility for the pension plans of two steel companies, Bethlehem Steel and National Steel, that together accounted for $5.16 billion of the probable loss. The steel industry accounted for $7.57 billion of the $9.31 billion in losses from completed and probable pension plan terminations in fiscal year 2002.

As of September 30, 2002, the single-employer program reported $25.43 billion in assets to cover $29.07 billion in liabilities. As of September 30, 2001, the program reported $21.77 billion in assets to cover $14.04 billion in liabilities. According to the PBGC, despite the loss and resulting deficit, the program's total assets assure that PBGC will be able to continue meeting its benefit and other obligations while it examines ways to restore a positive net position for the single-employer program. Table 3, below, summarizes the financial position of the single-employer program.

Table 3.–Summary of Financial Position of Single-Employer Program (millions)

	Fiscal year 2001	Fiscal year 2002
Single-employer program assets	$21,768	$25,430
Single-employer program liabilities	$14,036	$29,068
Single-employer program surplus/(deficit)	$7,732	($3,638)

Multiemployer program

The PBGC reported that the multiemployer program recorded a financial gain of $42 million for fiscal year 2002, compared with a net loss of $151 million in 2001. The PBGC attributed the gain to reduced losses from financial assistance to plans and increased investment income. For the fiscal year 2002, the multiemployer program reported a surplus of $158 million, with total assets of $944 million and liabilities totaling $786 million. According to the PBGC, investment income totaled $118 million and premium income totaled $25 million for fiscal year 2002. Table 4, below, summarizes the financial position of the multiemployer program.

Table 4.–Summary of Financial Position of Multiemployer Program (millions)

	Fiscal year 2001	Fiscal year 2002
Multiemployer program assets	$807	$944
Multiemployer program liabilities	$691	$786
Multiemployer program surplus/(deficit)	$116	$158

Single-employer program forecasts

The PBGC's expected claims are dependent on the amount of underfunding in the pension plans that the PBGC insures and the likelihood that corporate sponsors of the underfunded plans will encounter financial distress that results in bankruptcy and plan termination. The PBGC evaluates its exposure and expected claims. The PBGC classifies the underfunding of financially weak companies as "reasonable possible" exposure, as required under accounting principles. The reasonable possible exposure for the single-employer program as of September 30, 2002, was calculated at $35 billion compared to $11 billion for fiscal year 2001. Under the PBGC's model, median claims[103] for the single-employer program over the next 10 years are projected to be approximately $1.85 billion per year (expressed in today's dollars). According to the PBGC, the average level of claims for the single-employer program is projected to be approximately $2.25 billion per year.

[103] Half of the simulations show claims above this amount and half show claims below this amount.

The PBGC also projected its financial position for the single-employer program for 2012. The projected median financial position for 2012 is a $9.6 billion deficit (expressed in today's dollars). The average financial position for 2012 is predicted to be a $12.6 billion deficit. According to the PBGC, the probability of a surplus of any amount in 2012 is 30 percent.

IV. DATA RELATING TO QUALIFIED RETIREMENT PLANS

A. General Data on Qualified Retirement Plan Participation

The recent U.S. Department of Labor National Compensation Survey found that 48 percent of private sector employees participated in employer-sponsored qualified retirement plans in 2000. The survey found that, among full-time employees, participation was 55 percent.[104] Participation rates were higher among public sector employees. The Bureau of Census's Current Population Survey found that 87 percent of State and local government employees and 88 percent of Federal government employees participated in an employer-sponsored retirement plan in 1997.

The National Compensation Survey also found that, in 2000, among full-time employees in the private sector, 42 percent participated in an employer-sponsored defined contribution plan and 22 percent participated in an employer-sponsored defined benefit plan. Some employees participated in both.

Participation in employer-sponsored qualified retirement plans varies with firm size and industry. Figure 1 and Figure 2, below, present some of the findings of the more detailed 1999 National Compensation Survey. Figure 1 and Figure 2 document some of the variability of employee participation in employer-sponsored qualified retirement plans by industry and firm size.

