[JOINT COMMITTEE PRINT]

OVERVIEW OF CURRENT ISSUES RELATING TO SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS AND PENSION BENEFIT GUARANTY CORPORATION (PBGC) PREMIUMS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 7 AND 9, 1987

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of current issues relating to defined benefit pension plans and Pension Benefit Guaranty Corporation (PBGC) premiums. This pamphlet includes discussion of the proposals contained in (1) the President's FY 1988 budget to increase per-participant annual premiums to the Pension Benefit Guaranty Corporation (PBGC) and to make structural revisions to the premium program, and (2) the President's competitiveness proposals as they relate to defined benefit pension plans.

Part I of the pamphlet is a summary. This is followed by a discussion of minimum funding standard and deductions (Part II), termination of underfunded plans (Part III), employer access to assets of overfunded plans (Part IV), post-retirement medical benefits (Part V), and the PBGC single-employer insurance program and the variable rate premium proposal (Part VI). In each of Parts II–VI, there is a description of present law, the Administration proposal, and the General Accounting Office (GAO) report recommendation (where made), as well as an analysis of issues.

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled hearings on April 7 and 9, 1987, which will focus on the proposals to increase and revise the PBGC premium program, to modify minimum funding requirements for defined benefit pension plans, to alter the rules governing the termination of underfunded pension plan, and to revise the conditions under which employers may recover excess assets from overfunded pension plans.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Overview of Current Issues Relating to Single-Employer Defined Benefit Pension Plans and Pension Benefit Guaranty Corporation (PBGC) Premiums* (JCS-7-87), April 6, 1987.

I. SUMMARY

Defined benefit pension plans

Under a defined benefit pension plan maintained by an employer, employees who participate in the plan and satisfy the conditions for receipt of benefits under the plan are entitled to the benefit levels specified under the plan's benefit formula. An employee's benefits under the plan are not determined on the basis of an account for the employee. A defined benefit pension plan can provide benefits earned by employees only if contributions are made in sufficient amounts to pay an employee's expected retirement benefit. Under a defined benefit pension plan, the employer bears the risk of unfavorable investment experience.

For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan may also be specified as a flat- or step-rate percentage of the employee's average compensataion or career compensation.

Under present law, an employer is not required to maintain a defined benefit pension plan for employees nor, other than in the case of a top-heavy plan, required to provide minimum benefits to employees under a defined benefit pension plan. However, if an employer elects to maintain a defined benefit pension plan, then present law provides that certain minimum standards are to be satisfied.

Under present law,[2] a defined benefit pension plan is required to satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the method under which plan benefits are accrued (i.e., the method under which plan benefits are earned), and the rate at which benefits are required to be vested (i.e., nonforfeitable). In addition, an employer's contribution to a defined benefit pension plan is required to meet minimum funding requirements.

Minimum funding requirements

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 minimum funding requirements, 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 made for each plan year. If, as of the close of a plan year, the account does not have a balance of charges, the plan is treated as meeting the minimum funding

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[2] The requirements of present law with respect to pension plans are contained in the Employee Retirement Income Security Act of 1974 (ERISA), and, in the case of a plan that qualifies for special tax benefits, the Internal Revenue Code (the Code).

standard for the year. Thus, as a general rule, the minimum contribution for a plan year is the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Qualified plans

If a defined benefit pension plan qualifies under the Code ("qualified plan"), then (1) a trust under the plan generally is exempt from income tax, (2) employers generally are allowed deductions (within limits) for plan contributions for the year for which the contributions are made even though participants are not taxed on plan benefits until the benefits are distributed, and (3) certain benefit distributions may be eligible to be rolled over, tax free, to another qualified plan or an IRA, or may be accorded special income averaging treatment.

An employer's contributions to a defined benefit pension plan for a year generally are not deductible if the contributions would not otherwise qualify as ordinary and necessary business expenses or expenses for the production of income.

