PROPOSALS AND ISSUES RELATING
TO THE
FINANCIAL CONDITION OF THE
PENSION BENEFIT GUARANTY CORPORATION (PBGC)

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

On August 11, 1992

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of proposals and issues relating to the financial condition of the Pension Benefit Guaranty Corporation (PBGC). The Oversight Subcommittee of the House Committee on Ways and Means has scheduled a public hearing on August 11, 1992, on the PBGC, Federal contingent liabilities under the defined benefit pension plan program, and PBGC's information system.

Part I of the document is an overview. Part II discusses present law and background of the Federal pension insurance program and the financial condition of the PBGC. Part III describes present-law minimum funding standards and deductions. Part IV discusses the administration proposals and related issues.

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[1] This document may be cited as follows: Joint Committee on Taxation, Proposals and Issues Relating to the Financial Condition of the Pension Benefit Guaranty Corporation (PBGC) (JCX-33-92), August 10, 1992.

I. OVERVIEW

A defined benefit pension plan is a type of employer-sponsored retirement plan which provides benefits to employees covered by the plan based on a formula specified in the plan. In order to provide benefit security to plan participants, the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 (ERISA) impose minimum funding requirements on the sponsor of a defined benefit pension plan.

The minimum funding requirements provide employers considerable flexibility in determining the minimum required contribution, and also permit benefits to be funded over a long period of time. Thus, it is possible that a defined benefit plan may be terminated at a time when plan assets are insufficient to pay promised benefits.

ERISA created the Pension Benefit Guaranty Corporation (PBGC) in order to protect plan participants in the event a defined benefit pension plan terminates with insufficient assets. The PBGC guarantees basic retirement benefits, up to a current dollar maximum benefit of $2,352.57 per month.

In its most recent annual report, the PBGC reported a deficit of $2.5 billion. The PBGC reports that the defined benefit system as a whole is relatively healthy, but that certain pension plans, primarily in certain industries, are underfunded by about $40 billion, about $13 billion of which is in plans sponsored by financially troubled companies. The PBGC forecasts that, depending on the level of future losses, its deficit could increase to between $2.7 billion and $17.9 billion by the end of fiscal year 2001.

Despite recent changes in plan funding rules designed to increase the level of plan funding, the risk of loss upon plan termination has increased. To deal with this loss of pension security and increased risk to the PBGC, the Administration has proposed a number of changes to present law, including increasing minimum funding contributions for underfunded plans, and eliminating the PBGC guarantee for certain benefits and benefit increases.

II. THE FEDERAL PENSION INSURANCE PROGRAM

A. Present Law and Background

Defined benefit pension plans

A defined benefit pension plan is a type of employer-sponsored retirement plan which provides benefits to employees covered by the plan based upon a formula specified in the plan. For example, a defined benefic plan could provide a benefit equal to a percentage of an employee's average compensation multiplied by the number of years of service with the employer. A defined benefit plan could also, for example, provide a flat dollar benefit based on years of service, or a specified percentage of final compensation or average. The key feature of such a plan is that the benefit promised is based on the plan formula, not on the investment experience of the plan.

In order to help ensure that the promised benefits are paid to plan participants, defined benefit plans are subject to minimum funding requirements under both the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 ("ERISA") which require the employer sponsoring the plan to make certain contributions to fund the plan. These requirements are discussed in detail below.

The PBGC

As enacted in ERISA as well as under present law, the minimum funding requirements permit an employer to fund benefits over a period of time. Thus, it is possible that the 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 by ERISA to provide an insurance program for benefits under most defined benefit pension plans maintainec by private employers. According to the PBGC's latest annual report, the single-employer insurance program currently covers more than 32 million participants in more than 83,000 defined benefit pension plans.

Termination of underfunded pension plans

Prior to 1986, an employer generally could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the lesser of the insufficiency or an amount equal to 30 percent of the employer's net worth.

Under these rules, employers that wanted to rid themselves of underfunded liabilities could simply terminate the plan, and the PBGC would be liable for benefits. The PBGC was in some cases prevented from recouping its liability from the employer, even if the employer was financially sound. The plan termination rules were amended to prevent such dumping of liabilities on the PBGC by the Single Employer Pension Plan Amendments Act (SEPPA) and were modified further by the Pension Protection Act of 1987.

Under present law, a plan with assets insufficient to provide for benefit liabilities can be terminated voluntarily by the employer only if the employer and members of the controlled group of the employer are in financial distress. In general, benefit liabilities are all fixed and contingent liabilities to plan participants and beneficiaries.