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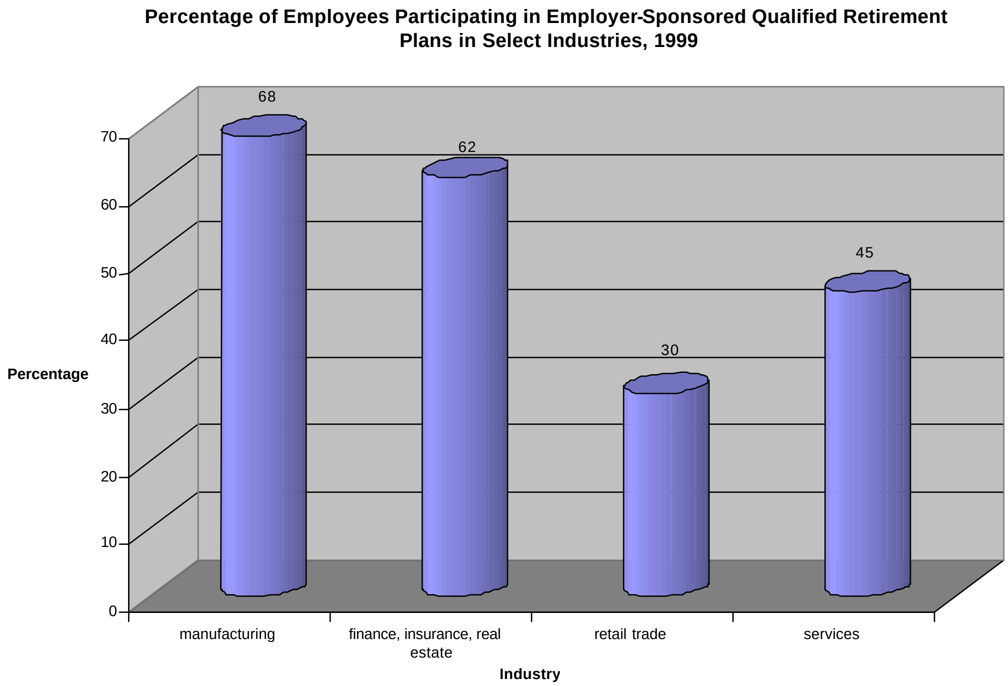
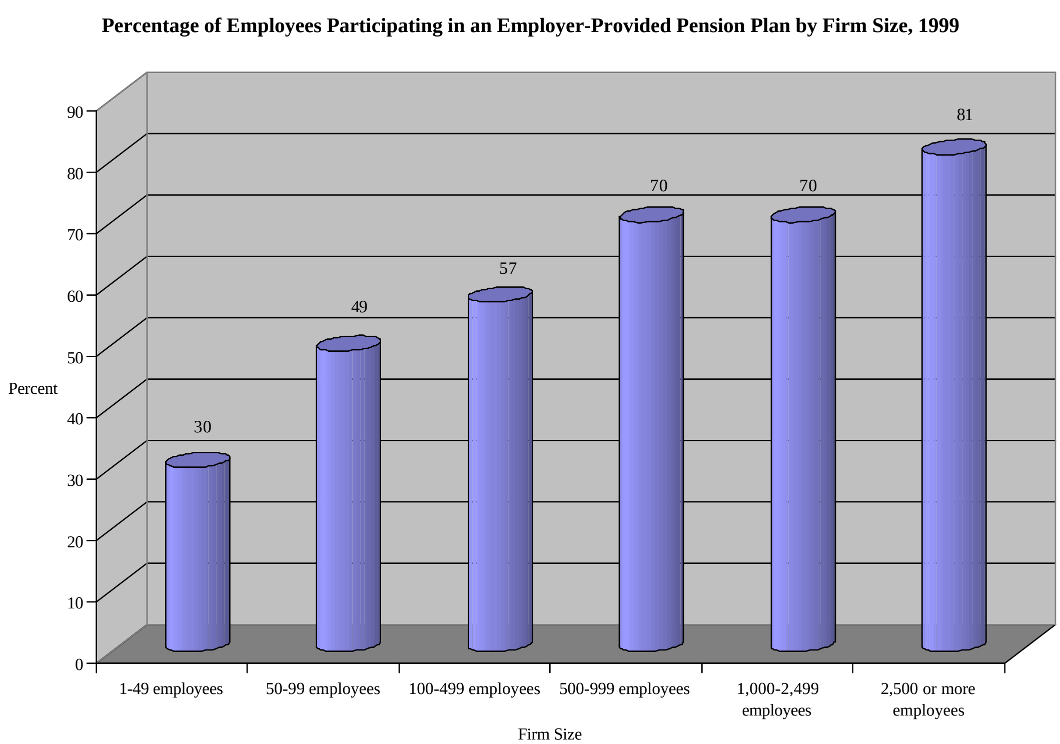
[104] Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry, 2000."

Figure 1



Source: Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry, 1999."

Figure 2



Source: Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry, 1999."

B. Data on Participation in Defined Benefit Plans and Defined Contribution Plans

In 1998, about 56 percent of workers in the private sector who participated in a qualified retirement plan were covered only by a defined contribution plan, 30 percent were covered by both a defined benefit plan and a defined contribution plan, and 14 percent were covered only by a defined benefit plan. Figure 3, Figure 4, and Figure 5, below, document the growth of private sector defined contribution plans relative to defined benefit plans. The data presented in these figures are based on Form 5500 filings. As illustrated in the figures below, the number of defined contribution plans and active participants in those plans have increased over time, while the number of defined benefit plans and the number of active participants in those plans have decreased. As Figure 5 indicates, the number of plan participants only in defined contribution plans grew steadily over the period 1979 to 1998. The number of participants in both defined contribution and defined benefit plans grew from 1979 through 1985 and then stagnated for a decade. The number of participants only in defined benefit plans fell in almost every year. The growth in defined contribution plans and active participants has occurred almost wholly in 401(k) plans.[105]

[105] Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* (JCX-9-02), February 25, 2002, documents the growth of 401(k) plans and the concurrent decline in defined benefit plans and other defined contribution plans.