Under the Code, if a contribution to a qualified plan for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contributions and benefits for employees. A nondeductible excise tax is imposed on an employer that makes a contribution to a qualified plan for a year in excess of the deduction limits.

Guaranteed benefits

ERISA established the Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor, to insure the pension benefits of employees when defined benefit pension plans terminate with assets insufficient to satisfy the plan's liability to provide benefits to employees.

Subject to limits, the PBGC guarantees basic benefits under a plan. Basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($1,857.95 for 1987).

Guarantees are limited with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable busiess purpose and not for the purpose of securing increased guaranteed benefits for participants.

Termination of underfunded 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 terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC, the employer had no further liability to the PBGC. 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 insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

Under the Single Employer Pension Plan Amendments Act (SEPPAA), effective January 1, 1986, an employer may voluntarily terminate a single-employer defined benefit pension plan under which benefits are guaranteed by the PBGC only in a "standard termination" or in a "distress termination." A standard termination is permitted only if the plan holds assets sufficient to pay all benefit commitments under the plan.

For purposes of determining whether a standard termination is allowed, benefit commitments include all guaranteed benefits and all benefits that would be guaranteed but for the dollar limit on the amount guaranteed or the length of time that the benefit has been in effect. In addition, benefit commitments include certain additional benefits for which a participant has satisfied all conditions of entitlement prior to termination, irrespective of whether those benefits are guaranteed. Benefit commitments are less than plan termination liability, which includes all fixed and contingent liabilities to participants. Benefit commitments do not include benefits that vest solely due to plan termination or contingent benefits (such as early retirement benefits) for which the participant has not satisfied all conditions for entitlement prior to termination. Such benefits are included in termination liability.

A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor and each substantial member of the contributing sponsors' controlled groups satisfy at least one of four distress standards.

Upon the termination of a plan with assets insufficient to fund benefits guaranteed by the PBGC pursuant to the distress termination rules, each contributing sponsor and each member of the controlled groups that include the contributing sponsors is liable to the PBGC for the sum of (1) the outstanding balance of any accumulated funding deficiency, and (2) the balance of the amount of any waived funding deficiencies. The full amount of such liability is due and payable to the PBGC as of the date of plan termination.

In addition, in a distress termination, each contributing sponsor of the plan and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the collective net worth of those persons liable to the PBGC; (2) an amount equal to the excess (if any) of (a) 75 percent of the total amount of all unfunded guaranteed benefits over (b) the amount described in (1); and (3) interest on the amount due calculated from the termination date.

Termination of overfunded plans

Under the Code and ERISA, a trust forming part of a pension plan is not qualified unless, under the trust instrument, it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries.

However, if a defined benefit pension plan is terminated and assets remain after the satisfaction of all fixed and contingent liabilities to plan participants and beneficiaries and such excess is attributable to actuarial error, then the employer is permitted to recover the excess assets (i.e., the assets in excess of termination liabilities). Under present law, if the excess assets are recovered from a qualified defined benefit pension plan upon termination, then generally such excess is included in gross income by the employer and a 10-percent excise tax is imposed on the employer.

Vesting

Upon any termination of a plan, all benefits accrued to the date of termination must be 100 percent vested and nonforfeitable. In addition, plan benefits are to be distributed to plan participants or annuities providing for the payment of vested accrued benefits must be purchased and distributed to participants.

PBGC premiums

Unless exempted by ERISA, all defined benefit pension plans maintained by an employer are subject to the termination insurance rules. An employer maintaining a plan that is subject to the termination insurance rules is required to pay to the PBGC an annual per-participant premium.

Under SEPPAA, the annual per-participant premium was increased to $8.50 from $2.60, effective January 1, 1986.

Solvency of the PBGC

For the fiscal year ending September 30, 1986, the PBGC's deficit (i.e., its liability to pay benefits in excess of its assets) from the single-employer plan termination insurance program equaled $3.8 billion, nearly three times the PBGC's deficit at the end of the 1985 fiscal year. During fiscal year 1986, the PBGC's liabilities doubled, while its assets grew only 50 percent. Nearly 80 percent of the PBGC's deficit is attributable to plan terminations of employers in the steel industry. The PBGC is currently paying out more in benefits than it receives in premium income and interest on its assets. Under current PBGC forecasts, all funds available to pay guaranteed benefits will be depleted by the end of fiscal year 2003.