Following a distress termination, the PBGC pays out all benefits under the plan, including guaranteed benefits and those not guaranteed. The amount of benefits in excess of guaranteed benefits that are paid to plan participants depends on the level of plan funding, and the amount the PBGC is able to recover from the employer. The employer is liable to the PBGC for the full amount of unfunded benefit liabilities.

Guaranteed benefits

The PBGC guarantees vested retirement benefits (other than those that vest solely on account of the plan termination), up to a maximum benefit of $2,352.57 per month in 1992. The dollar limit is indexed annually for inflation. The guarantee 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 5 years before a plan termination, the amount guaranteed is phased in by 20 percent a year.

Sources of PBGC funding

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, and by premiums paid with respect to covered plans. All covered 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 $1.00 per plan participant. The flat-rate per participant premium has been increased several times since the enactment of ERISA, and is currently $19 per participant.

The variable rate premium was enacted by the Pension Protection Act of 1987. It was believed that underfunded plans should bear a greater burden than well-funded plans because they pose a greater risk of exposure to the PBGC. The amount of the variable rate premium is $9.00 per each $1,000 of unfunded vested benefits, up to a maximum of $53 per participant. Thus, the maximum total per participant premium for an underfunded plan is $72.

B. Financial Status of the PBGC

As of September 30, 1991, the PBGC reported a deficit of $2.5 billion. This is an increase over the $1.9 billion deficit reported as of the end of the prior year. The PBGC experienced its largest losses in the history of the termination insurance program in the year ending September 30, 1991. The PBGC attributes these losses primarily to lower expected recoveries from employers in bankruptcy for plans added to PBGC's liabilities in 1990. The PBGC reports that the defined benefit plan system is healthy as a whole, but that some pension plans, primarily in the steel, automobile, tire, and airline industries, are underfunded by about $40 billion. Of this, the PBGC reports that about $13 billion is in plans sponsored by financially troubled companies.

The PBGC has estimated its future financial status under a variety of assumptions. Bases on various assumptions as to the future level of PBGC's losses, it has estimated that the deficit could range from about $2.7 billion by the end of 2001 if losses are relatively low, to about $17.9 billion by the end of 2001 if losses are high. According to the PBGC, the estimate of a potential deficit of $17.9 is not a worst-case scenario.

III. MINIMUM FUNDING STANDARD AND DEDUCTIONS

Present Law

In general

The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to a defined benefit plan. The requirements recognize that, in an on-going plan, pension liabilities are generally a long-term liability. Thus, benefits are not required to be immediately funded, but can be funded over a long period of time.

The minimum funding requirements provide the employer considerable flexibility in determining the amount of the contribution that must be or can be made in any given year. The minimum required or maximum permitted contribution that can be made depends on the funding or actuarial cost method used by the plan and the actuarial assumptions used by the plan actuary.

In response to concerns about the financial status of underfunded pension plans, the minimum funding standards were modified, and special additional funding requirements were added for underfunded pension plans by the Pension Protection Act of 1987.

The minimum funding standards and the special rules for underfunded pension plans are discussed in detail below.

Minimum funding standard

In general

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (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 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.

Accumulated funding deficiencies

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan with an accumulated funding deficiency is subject to a 5-percent nondeductible excise tax on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 5-percent tax or (2) the date on which the 5-percent tax is assessed by the Internal Revenue Service (IRS).

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 in that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer (or employers) responsible for contributing to the plan would be subject to an excise tax equal to 5 percent of the deficiency for the year. If the deficiency were not corrected within the specified period, then the 100-percent excise tax would be imposed on such employer (or employers).

Actuarial cost methods

In general.--A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the balance 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 a 2 elements for each plan year. These elements are referred to as (1) normal cost, and (2) past service liability.

Normal cost.--The normal cost of 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. 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 accruing under the plan in particular plan years.

Past service liability.--The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (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.

Acceptable methods.--Normal cost and past service liability 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 an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once every 3 plan years. More frequent valuations may be required by the IRS.

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 3 separate charges to the funding standard account that may arise 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 for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, and employer contribution will be required for the year to avoid and accumulated funding deficiency.

In the case of a plan that was in existence on January 1, 1974, the funding standard account is charged annually with a portion of the past service liability determined as of the first day of the plan year of which the funding standard applied to the plan (generally the plan year beginning in 1976). In the case of a single-employer plan, the amount of the liability with which the account is charged for a year is based on amortization of the past service liability over a period of 40 plan years. The liability is required to be amortized (in much the same manner as a 40-year mortgage) in equal annual installments over the 40-year funding period unless the plan becomes fully funded.