Figure 3

Number of Qualified Retirement Plans
1978-1998

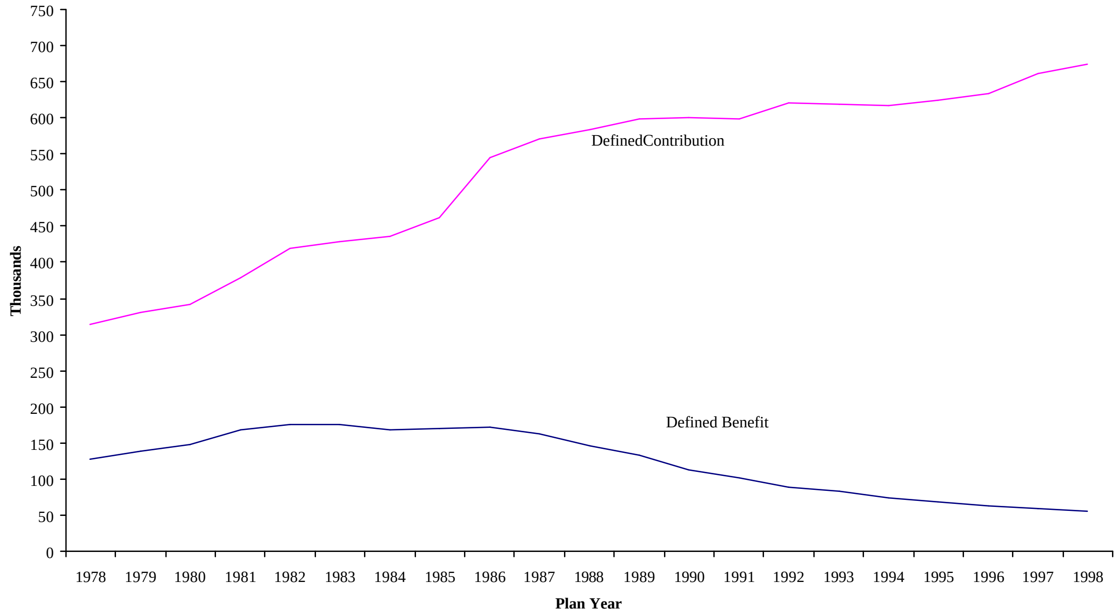


Figure 4

Qualified Retirement Plan Active Participants
1979-1998

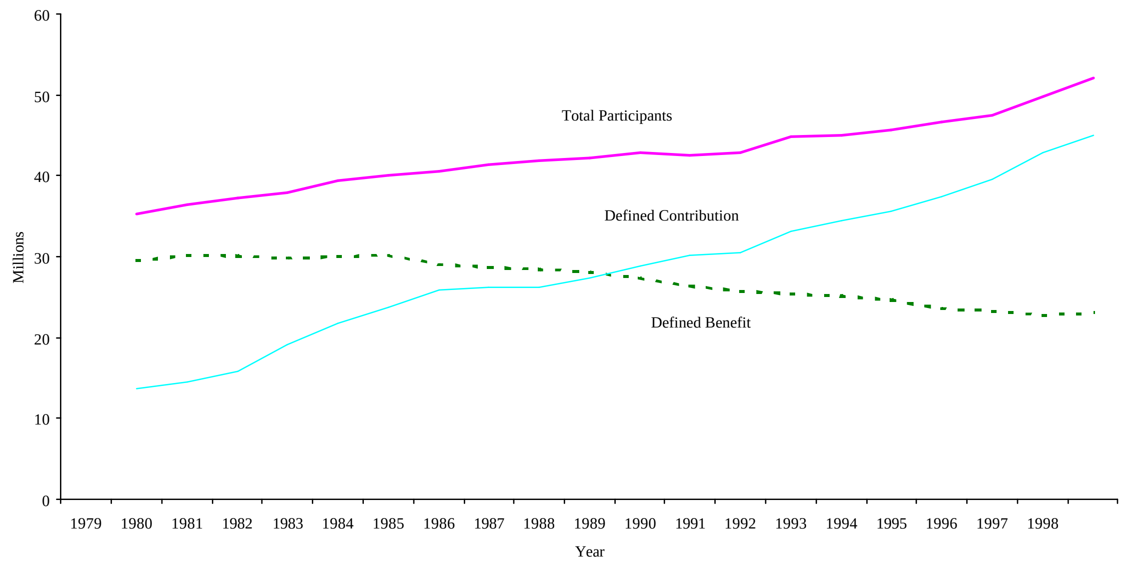
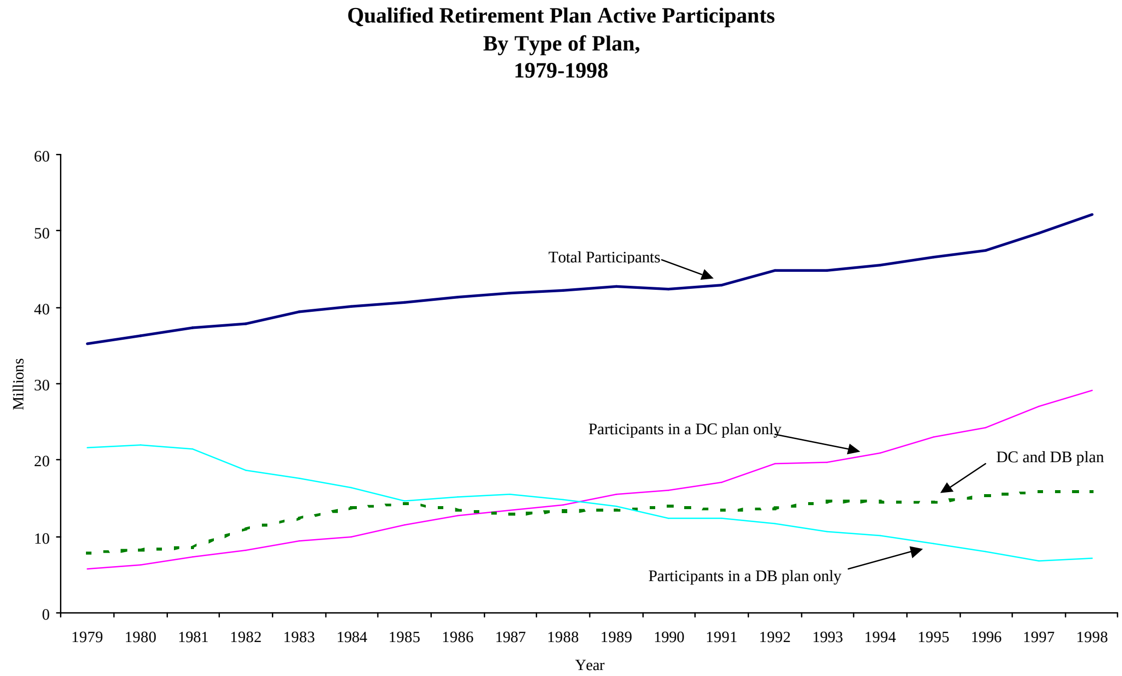


Figure 5



The data for Figure 3, Figure 4, and Figure 5 were compiled by the staff of the Joint Committee on Taxation from Form 5500 Annual Reports filed with the Internal Revenue Service.