President's proposals

The President's competitiveness proposals (submitted to the Congress in March 1987) include proposals relating to the funding and termination of defined benefit pension plans. The proposals generally would make the following modifications:

(1) the funded status of underfunded defined benefit pension plans would be improved by requiring more rapid amortization schedules for certain unfunded liabilities and waived contributions, applying special minimum funding rules to prevent plans from becoming more underfunded, and imposing a minimum funding contribution for a year based on a plan's distributions and expenses during the year;

(2) employers would be required to accelerate the date by which contributions are to be made for a taxable year;

(3) the availability of waivers for contributions required under the minimum funding requirements would be limited;

(4) an employer's liability to plan participants and the PBGC upon termination of an underfunded plan would be increased;

(5) the employer would be required to transfer certain assets from any overfunded plans maintained by the employer to any underfunded, terminating plan maintained by the employer;

(6) employers would be permitted to withdraw excess assets from ongoing defined benefit pension plans provided a sufficient cushion of assets is maintained in all defined benefit plans maintained by the employer (calculated as if such plans were a single plan;

(7) plan assets in excess of a plan's termination liability could only be recovered upon plan termination without regard to the asset cushion as long as all defined benefit pension plans of the employer are terminated, but the employer would be prohibited from covering its employees under a defined benefit pension plans for a 5-year period;

(8) the present-law rules permitting post-retirement health benefits to be provided under a pension plan would be repealed, and employers would be permitted to transfer excess assets otherwise available for withdrawal by the employer to tax-exempt welfare benefit trusts established by the employer to provide health benefits to retirees; and

(9) the funded status of a defined benefit pension plan and the ability of an employer to withdraw excess assets from an ongoing or terminated plan would be determined on a controlled group basis.

Further, the President's 1988 fiscal year budget proposals proposed an increase in the revenue collected from PBGC premiums and a restructuring of the premium program to assess higher premiums on employers that are more likely to shift liabilities to the PBGC. The Administration has not yet provided details on the structure of such a variable rate premium program.

GAO report

On March 19, 1987, the General Accounting Office submitted a report [3] to the Subcommittee on Oversight of the House Committee on Ways and Means on the causes of large claims against the PBGC and the potential effects of SEPPAA on the plan termination insurance program.

The GAO concluded in its report that 70 percent of the claims against the PBGC during the 1983–85 period were a result of the present-law funding requirements not requiring sufficient contributions to pay for increases in unfunded liabilities (such as increases in liabilities due to benefit increases adopted by plan amendment) and that 30 percent of such claims were caused by the failure of employers to make contributions to a defined benefit pension plan prior to plan termination. The GAO studied the terminations of 33 plans maintained by 23 employers, which represented 90 percent of the increased claims to the PBGC during the period.

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[3] U.S. General Accounting Office, *Government Insurance Program Threatened By Its Growing Deficit* (GAO-HRD-87-42).

Further, the GAO concluded that, if the amendments made by SEPPAA had been in place for 1983–1985, the financial status of the PBGC would not have significantly improved because most of the employers who terminated plans would have qualified for distress terminations under SEPPAA and, because the employers were in bankruptcy proceedings in which the PBGC's claims have a low priority, the PBGC's recovery of claims would not have increased significantly.

The GAO suggested the following modifications to the defined benefit pension plan system and the plan termination insurance program to improve the long-term financial solvency of the PBGC:

(1) raising minimum contribution requirements for defined benefit pension plans;

(2) accelerating the date by which employers are required to make contributions for a plan year;

(3) reducing the amount of plan benefits guaranteed by the PBGC;

(4) raising the priority of PBGC claims against employers in bankruptcy proceedings; and

(5) increasing the PBGC per-participant annual premium.

