TECHNICAL EXPLANATION OF H.R. 3108, THE "PENSION FUNDING EQUITY ACT OF 2003," AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON OCTOBER 8, 2003

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 3108, the "Pension Funding Equity Act of 2003," as scheduled for consideration by the House of Representatives on October 8, 2003.

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PRESENT LAW AND EXPLANATION OF H.R. 3108

Present Law

Funding rules

In general

The Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA") impose both minimum and maximum[2] funding requirements with respect to defined benefit pension plans.[3] Under the minimum funding rules, the amount of contributions required for a plan year is generally the plan's normal cost for the year (i.e., the cost of benefits allocated to the year under the plan's funding method) 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.

Additional contributions for underfunded plans

Under a special funding rule,[4] additional contributions to a plan are generally required if the plan's funded current liability percentage is less than 90 percent.[5] A plan's "funded current liability percentage" is the value of plan assets as a percentage of the plan's current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan.

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[2] The maximum funding requirement for a defined benefit pension plan is referred to as the full funding limitation. Further contributions are not required if a plan has reached the full funding limitation. The full funding limitation 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 years). The full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter.

[3] Code sec. 412; ERISA sec. 302.

[4] The rule applies to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. 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.

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

If a plan is subject to the special rule, an additional contribution, called a "deficit reduction contribution," is required. The amount of the deficit reduction contribution for a plan year is based on a variety of elements. In general, however, the deficit reduction contribution includes the amount equal to 30 percent of unfunded liabilities.[6] This amount is reduced if the plan's funded current liability percentage is greater than 60 percent. Other factors that affect the amount of the deficit reduction contribution include whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or due to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). In any case, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

<u>Required interest rate and mortality table</u>

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 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.[7] The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[8] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.

The permissible range is generally from 90 percent to 105 percent.[9] The IRS publishes the applicable rate on a monthly basis. The Department of the Treasury does not currently issue 30-year Treasury securities. As of March 2002, the IRS publishes the average yield on the 30-year Treasury bond maturing in February 2031 as a substitute.

The Job Creation and Worker Assistance Act of 2002[10] amended the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements. Under this provision, the permissible range is from

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[6] Only "new" unfunded liabilities are subject to this rule. "New" unfunded liabilities do not include certain liabilities as of 1988 or 1995.

[7] Code sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II).

[8] 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.

[9] 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.

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

90 percent to 120 percent for plan years beginning after December 31, 2001, and before January 1, 2004.[11]

The Secretary of the Treasury is required to prescribe mortality tables and to periodically review (at least every five years) and update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[12] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[13]

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

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 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.

Deductions for contributions

In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over ten years.[14] The maximum amount otherwise

[11] 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 plan 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.

[12] Code sec. 412(l)(7)(C)(ii); ERISA sec. 302(d)(7)(C)(ii).

[13] Rev. Rul. 95-28, 1995-1 C.B. 74. The IRS and Treasury Department have announced that they are undertaking a review of the applicable mortality table and have requested comments on related issues, such as how mortality trends should be reflected. Notice 2003-62, 2003-38 I.R.B. 576; Announcement 2000-7, 2000-1 C.B. 586.

[14] Code sec. 404(a)(1).

deductible is generally limited to the greater of: (1) the full funding limitation for the year; or (2) the plan's unfunded current liability.[15]

PBGC premiums

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. The Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans (up to certain limits) in the event the plan is terminated with insufficient assets. Employers pay premiums to the PBGC for this insurance coverage.

PBGC premiums include a flat-rate premium and, in the case of an underfunded plan, a variable rate premium based on the amount of unfunded vested benefits.[16] In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Under the Job Creation and Worker Assistance Act of 2002, for plan years beginning after December 31, 2001, and before January 1, 2004, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes is increased to 100 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Lump-sum distributions

Accrued benefits under a defined benefit pension 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. Defined benefit pension 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.

A defined benefit pension 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.

Statutory assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.[17] That is, the lump sum payable under the plan

[15] 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.

[16] ERISA sec. 4006.

[17] Code sec. 417(e)(3); ERISA sec. 205(g)(3).

may not be less than the amount of the lump sum that is actuarially equivalent to 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 IRS) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of the 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.