C. Data on Qualified Retirement Plan Assets

Figure 3 and Figure 4, above, document the increase in the number of defined contribution plans and the number of participants in defined contribution plans, as well as the concomitant decline in the number of defined benefit plans and the number of participants in defined benefit plans. However, the assets held in both types of plans increased substantially from 1988 through 2001. As of December 31, 1988, data from the Federal Reserve Board of Governors showed that defined benefit plans held assets valued at $812.8 billion and defined contribution plans held assets valued at $594.7 billion. As of December 31, 2002, data showed that defined benefit plans held assets valued at $1.6 trillion and defined contribution plans held assets valued at $2.1 trillion.

Despite the declining number of plans and participants, the market value of assets held in defined benefit plans increased every year throughout the period 1988 through 1999 except in 1990. The value of assets in defined benefit plans has declined in each of 2000, 2001, and 2002. The market value of assets held in defined contribution plans increased in every year throughout the period 1988 through 1999. As with defined benefit plans, the value of assets in defined contribution plans declined in each of 2000, 2001, and 2002. Figure 6, below, shows the increase in market value of assets held in defined benefit plans. Figure 7, below, shows the more rapid increase in the market value of assets held in defined contribution plans that would be expected with the growth in number of participants in such plans.[106] In addition to retirement assets held in defined benefit and defined contribution plans, between 1988 and 2002 the market value of assets held by individuals in IRAs and Keogh accounts (i.e., qualified retirement plans for self-employed individuals), increased from $452 billion at the end of 1988 to $2.5 trillion at the end of 2001.[107]

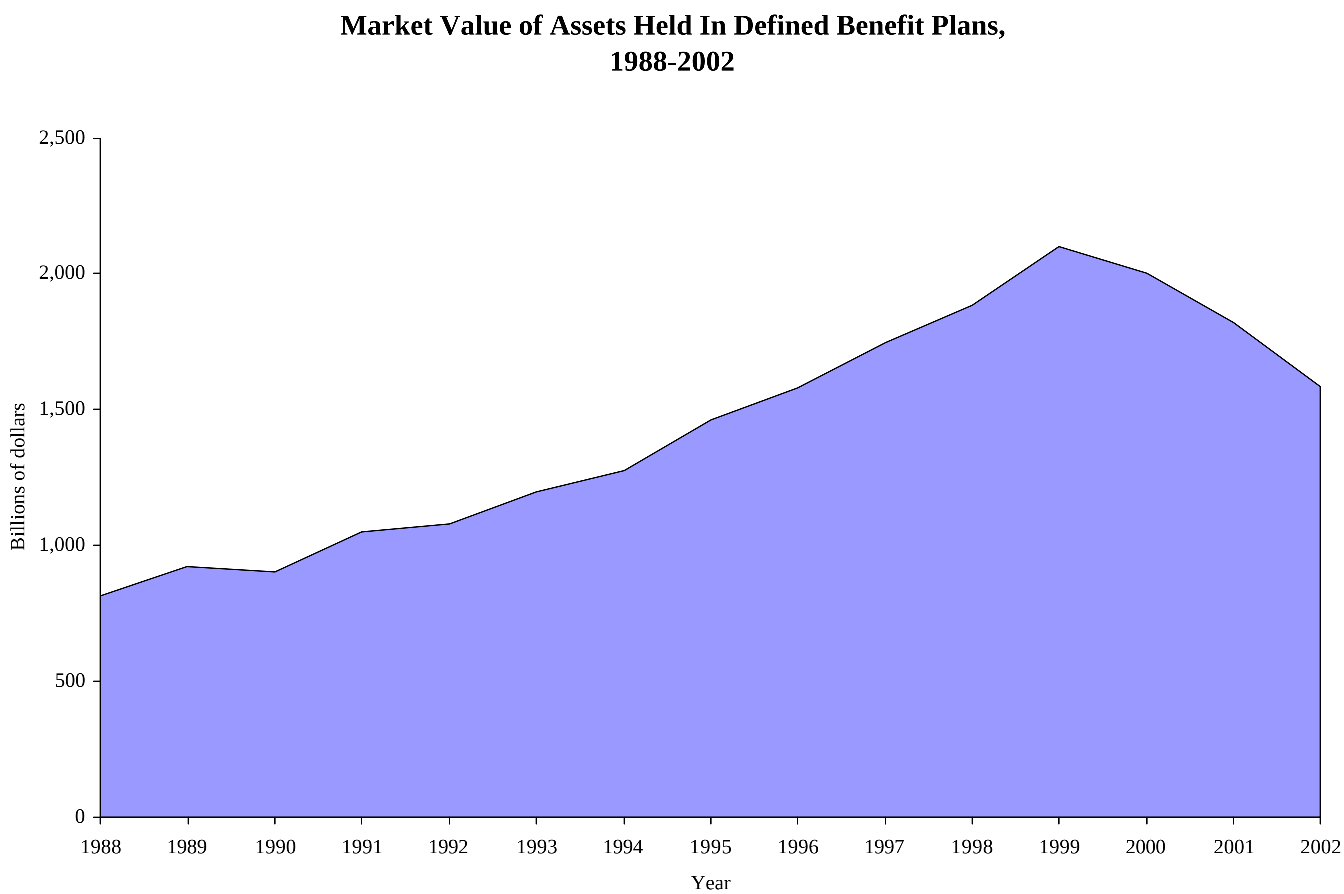
As noted above, a high percentage of employees of State and local governments participate in employer-sponsored pension plans. These plans have significant holdings of financial assets. As of the end of 2002, State and local government pension plans held $1.97 trillion in financial assets. Figure 8, below, documents that the value of assets in State and local

[106] Data for Figure 6 and Figure 7 are from the Board of Governors, United States Federal Reserve System, *Flow of Funds*, March 6, 2003. The data reported on defined contribution plans include balances in the Federal Retirement System Thrift Savings Plan. The data reported in Figure 6 and Figure 7 do not include the value of direct holdings of real estate by private pension plans and thereby understate the total value of private pension fund assets. The Federal Reserve reported this understatement to be less than $100 billion as of the end of 2001.