A plan that was not in existence on January 1, 1974, is generally required to determine past service liability as of the first day of its first plan year beginning after September 2, 1974 (the date ERISA was enacted). This liability is required to be amortized by a single-employer plan in equal annual installments over a period of 30 plan years. Accordingly, if there are no other credits in the account to offset the charge for this past service liability, and if the plan does not become fully funded, annual employer contributions will be required for 30 plan years to offset charges for this past service liability.

With respect to all plans (whether or not in existence on January 1, 1974), if a net benefit increase takes place as the result of a plan amendment, then the unfunded past service liability attributable to the net increase is determined that year and amortized over a period of 30 years.

For example, assume that a plan uses the calendar year as the plan year. Further, assume that, during 1987, the plan is amended to increase benefits and that the net result of plan amendments for 1987 is that the past service liability under the plan is increased by $500,000. In addition, the plan's actuary uses an interest rate of 8 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.

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 and accumulated funding deficiency unless the plan becomes fully funded.

<u>Gains and losses from changes in assumptions.</u>--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 charges 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. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years (30 plan years in the case of a multiemployer plan), 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 in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period (15 plan years in the case of a multiemployer plan).

Waived funding deficiencies.--Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 5 plan years, beginning with 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.

With respect to applications for waivers submitted after April 7, 1986, SEPPAA provides that 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 $2 million.

Switchback liability.--ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account.

ERISA prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

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.

Special rules for underfunded plans

In general

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted due to Congressional concerns regarding the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

Calculation of deficit reduction contribution

With respect to plans subject to the special rule, the minimum required contribution is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the sum of (i) normal cost, (ii) the amount necessary to amortize experience gains and losses over 5 years and gains and losses resulting from changes in actuarial assumptions over 10 years, and (iii) the deficit reduction contribution. In addition, a special funding rule applies with respect to benefits that are contingent on unpredictable events. In no event is the amount of the contribution to exceed the amount necessary to increase the funded ratio of the plan to 100 percent.

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based on the plan's current liability.

Current liability

The term "current liability" generally means all liabilities to employees and their beneficiaries under the plan determined as if the plan terminated. However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs.

The interest rate used in determining the current liability of a plan, as well as the contribution required under the special rule, is required to be within a specified range. The permissible range is defined as a rate of interest that is not more than 10 percent above or below the average mid-term applicable Federal rate (AFR) for the 4-year period ending on the last day before the beginning of the plan year for which the interest rate is being used (or, if shorter, the period that the AFR has been computed). The Secretary may, where appropriate, allow a lower rate of interest except that such rate may not be less than 80 percent of the average rate discussed above.

Within the permissible range, the interest rate is required to be reasonable. The determination of whether an interest rate is reasonable depends on the cost of purchasing an annuity sufficient to satisfy current liability. The interest rate is to be a reasonable estimate of the interest rate used to determine the cost of such annuity, assuming that the cost only reflected the present value of the payments under the annuity (i.e., and did not reflect the seller's profit, administrative expenses, etc.).

Unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

Unfunded old liability amount

The unfunded old liability 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 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).

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 (and the unamortized portion of certain unfunded liability from certain benefit increases) 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 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent.

Unpredictable contingent event benefits

The value of any unpredictable contingent event benefit is not considered in determining current liability until the event has occurred. 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 funding 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 greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

The rule relating to unpredictable contingent event benefits is phased in for plan years beginning in 1989 through 2001.

Small plan rule

In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100.

Full funding limitation

No contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limitation. In addition, under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to 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) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

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. 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. 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 3 waivers may be granted within any period of 15 consecutive plan years. The IRS may require an employer to provide security as a condition of granting a waiver.

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.

Controlled group liability

The funding requirements applicable to a plan are imposed on all employers that are members of the same controlled group of corporations as the employer who is responsible for making the contributions.

Sanction for failure to meet minimum funding standard

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan (and the controlled group of which the employer is a part) with an accumulated funding deficiency is subject to a 10-percent nondeductible excise tax (5 percent in the case of a multiemployer plan) on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan (and the controlled group of which the employer is a part) is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 10-percent tax, or (2) the date on which the 10-percent tax is assessed by the IRS.

Deductions for employer contributions

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. However, no deduction is allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits.

Under the Internal Revenue Code, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan. The purpose of the excise tax is to discourage employers from making excessive contributions to a plan in order to obtain the benefit of tax-free growth on the contributions.

A special deduction rule applies to underfunded defined benefit pension plans. In the case of a single-employer defined benefit pension plan which has more than 100 participants, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules.