II. MINIMUM FUNDING STANDARD AND DEDUCTIONS

Present Law and Background

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 the employer obtained a minimum funding waiver, 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 the employers who are responsible for contributing to the plan are 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).

Controlled group liability

The funding requirements and the excise taxes imposed with respect to an accumulated funding deficiency under a plan are imposed only on an employer who is responsible for contributing to that particular plan in which the deficiency arises. Another taxpayer that is a member of the same controlled group of corporations as the employer is not liable for a funding deficiency or subject to the excise taxes unless the other taxpayer is also responsible for contributing to that plan.

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 under 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 which 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.

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 Internal Revenue Service.

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, an employer contribution will be required for the year to avoid an 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 under the plan 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 that 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 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 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 30 plan 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 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 15-year period.

Waived funding deficiencies.—Within limits, the Internal Revenue Service 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 substantial business hardship. The Internal Revenue Service generally takes the position that a waiver will not be granted unless the hardship is temporary and the employer demonstrates that recovery is likely. No more than 5 waivers may be granted within any period of 15 consecutive plan years. The Internal Revenue Service may require an employer to provide security as a condition of granting a waiver. The waived contribution is a waived funding deficiency.

Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 15 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. Interest on the waived amount is equal to the rate applicable to late payment of taxes (Code sec. 6621(b)).

With respect to applications for waivers submitted after April 7, 1986, SEPPAA provided 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.

Full funding limit

Under the minimum funding standard, the full funding limitation is the point at which the plan is considered to be sufficiently well-funded so that a contribution is not required. The full funding limit is designed to eliminate the requirement that additional employer contributions be made for a period during which a plan is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of the full funding limitation; however, an employer may not deduct contributions made to a plan that is funded at or above the full funding limit.

Time for making contributions

Under present law, an employer is treated as making a contribution that satisfies its minimum funding requirement for a year if the contribution is made within 8½ month following the close of the plan year. Of that 8½-month period, 6 months are provided under Treasury regulations.

Deductions for employer contributions

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (Code 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. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contributions and benefits (secs. 404(j) and 415))).

Under the Code, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. A nondeductible 10-percent excise tax is imposed on an employer that makes a contribution to a qualified plan in excess of the deduction limit and the excise tax continues to be imposed for each year until the excess contribution is eliminated.

Defined benefit pension plans

As outlined above, employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. In the case of a group of affliated employers, the deduction for employer contributions is allowed only to those members of the group that maintain the plan. The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[4]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least 5 taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits in equal annual payments over 10 years.

Factors contributing to overfunding of defined benefit plans

The funding standard under present law provides for funding under an acceptable funding method on a "going concern" basis, rather than a "termination" basis. Accordingly, employers are permitted to provide funding for benefits that are expected to be provided in the future, even though there is no current liability for those benefits. For example, if benefits under a plan are based on the level of employees' pay and years of service during a period preceding retirement, the funding method used by the plan may require that current contributions be based on the anticipated future pay and rate of turnover of the employees. Under these circumstances, current funding may reflect pay raises that are anticipated

[4] Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

to be provided under the plan's existing benefit formula, benefits expected to be earned, and the number of employees expected to vest, many years in the future.

In funding a plan, assumptions are made with respect to the anticipated rate of investment earnings. Because actual investment experience often differs from anticipated investment experience, plans periodically record experience gains (when the experience is better than anticipated) or experience losses (when the experience is worse than anticipated). These experience gains and losses are taken into account by plans, through changes in funding, over a period of at least 15 years. Similarly, changes in actuarial assumptions under a plan may result in increases or decreases in anticipated liabilities, which are taken into account over a 30-year period.