[107] Board of Governors, United States Federal Reserve System, *Flow of Funds*, March 6, 2003. Estimates of IRA balances as of the close of 2002 are not yet available. Like the value of assets in defined contribution plans, the value of assets in IRAs increased every year from 1988 through 1999, and declined in 2000 and 2001.

plans has increased by one half since 1995. As was the experience for private plans, the value of assets in State and local government pension plans declined in 2001 and 2002. [108]

Figure 6



Source: Board of Governors, Federal Reserve, *Flow of Funds*.

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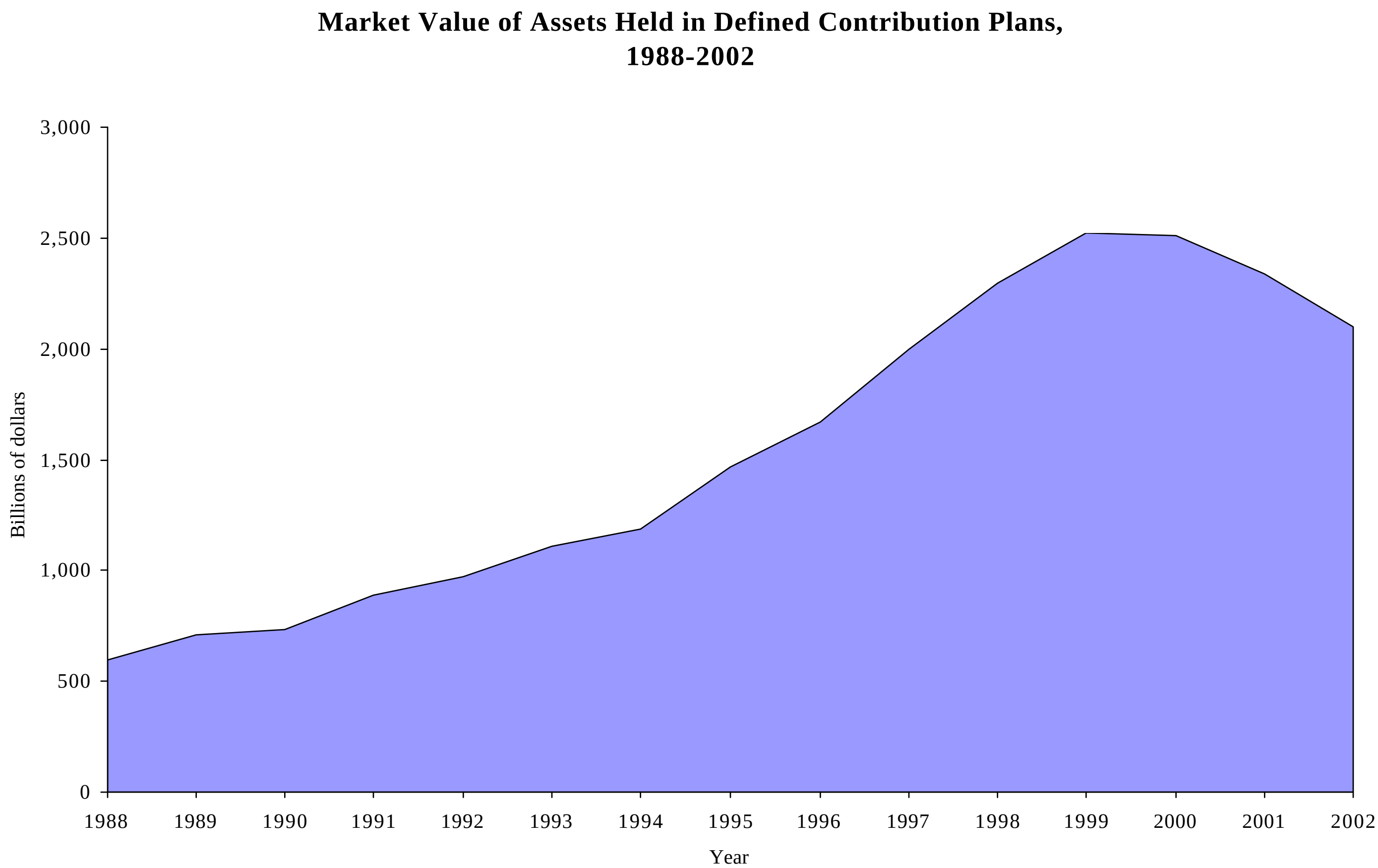
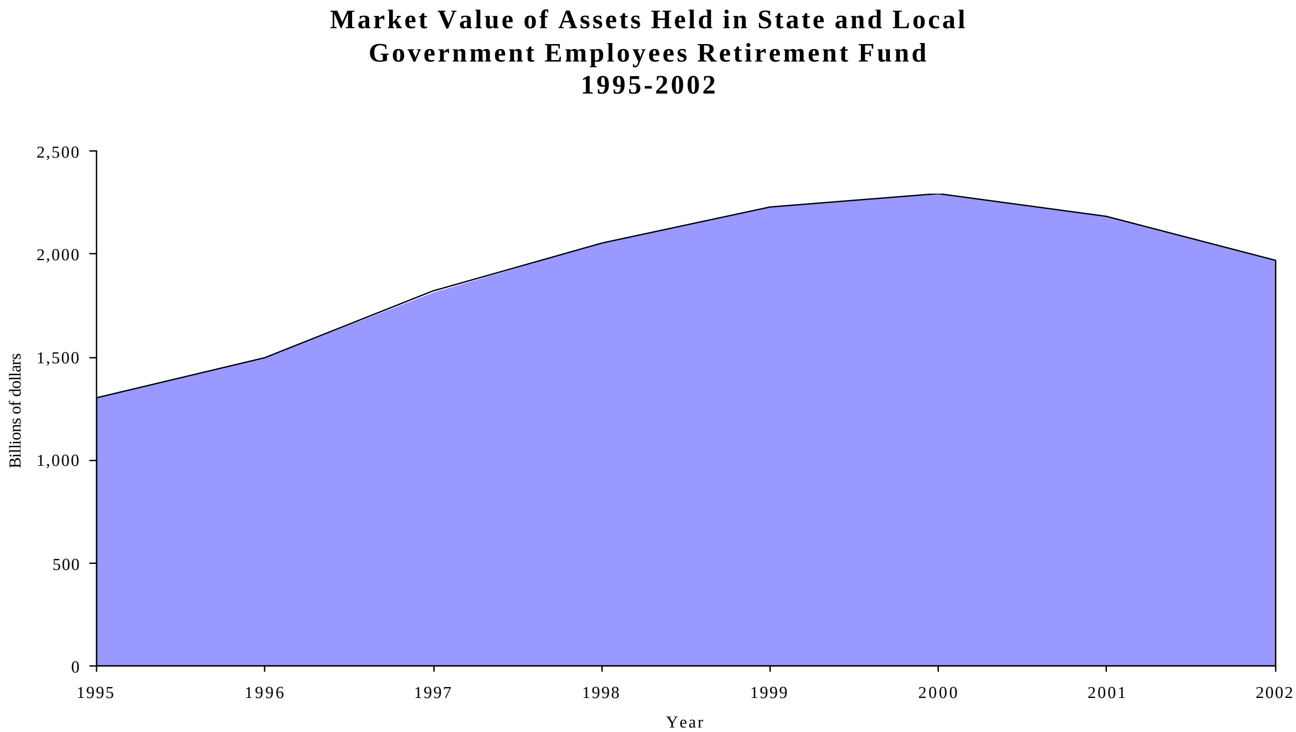
[108] As with the data reported above for private pension plans, the data in Figure 8 do not include direct holding of real estate. The Federal Reserve estimates that direct holdings of real estate by State and local pension plans are less than $50 billion in value. Board of Governors, United States Federal Reserve System, *Flow of Funds*, March 6, 2003.