IV. PROPOSALS AND ISSUES

Administration Proposals

The Administration has proposed a number of reforms relating to the PBGC termination insurance system, including increasing the minimum funding rules for certain plans and modifying the PBGC guarantee with respect to plan amendments.[2]

Minimum funding requirements

In general, the Administration's minimum funding proposal would build on the changes made by the Pension Protection Act of 1987 by requiring sponsors of underfunded plans to pay off pension liabilities more rapidly than under present-law rules. Alternatively, underfunded plans with high levels of payments would be required each year to make contributions to the plan equal to disbursements plus interest on the plan's unfunded liability. The proposed rules would require underfunded plans to increase their funding levels over a period of time.

To accomplish these goals, the proposal would replace the current deficit reduction contribution with 2 new rules: (1) the "underfunding reduction requirement," and (2) the "solvency maintenance requirement". The required minimum funding contribution would be the greatest of (a) the amount of any funding deficiency according to the regular funding standard account, (b) the amount required by the underfunding reduction rule, or (c) the amount required by the solvency maintenance rule. The two new rules would only apply to underfunded pension plans with more than 100 participants, and would only have a limited effect on plans with more than 100, but no more than 150 participants.

The underfunding reduction requirement (revised Code sec. 412(l)) would apply the formula for the unfunded new liability amount from the deficit reduction contribution to the entire underfunding, thereby eliminating the grandfathering of pre-1987 liabilities over an 18-year period. As under present law, the rule would require higher contributions from the worst funded plans. To this amount would be added normal cost, the repayment of waived contributions, and charges for experience losses and losses from changes in actuarial assumptions. Credit for experience gains, gains from changes in actuarial assumptions and

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2 These and other proposals were included in the President's fiscal year 1993 budget, and are in H.R. 4545, introduced by Mr. Michel (by request) on March 24, 1992.

greater than required minimum contributions (per sec. 412(b)) would be allowed as offsets, but only to the extent of the charges for experience losses and the losses from changes in actuarial assumptions.

The solvency maintenance requirement (new sec. 412(o)) has 2 main components: (1) disbursements from the plan (i.e., benefit payments, including annuity purchases, administrative expenses and other disbursements), and (2) the plan's initial unfunded liability multiplied by the interest rate used for purposes of the funding standard account under section 412(b). Normal cost and other charges are added to this amount, and credits are allowed, in the same manner as under the underfunding reduction requirement.

To protect firms against possibly large increases in their required contributions on account of this rule, the solvency maintenance requirement would be phased in over a 5-year transition period. In addition, with respect to both requirements, any positive credit balances that antedate 1992 would be allowed as full offsets under both the new requirements.

Discipline in actuarial assumptions would be maintained by use of the funding standard account concepts of experience losses and losses from changes in actuarial assumptions. Limiting credit for experience gains, gains from changes in actuarial assumptions, and for greater-than-required minimum contributions in past years buttresses that discipline and assures that underfunded pension plans always make a contribution in each year that they are underfunded.

<u>PBGC guarantee</u>

The proposal would provide that the PBGC guarantee does not apply to benefits under a new plan or an increase in benefits resulting from a plan amendment unless the plan is fully funded. In addition, the proposal would provide that the PBGC guarantee does not apply to any new unpredictable contingent event benefits or any increases in such benefits. An unpredictable contingent event benefit is any benefit contingent on an event other than age, service, compensation, death, or disability or an event which is reasonably and reliably predicable.

Analysis of Issues

Increased funding rate

Those in favor of increasing the minimum funding standards argue that the rate of funding required under the present-law minimum funding standard exposes plan participants and the PBGC to excessive risk. Under present law, the funded status of a plan could deteriorate even if the minimum funding requirements are fully satisfied. Thus, it is argued that, given the existence of a plan termination insurance program, the present-law rules providing long-term financing of increases in unfunded liabilities create an incentive for employers to provide benefit increases that might otherwise not be affordable. In addition, the existence of benefit guarantees makes it less likely that employees will express concern about the security of their promised benefits.

As a result, supporters of increases in the minimum funding rules believe that more rapid funding would more appropriately limit the ability of employers to delay or avoid funding obligations. They argue that an employer should not have the opportunity to make pension promises that exceed its financial capacity. They suggest that the purpose of sound funding is to protect employee benefits by insulating them from business risk of the employer, as well as to protect the PBGC from systematic loss. Further, they argue that if the risk of loss to the PBGC is not minimized, taxpayers may ultimately have to pay for unfunded benefit promises, just as they have had to pay for losses in the recent savings and loan industry crisis.