If a defined benefit pension plan is terminated, then no further benefits will be earned under the plan. In addition, pay raises and future service after the date of termination are not taken into account in determining benefits. Upon a termination, an employer may recover assets in excess of termination liability, provided that the excess is attributable to actuarial error. Actuarial error results because the anticipated expense of benefits expected to be earned, including benefits based on expected pay raises and future service, are not incurred. Similarly, actuarial error may arise because experience gains and losses, as well as gains and losses from changes in actuarial assumptions, may not have been fully amortized prior to the date of termination. The resulting reduction in liabilities may be offset by the cost of complying with the requirement that all accrued benefits under a defined benefit pension plan must be fully vested, to the extent funded, upon plan termination.

In addition, some terminated defined benefit pension plans have realized substantial experience gains in recent years because they have been able to meet their benefit obligations by purchasing annuity contracts providing a significantly higher rate of return than was assumed by the plan.

Factors contributing to underfunding of defined benefit plans

A plan is considered to be underfunded if, upon termination, it lacks sufficient assets to discharge its liabilities. One reason underfunding may arise is that, despite the minimum funding standard, the plan may terminate before the time required for amortization of its liabilities has expired.

For example, assume that, at the time a plan was adopted, it provided benefits measured (in part) by service performed before the plan was adopted. The liability for those benefits (past service liability) is amortized over a period of 30 years. If the plan terminates before the end of the 30-year period, then the plan will be underfunded unless investment gains exceed assumed investment gains by an amount that is sufficient to offset the unfunded liability arising from the past service benefit.

Underfunding may also be attributable to unamortized losses arising from investment experience or other experience (e.g., mortality, morbidity, employee turnover) that is less favorable than anticipated. In some cases, a plan is underfunded at termination because the employer obtained a waiver of the funding standard and the plan was terminated before the waived funding deficiency was fully amortized.

Administration Proposal

In general

The Administration proposal would (1) impose new funding requirements with respect to certain defined benefit pension plans; (2) expand the group of employers that are required to make plan contributions; (3) increase the deduction limit applicable with respect to employer contributions to defined benefit pension plans; (4) expand the liability for required contributions to all members of a controlled group of corporations; (5) accelerate the due date for contributions for a year; and (6) limit the availability and attractiveness of minimum funding waivers.

The Administration proposal would impose funding requirements based on a four-part test. Under the proposal, the minimum required funding amount for the year would be the greater of the following amounts: (1) the amount determined under the present-law funding requirements, (2) the amount determined under a "complement rule," which relates to certain accrued liabilities in underfunded plans, (3) the amount determined under the "funded ratio maintenance requirement", which prevents declines in the fundedness of a plan not taken into account under the complement rule, and (4) a cash-flow rule.

The proposal would apply to existing unfunded liabilities, and to increases in unfunded liability (e.g., by the adoption of a new plan or a benefit increase, or by the expansion of coverage under a plan).

The Administration has determined that many plans will not be affected by the new funding requirements, but will be able to continue to fund under the present-law rules.

Complement rule

The Administration proposal would provide shorter funding (amortization) periods under the minimum funding standard for certain defined benefit pension plans without assets at least equal to 110 percent of termination liability. Termination liability would be determined using the plan's actuarial assumptions. Generally, under the proposal, the funding period would not be shorter than 3 to 5 years and, in most cases, would be between 10 and 20 years.

For a plan with assets less than 110 percent of termination liability, the exact length of the applicable funding period for a year would be directly related to (1) the extent to which the plan is underfunded, and (2) the maturity of the plan's benefits (i.e., the extent to which the plan's unfunded projected liabilities are attributable to past service). The funding period of a plan would not be reduced under the proposal merely because the plan's assets are less than 110 percent of termination liability.

Funded ratio maintenance requirement

To prevent the deterioration of a plan's funded status below 110 percent of termination liability generally due to experience losses and certain benefit increases not triggering a shorter funding period under the rules described above, the Administration proposal contains a funded ratio maintenance. Generally, the funding period for liabilities subject to the funded ratio maintenance requirement would be 3 years.