Figure 7



Source: Board of Governors, Federal Reserve, *Flow of Funds*.

Figure 8



Source: Board of Governors, Federal Reserve; *Flow of Funds*.

V. GENERAL POLICY ISSUES RELATING TO DEFINED BENEFIT PLANS

In general

Almost all changes to pension laws require the balancing of competing policy objectives, including concerns regarding retirement income security, simplification, reduction of administrative burdens, and fiscal and tax policy. In some cases, a single policy concern may result in competing issues. For example, concerns regarding retirement income security may lead to the enactment of provisions giving employees greater rights under pension plans; however, if the new provisions are too severe, plan sponsors may modify plans or reduce benefits, thereby potentially reducing retirement security.

Any legislative changes to the rules relating to defined benefit plans are likely to involve such balancing. General policy issues that may arise in connection with legislative proposals relating to defined benefit plan are discussed below.

Retirement income security

Helping to ensure that individuals have retirement income security is the major objective of the U.S. private pension system. Defined benefit plans are considered by many to provide greater retirement income security than defined contribution plans. Factors that contribute to this view include the fact that such plans offer a specified benefit, the employer bears the risk of investment loss, and benefits are guaranteed (within limits) by the PBGC in the event the plan terminates and plan assets are not sufficient to pay promised benefits. In addition, defined benefit plans are required to provide certain benefits to the spouse of the employee, unless both the spouse and employee elect otherwise, thus providing some degree of income security for spouses.

In contrast, defined contribution plans do not promise a specific benefit, but instead pay the value of the participant’s account. Under defined contribution plans, the plan participant, rather than the employer, bears the risk of investment loss. Benefits provided by defined contribution plans are not guaranteed by the PBGC. The spousal rules applicable to defined contribution plans vary based on the specifics of the plan; however, in most cases, the spouse has only the right to be named the beneficiary of the amount (if any) remaining upon death. Thus, spousal rights are not as great as under defined benefit plans.

The relative decline in defined benefit plan coverage has caused some to be concerned about a possible decline in retirement income security. This concern has focused attention on both defined contribution plans and defined benefit plans.

The reasons for the decline in defined benefit plan coverage are not entirely clear. A number of possible reasons have been cited, including changing worker demographics, administrative burdens on employers, applicable legal restrictions, worker preferences, and employer cost. The need for and design of any legislative changes relating to the defined benefit plan system depend in part on what is viewed as the source of the decline in coverage. For example, EGTRRA made a variety of changes with respect to the rules relating to employer-sponsored retirement plans with a stated goal of expanding coverage. The changes relating to defined benefit plans include increases in the amount of benefits that can be provided, provisions designed to reduce administrative burdens, and greater flexibility in funding rules. The EGTRRA changes may make defined benefit plans more attractive to employers, owner-employees, and highly compensated employees, thus leading to the establishment of new plans or the expansion of existing arrangements.[109]

Some view the decline in defined benefit plan coverage as part of a natural shift toward defined contribution plans. Some argue that many employees prefer defined contribution plans to defined benefit plans and are better off under such plans. For example, traditional defined benefit plans provide the greatest level of benefits to longer-service employees; employees who terminate employment after only a few years of service may have a very low accrued benefit under a traditional defined benefit plan. Workers who change jobs relatively frequently may prefer the portability typically offered by a defined contribution plan; their account balance can be rolled over and continue to accumulate earnings. While some defined benefit plans may offer lump-sum benefits that would provide the same portability opportunities, not all do. Thus, in some cases, defined contribution plans may enable employees to accrue greater benefits under a defined contribution plan than under a defined benefit plan, thereby increasing retirement security.[110] Employees often find defined contribution plans easier to understand than defined benefit plans, and also often like the opportunity provided by some defined contribution plans to make their own investment decisions. Some argue that legislative changes addressing retirement income security should adapt to the shift toward defined contribution plans, and focus on ways in which to enhance security with respect to such plans.