Concerns have been expressed that the rate of funding proposed by the Administration is unnecessarily high, and that an employer who otherwise would have been able to fully fund plan liabilities may, instead, choose bankruptcy as a means of avoiding the faster funding of its unfunded liability. Sharply higher contribution requirements, particularly requirements imposed with respect to existing unfunded liabilities, could prove burdensome for employers in cyclical businesses. For employers who incur losses, the increased contributions may not be fully deductible when paid.

Others argue that the rapid rates mandated by the Administration proposal would unduly restrict funding flexibility under defined benefit pension plans and may cause termination of plans by employers that are unwilling to bear the increased current costs of funding. They argue that the objective of greater benefit security can be obtained with a less extensive increase in the rate of funding that is less likely to cause the termination of defined benefit pension plans.

Some who oppose faster funding believe that the requirements will interfere with collective bargaining. They suggest that the extent to which amounts earned by employees should be divided between pension plan contributions and other forms of compensation is more appropriately left to employee representatives and to employers. On the other hand, it can be argued that restraints on the collective bargaining process are appropriate in light of the PBGC's unique role as guarantor of an employer's benefit promises to employees. Because employees are assured of receipt of their benefits from the PBGC if the employer is unable to meet its benefit commitments, some argue that the normal arm's-length nature of the collective bargaining process is weakened and that employees have less incentive to bargain for adequate funding by the employer.

Some argue that a more extensive evaluation of the present-law funding requirements is appropriate. For example, the flexibility provided to employers in selecting the method of funding to be used for a particular plan could be reexamined. The particular characteristics of employers in various industries could be studied to determine whether certain funding methods are more appropriate or desirable from a benefit security perspective. The flexibility in choosing actuarial assumptions could also be reexamined.

The PBGC reports that most of its exposure is from collectively bargained plans that provide a flat benefit (e.g., $20 per month times number of years of service). Under such plans, the flat benefit amount is increased periodically. The present-law funding rules do not permit increases in the flat benefit to be anticipated. In contrast, in plans based on compensation, increases in compensation can be anticipated. Thus, some argue that increases in flat benefits should be permitted to be anticipated so that the benefits can be funded in advance.

Some argue that such a proposal should not be adopted, or should be adopted only with appropriate restrictions to prevent employers who want to increase deductions from anticipating increases in benefits that may never take place. On the other hand, proponents of the proposal argue that the employer does not have an incentive to overestimate benefit increases because there is limited ability to recoup any overfunding. First, in most collectively bargained plans, the employer has no incentive to overfund, because any excess pension assets revert to employees on plan termination. Second, even if the employer has a right to any reversion, the present-law excise tax on reversions substantially reduces the amount of excess assets an employer can claim.

Others doubt that permitting increases in flat benefits will have any real impact on plan funding. Such plans typically are underfunded before any increases are granted. If the employer does not fund existing benefits, then the employer is unlikely to take advantage of the opportunity to fund benefit increases that have not been granted.

Some have suggested that an alternative way to protect against pension losses would be to increase the PBGC premiums for all plans. They argue that the PBGC program is an insurance program, so that risk of loss should be spread among all premium payers.

Opponents of increasing the PBGC premium argue that, while risk spreading is appropriate, there is an underlying moral hazard in the PBGC system that needs to be addressed -- the incentive to underfund knowing the PBGC will pay benefits. Further, they argue that because the defined benefit system in voluntary, if premiums on low-risk plans are too high they will simply exit the system, leaving only plans that represent significant exposure to the PBGC. The best way to deal with systematic underfunding, they argue, is to require employers to fund their own benefit promises.

PBGC guarantee

The Administration proposal to eliminate the PBGC guarantee in certain circumstances is designed to limit the PBGC's exposure to chronically underfunded plans and to provide an incentive to employers to fund benefit increases. The general theory behind the proposal is that employers will not provide and employees will not want benefit increases that are not guaranteed.

Opponents of the Administration proposal argue that the proposal is simply a way to limit PBGC exposure, and undermines the whole purpose of the PBGC -- which is to guarantee benefits. They argue that the proposal will do nothing to help benefit security, but will make it worse by weakening the guarantee. Further, they argue that participants may be mislead, because they may not know that the particular benefit or benefit increase is not guaranteed.

Some opponents of the Administration proposal agree that the goal of limiting unfunded benefit increases in chronically underfunded plans is appropriate, but would address it in a different way. For example, benefit increases in underfunded plans could be prohibited unless the plan is funded to a certain level, or security is provided. Such a proposal could build on the present-law requirement that sponsors of plans which are less than 60 percent funded provide security in the case of plan amendments.