Under the Administration proposal, if a plan's level of funding declines, then a portion of the plan's termination liability, measured by the decline, would be subject to a shorter funding period. For example, under the proposal, if a plan's funding declines by 10 percent, and if the termination liability of the plan after the decline is $1 million, then $100,000 of the plan's termination liability (10 percent of $1 million) would be subject to a shorter funding period.

Cash flow requirement

The Administration proposal provides that, if a plan's assets are less than 110 percent of termination liability, then the minimum required contribution for a year would not be less than the total distributions for the year or the amount needed to bring the plan up to that level of assets, whichever is less. Total distributions would include benefit payments, as well as administrative and investment expenses. Under the proposal, special rules would be developed for plans that have frozen benefit accruals and for plans that have no active participants.

Controlled group liability

The Administration proposal provides that the particular employer who maintains a defined benefit pension plan, and each member of that employer's controlled group would be jointly and severally liable for contributions required under the minimum funding rules. The rules allowing deductions for employer contributions would be modifed to permit a controlled group member to deduct contributions made to a plan maintained by another member of the controlled group.

Contribution due date

Quarterly payments would be required under the minimum funding standard. The last payment would be due not later than 2½ months after the close of the plan year. As under present law, failure to make a contribution by the applicable due date would result in the imposition of excise taxes.

Minimum funding waivers

The proposal would modify the rules governing the availability of minimum funding waivers in several respects. Under the proposal, a waiver application would have to be filed within 2½ months after the end of the plan year. The standards for obtaining a waiver would be clarified by providing that the employer seeking a waiver would have to establish that the financial hardship is temporary. Because all members of the controlled group of the employer maintaining the plan would be liable under the minimum funding rules, the hardship determination would be based upon the circumstances of the entire controlled group.

In order to make funding waivers more equivalent to commercial loans, the interest rate on waived contributions would be increased from the interest rate applicable to the late payment of taxes to the greater of the plan's interest rate for funding purposes and the market rate for loans to distressed companies.

To protect plans against protracted periods of serious underfunding and serious deterioration of the funded status of the plan, the number of annual waivers that could be granted with respect to any plan within a 15-year period would be reduced from 5 to 3.

Under the Administration proposal, the maximum funding period for waived contributions would be determined by reference to the plan's funded status. If the plan's assets are at least 110 percent of termination liability, then the funding period would be 15 years (as under present law). Under the proposal, if the plan's assets are less than 110 percent of termination liability, then the funding period would be reduced from 15 years to a period depending on the underfendedness of the plan.

An employer would be required to notify plan participants and benficiaries of any funding waiver application and to provide them with an opportunity to comment in order to ensure that the participants are aware of the potential loss of contributions to the plan.

Finally, the Administration proposal states that any additional restrictions which would further ensure that waivers are granted only when absolutely necessary should be considered.

Deduction limits

Under the Administration proposal, the limit on deductions allowed with respect to employer contributions to defined benefit pension plans would be increased in certain cases. Under the increased limit, a contribution to a defined benefit plan in excess of the otherwise applicable limit would be deductible for a year to the extent that (1) it does not cause the level of assets in the plan to exceed the plan's termination liability, and (2) it does not cause the level of assets in all plans maintained by the controlled group to exceed the total termination liability of the controlled group's plans. The 10-percent excise tax on nondeductible contributions would not apply to these contributions.

General Accounting Office Report

The GAO report recommended that (1) the minimum contribution requirements be increased to reduce the amount of a plan's unfunded benefits, and (2) the date by which employers are required to make contributions be accelerated.

The GAO report pointed out that, during the years 1983–85, 70 percent of the claims against the PBGC for termination of underfunded plans resulted because the present-law funding standards do not require sufficient contributions to fund increasing unfunded liabilities arising in part from numerous benefit increases within 5 years of plan termination. Of the 33 underfunded plans terminated during the period, which represented 90 percent of the PBGC's claims, 27 plans had increased benefits within 5 years of plan termination. The GAO report also found that 30 percent of the claims against the PBGC were caused by the failure of employers to make required contributions prior to plan termination.