In some cases, particular plan features may give rise to concerns regarding retirement benefit security. For example, conversions of more traditional defined benefit plans to cash balance plans have raised issues with respect to whether employees in general and in specific cases are better off under the new plan design or the old plan design and whether employees have sufficient information to understand the plan changes. Concerns regarding conversions to cash balance plans led to the enactment in EGTRRA of new notification requirements regarding a significant reduction in future benefit accruals.

<u>Issues relating to funding and the solvency of the PBGC insurance program</u>

As discussed above, present law imposes minimum funding requirements with respect to defined benefit plans and a limit on the maximum amount of deductible contributions. In addition, nondeductible contributions are discouraged through the imposition of an excise tax. Contributions in excess of the amount needed to provide plan benefits are also discouraged through the restrictions on reversions of plan assets. These funding rules are a cornerstone of the

[109] On the other hand, some have raised concerns that some of EGTRRA's changes may serve merely to increase benefits for highly compensated employees without any change in benefits for rank and file workers.

[110] On the other hand, some argue that this increased retirement security may not materialize if the individual incurs investment losses or low investment earnings on his or her account balance.

defined benefit plan system and, over time, have been a frequent source of discussion and change.

Like many of the qualified retirement plan rules, the funding rules for defined benefit plans involve balancing competing policy interests. The minimum funding rules are designed to promote benefit security by helping to ensure that plan assets will be sufficient to pay promised benefits when due. The minimum funding rules also address moral hazard concerns relating to the PBGC insurance program by preventing employers from purposely underfunding plans. Such underfunding can increase costs to the Federal government as well as PBGC premium payors.

On the other hand, the minimum funding rules recognize that pension benefits are often long-term liabilities that can be funded over a period of time. Some argue that if minimum funding requirements are too stringent, funds may be unnecessarily diverted from the employer's other business needs and may cause financial problems for the business, thus jeopardizing the future of not just the employees' retirement benefits, but also their jobs. This suggestion tends to arise during a period of economic downturn, either generally or in a particular industry. Some also argue that overly stringent funding requirements may discourage the establishment of defined benefit plans.

The limits on deductible contributions, the excise tax on nondeductible contributions, and the rules relating to reversions of defined benefit plan assets have as a major objective preventing the use of defined benefit plans as a tax-favored funding mechanism for the business needs of the employer. They also serve to limit the tax expenditure associated with defined benefit plans. Some argue that if the maximum limits on plan funding are too low, then benefit security will be jeopardized. They argue that employers need flexibility to make greater contributions when possible, in order to ensure adequate funding in years in which the business may not be as profitable. In addition, some argue that if restrictions on reversions are too strict, employers may be discouraged from making contributions in excess of the required minimums.

The desire to achieve the proper balance between these competing policy objectives has resulted in a variety of legislative changes to address the concerns arising at particular times. For example, the Omnibus Budget Reconciliation Act of 1987 made comprehensive changes to the minimum funding rules promoted by concerns regarding the solvency of the defined benefit plan system. That Act also added the current liability full funding limit. Legislation enacted in 1990 allowed employers access to excess assets in defined benefit plans in order to pay retiree health liabilities. The Retirement Protection Act of 1994 again made comprehensive changes to the funding rules. Recent changes to the funding rules have focused on increasing the maximum deductible contribution, and on the interest rate that must be used to calculate required contributions. For example, EGTRRA increased the current liability full funding limit and then repeals the current liability full funding limit in 2004.

<u>Issues related to the interest rate used to value benefits under a plan</u>

<u>In general</u>

One issue relating to defined benefit plans that has received attention is the rate of interest used to determine the present value of benefits under such plans for purposes of the plan's current liability (and hence the amount of contributions required under the funding rules) and the amount of minimum and maximum lump sum benefits under the plan. The theoretical basis for the interest rate to be used to determine the present value of pension plan benefits is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits. However, in practice, the price of an annuity contact encompasses not only an interest rate factor but also other factors, such as the costs of servicing the contract and recordkeeping. Under present law, the interest rate used for determining current liability is intended to embody all of these factors.[111]

Under present law, the interest rate used for these purposes is based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate, and statutory changes are necessary to reflect this. In addition, as discussed below, concerns have been raised by some that the 30-year Treasury rate was too low compared to annuity purchase rates and therefore caused inappropriate results.

For plan funding purposes, the use of a lower interest rate in determining current liability results in a higher present value of the benefits and larger contributions required to fund those benefits. Alternatively, the use of a higher interest rate results in a lower present value of future liabilities and therefore lower required contributions. Because minimum lump-sum distributions are calculated as the present value of future benefits, the interest rate used to calculate this present value will affect the value of the lump-sum benefit. Specifically, the use of a lower interest rate results in larger lump sum benefits; the use of a higher interest rate results in lower lump sum benefits.

Some have argued that the 30-year Treasury rate was too low compared to annuity rates, resulting in inappropriately high levels of minimum funding requirements on employers that are not necessary to maintain appropriate retirement income security. In addition, some argue that the 30-year Treasury rate was so low as to make lump-sum benefits disproportionately large in comparison with a life annuity benefit payable under the plan, thus providing an incentive for employees to take benefits in a lump sum rather than in the form of a life annuity. Some argue that lump sums should not be favored as a form of benefit, because they can cause a cash drain on the plan. In addition, an annuity assures the individual of an income stream during retirement years, which may not be available in the case of a lump-sum payment, depending on what use the individual makes of the payment (e.g., whether the individual spends the lump sum currently or uses the funds to purchase an annuity).