Limits on benefits

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $160,000 (for 2003).[18] The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning no earlier than age 62. The limit is reduced if benefits are paid before age 62. In addition, if the benefit is not in the form of a straight life annuity, the benefit generally is adjusted to an equivalent straight life annuity. In making these reductions and adjustments, the interest rate used generally must be not less than the greater of: (1) five percent; or (2) the interest rate specified in the plan. However, for purposes of adjusting a benefit in a form that is subject to the minimum value rules (including the use of the interest rate on 30-year Treasury securities), such as a lump-sum benefit, the interest rate used must be not less than the greater of: (1) the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan.

Explanation of Provision

Findings and sense of the Congress

The bill makes various findings and expresses the sense of the Congress with respect to the interest rate used to value pension plan liabilities.

Specifically, the bill provides that the Congress finds: (1) the defined benefit pension system has recently experienced severe difficulties due to an unprecedented economic climate of low interest rates, market losses, and an increased number of retirees; (2) the discontinuance of the issuance of 30-year Treasury securities has made the interest rate on such securities an inappropriate and inaccurate benchmark for measuring pension liabilities; (3) using the current 30-year Treasury bond interest rate has artificially inflated pension liabilities and adversely affected employers offering defined benefit pension plans and working families who rely on the safe and secure benefits these plans provide; (4) there is consensus among pension experts that an interest rate based on long-term, conservative corporate bonds would provide a more accurate benchmark for measuring pension plan liabilities; and (5) a temporary replacement for the 30-year Treasury bond interest rate should be enacted while the Congress evaluates permanent and comprehensive funding reforms.

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[18] Code sec. 415(b).

In addition, the bill provides that it is the sense of the Congress that the Congress must ensure the financial health of the defined benefit pension system by working to promptly implement: (1) a permanent replacement for the discount rate used for defined benefit pension plan calculations; and (2) comprehensive funding reforms aimed at achieving accurate and sound pension plan funding to enhance retirement security for workers who rely on defined benefit pension plan benefits, to reduce the volatility of contributions, to provide plan sponsors with predictability for plan contributions, and to ensure adequate disclosures for plan participants in the case of underfunded plans.

Interest rate for funding and PBGC premium purposes

The bill changes the interest rate used for plan years beginning after December 31, 2003, and before January 1, 2006, in determining current liability for funding and deduction purposes and in determining PBGC variable rate premiums. For these purposes, the provision replaces the interest rate on 30-year Treasury securities with the rate of interest on amounts conservatively invested in long-term corporate bonds.

For purposes of determining a plan's current liability for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts conservatively invested in long-term corporate bonds during the four-year period ending on the last day before the plan year begins, as determined by the Secretary of the Treasury on the basis of one or more indices selected periodically by the Secretary. The permissible range for these years is from 90 percent to 100 percent. The Secretary of the Treasury is directed to publish the interest rate within the permissible range. It is intended that the interest rate determined by the Secretary will be based on at least two indices of long-term corporate bonds rates unless there is a compelling reason why at least two indices cannot be used.

In determining the amount of unfunded vested benefits for PBGC variable rate premium purposes for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used is the annual yield on amounts conservatively invested in long-term corporate bonds for the month preceding the month in which the plan year begins, as determined by the Secretary of the Treasury on the basis of one or more indices selected periodically by the Secretary. The Secretary of the Treasury is directed to publish such annual yield.

Effective Date

The provision relating to findings and the sense of the Congress is effective on the date of enactment.

The provision providing a temporary replacement interest rate is generally effective for plan years beginning after December 31, 2003. For purposes of applying certain rules ("lookback rules") to plan years beginning after December 31, 2003, the amendments made by the provision may be applied as if they had been in effect for all years beginning before the effective date. For purposes of the provision, "lookback rules" means: (1) the rule under which a plan is not subject to the additional funding requirements for a plan year if the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years; and (2) the rule under which quarterly contributions are required for a plan year if the plan's funded current liability percentage was less than 100 percent for the preceding plan year. The amendments made by the provision may be applied for purposes of the lookback rules, regardless of the funded current liability percentage reported for the plan on the plan's annual reports (i.e., Form 5500) for preceding years.