Analysis of Issues

Increased funding rate

In its proposal, the Administration stated that the rate of funding required under the minimum funding standard exposes plan participants and the PBGC to excessive risk. The Administration further pointed out that, under present law, the funded status of a plan could deteriorate even if the minimum funding requirements are fully satisfied. Thus, it could be argued that, given the existence of a plan termination insurance program, the present-law rules providing for 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 the Administration proposal 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 the business risk of the employer, as well as to protect the PBGC from systematic loss.

Concerns have been expressed that the rate of funding proposed by the Administration is unnecessarily high, and that employers who otherwise would have been able to fund fully 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 absent and that employees have less incentive to bargain for adequate funding by the employer.

Some would 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.

In addition, consideration could be given to whether it is appropriate to allow an employer that maintains more than one defined benefit pension plan to use different funding methods in each plan, thereby creating different levels of benefit security for employees covered under different plans. Note that the Administration proposal would indirectly address this issue in the context of asset reversions. Some question why this issue is not addressed directly.

Finally, some individuals have proposed restrictions on the present-law flexibility of actuarial assumptions used in calculating required plan contributions. This issue arises in two contexts—whether parameters should be imposed on any particular actuarial assumption (such as a permissible interest rate or interest rate corridor) and whether any or all actuarial assumptions should be required to be separately reasonable, rather than reasonable in the aggregate.

Contribution due date

Of the 8½ month post-year period for making required plan contributions, 6 months was provided under Treasury regulations issued during the transition period that followed the enactment of ERISA. Some question the need to continue this transition rule in light of the GAO report indicating that unpaid contributions are a significant element of the PBGC's cost. The GAO report found that a significant amount of claims against the PBGC occurred because plan contributions for a year were not made because the payment deadline did not expire before the date of plan termination. Requiring quarterly payments could provide an early warning to the PBGC, the IRS, and plan participants of possible employer difficulty in meeting its benefit obligations. It is not unusual to require that the contributions be paid on a quarterly basis. Due to enforcement and collection problems, the Code requires quarterly payments in a number of cases, for example, withholding taxes and estimated taxes must be paid on a quarterly basis.

Some question whether plan contributions should be made on a quarterly basis during the year. Such a requirement could impose additional administrative costs on plans without a corresponding increase in benefit security. An alternative to the Administration proposal would be to require quarterly payments only in the case of an employer that is experiencing financial distress or in the case of an under funded plan.

Funding waivers

Proponents of the Administration proposal to establish more stringent limits with respect to funding waivers argue that employers used waivers to minimize contributions during the period immediately preceding the termination of a plan. The GAO report found that 30 percent of the claims against the PBGC arising during the period 1983–85 resulted from the failure of employers to make required plan contributions prior to plan termination. The GAO concluded that significant percentages of the large claims represented required contributions that were overdue or had been waived by the IRS.

Under present law, funding waivers are equivalent to loans from a plan to the employer that normally would be treated as prohibited transactions. It is arguable that such loans are inappropriate unless the employer can demonstrate appropriate creditworthiness. Some argue that employers should not have the opportunity to avoid liability for pension promises by terminating underfunded plans at the expense of other employers who moderated their promises and remain in the defined benefit system.

Those who oppose further restrictions on funding waivers suggest that the effects of recent restrictions on waivers should be examined before new restrictions are imposed. They would argue that the impact of restrictions on funding waivers should be carefully examined and that the potential for plan terminations that will result in loss of employee benefits and in increased liability for the PBGC should be considered.

Further, it may be appropriate to consider whether funding waivers should be granted under any circumstances. To the extent that an employer's request for a funding waiver represents an early indication of employer financial difficulty, some might argue that the granting of funding waivers puts the interests of plan participants at a lower priority than other employer creditors. Given the potential liability of the PBGC, some question whether this ordering of creditor priority should be sanctioned by the IRS.

It may also be appropriate to consider whether funding waivers should be permitted in the case of an underfunded plan of an employer when the employer also maintains a defined benefit plan that is overfunded on a termination basis.