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[111] *See* H.R. Rpt. No. 100-495, at 868 (1987).

Others have pointed out that a variety of policy issues relating to the funding requirements may arise in the context of the interest rate discussion, and that some of these issues are better resolved through means other than the interest rate. For example, recent declines in pension plan assets have adversely affected the funded status of many plans, resulting in what some view as unduly burdensome funding requirements on employers. Some in favor of funding relief believe it should be provided through interest rate adjustments. Others argue that, if funding relief is desired, it would be better to prescribe a more theoretically correct interest rate, and make other changes in the minimum funding requirements. They suggest that this type of approach would provide relief to employers without resulting in potentially inappropriate results in other cases, e.g., in determining lump-sum benefits. On the other hand, some argue that funding relief is not appropriate at all, and that higher contributions should be required in order to increase funding levels, thereby enhancing retirement security and reducing potential PBGC liabilities.

Other issues that may arise in the context of the interest rate discussion include employer flexibility in making contributions and the appropriate level of tax benefits for defined benefit plans.[112] For example, a given employer may prefer a lower interest rate that enables the employer to make large deductible contributions and thereby maximize the tax benefit from maintaining the plan. Alternatively, another employer may prefer a higher rate that would reduce required contributions, thus freeing up funds for other business uses. Some would argue that the degree of flexibility to be provided to employers should be addressed through means other than the choice of interest rate.

Possible interest rates

The theoretically correct interest rate to be used to determine the present value of pension plan benefits is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits.[113] Some studies have shown that it is not practicable to identify such a rate accurately because of variation in the manner in which prices of private annuity contracts are determined.[114] As a result, the interest rate used to value pension benefits is intended to approximate the rate used in pricing annuity contracts. Some have described this standard as a rate comparable to the rate earned on a conservatively invested portfolio of assets.

Various interest rate indexes have been suggested as possible substitutes for the 30-year Treasury rate. Possible interest rate indexes include rates on Treasury or other Federal agency obligations (e.g., Federal National Mortgage Association notes), rates determined by the PBGC

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[112] A tax benefit results from the prefunding of the retirement benefit, which produces tax-free inside building on the earnings from the assets held by the plan.

[113] As discussed above, in practice the price of an annuity contract may reflect factors other than the interest rate, and present-law rules relating to interest rates are intended to encompass such other factors.

[114] *See, e.g.*, Victor Modugno, *30-Year Treasury Rates and Defined Benefit Pension Plans* (2001), Commissioned for Society of Actuaries, <http://www.soa.org/sections/dbpp.pdf>.

for use in valuing benefit liabilities, rates based on high-quality corporate bonds, or rates used in interest rate swaps. Some have suggested the use of an interest rate determined as a blend or composite of different interest rate indexes.

Some favor use of an interest rate index based on Treasury or other Federal agency obligations out of concern that a privately determined index could be improperly manipulated because the elements on which the index is based, such as the bonds on which a corporate bond index is based, may not be known (i.e., the rate is not "transparent") or because those elements are subject to change by the organization determining the index.[115] On the other hand, some argue that, compared with interest rates on government obligations, private interest rate indexes are more consistent with the interest rates used in pricing annuity contracts.

With respect to the use of a private interest rate index, some have raised the concern that information on some private indexes is available to the public only by subscription. However, whatever interest rate applies for pension purposes can be published by the IRS, consistent with current practice.

Some have suggested that use of any single interest rate is inappropriate, and rather that multiple interest rates should be used to reflect the varying times when benefits become payable under a plan, because of, for example, different expected retirement dates of employees.[116] The rationale for this approach is that interest rates differ depending, in part, on the term of an obligation. In general, longer term bonds pay a higher rate, and shorter term bonds a lower rate. (A graph of this relationship is known as the "yield curve.") Because plan liabilities may be payable both in the short term and the long term, this approach would determine the present value of these liabilities with multiple interest rates, chosen to match the times at which the benefits are payable under the plan. Thus, in general, a shorter-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the nearer term, and a longer-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the more distant future. Under this approach, interest rates would be based on the yield curve for certain types of obligations (e.g., Treasury obligations) of various terms. Some have raised concerns that this approach would be more complicated than the use of a single rate, particularly for smaller plans and for purposes of calculating lump-sum distributions.

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[115] This concern has been raised also in connection with rates determined by the PBGC.

[116] *See, e.g.*, letter dated February 21, 2003, from Peter R. Fisher, Under Secretary for Domestic Finance, Department of Treasury, to Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, United States General Accounting Office, included as Appendix III to *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, GAO-03-313 (February 2003). This approach would mirror the manner in which financial institutions value a series of future liabilities. *See, e.g.*, Ryan Labs, Inc., *Pension Financial Management and Valuation Discount Rates* (2001), Commissioned for Society of Actuaries, <http://www.soa.org/sections/dbpp.pdf>.

Miscellaneous issues

Other issues may also arise in connection with the interest rate used to determine the present value of pension plan benefits. One such issue relates to the fact that the interest rate used for pension purposes is not the 30-year Treasury rate per se, but is based on that rate. For example, present law relies on a weighted average of 30-year Treasury rates and an interest rate corridor that allows plans to adjust the otherwise applicable rate higher or lower. It may be appropriate to review such rules. As another example, one issue that may arise is whether it is appropriate to grant the Treasury Department authority to prescribe limited interest rate adjustments if the statutory rate is unreasonably low (similar to its current authority to prescribe a lower rate if the statutory rate is unreasonably high), thereby permitting changes in the rate to be made administratively. Another issue that may arise is whether transition rules are appropriate, e.g., because employers or employees have relied on present-law rules.