Deductions

The allowance of a deduction for the full amount necessary to increase the assets of a plan to offset all termination liability promotes the theory that public policy should encourage funding that is optimal, rather than deficient or excessive.

On the other hand, the increased deduction limits may be used to best advantage by employers who present the least risk of benefit loss to their employees and the least risk of liability to the PBGC. If such a result occurs, expansion of the deduction limits for employers who are able to fund all termination liability under their plans with a single payment may be inconsistent with sound tax policy because it may cause a revenue loss that would not significantly decrease risk to the PBGC or increase benefit security.

III. TERMINATION OF UNDERFUNDED PLANS

A. Conditions for Plan Termination

Present Law and Background

Law before 1986

Prior to 1986, an employer 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 terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC (described below), the employer had no further liability to the PBGC. 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 insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a plan. Basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($1,857.95 for 1987).

Guarantees do not apply with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants. In cases in which they apply, guarantees are phased in at the rate of $20 per month or 20 percent per year, whichever is greater, for (1) basic benefits that have been in effect for less than 60 months at the time that the plan terminates, or (2) any increase in the amount of basic benefits under a plan resulting from a plan amendment within 60 months before the date of plan termination.

Voluntary terminations

In general

The Single Employer Pension Plan Amendments Act (SEPPAA), enacted in 1986, substantially modified the rules relating to the termination of single employer pension plans. Under SEPPAA, the conditions under which an employer may voluntarily terminate were revised and an employer's liability to plan participants and the PBGC was increased in the case of a termination of an underfunded plan.

Standard terminations

A single-employer defined benefit plan may be voluntarily terminated only in a standard termination or in a distress termination. A plan may be terminated in a standard termination only if it has sufficient assets to pay all benefit commitments under the plan. Benefit commitments are greater than guaranteed benefits, and include all benefits guaranteed by the PBGC and all benefits that would be guaranteed but for the dollar limit on the guarantee or the length of time the benefit has been in existence (see above). In addition, benefit commitments include early retirement supplements or subsidies and plant closing benefits, without regard to whether such benefits are guaranteed, with respect to participants who have satisfied all conditions for entitlement prior to termination.

Benefit commitments are less than plan termination liability, which includes all fixed and contingent liabilities. Benefit commitments do not include benefits which vest solely due to plan termination or contingent benefits (such as early retirement benefits) for which the participant has not satisfied all conditions for entitlement prior to termination. Such benefits are included in termination liability.

If a plan is terminated in a standard termination so that the plan assets are sufficient to satisfy benefit commitments, the employer has no further liability to the PBGC or to plan participants, even if the plan is not sufficiently funded to meet termination liabilities. In such cases, the participants lose their rights to benefit promises because the PBGC has no liability for benefits in excess of guaranteed benefits. Thus, participants may lose benefits that vest on account of the plan termination and certain contingent benefits.

Distress terminations

In general.—A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor (described below) and each substantial member (described below) of the contributing sponsors' controlled groups satisfies at least one of four distress standards described in ERISA.

In order to terminate a plan in a distress termination, a plan administrator is required to demonstrate that (1) a petition in bankruptcy or a State insolvency proceeding has been filed seeking liquidation of each contributing sponsor of the plan and each substantial member of the controlled group of each contributing sponsor and that the petition has not been dismissed or converted to one seeking reorganization; (2) a petition in bankruptcy or a State insolvency proceeding has been filed seeking reorganization of each contributing sponsor of the plan and each substantial member of the controlled group of each sponsor and that the bankruptcy court has approved the plan termination; (3) unless a distress termination occurs, each of the contributing sponsors and the substantial members of the controlled group will be unable to pay its debts when due and will be unable to continue in business, or (4) with respect to the contributing sponsors and each substantial member of the controlled group, the costs of providing pension coverage have become unreasonably burdensome, solely as a result of a decline in the workforce covered as participants under single-employer defined benefit pension plans.

For purposes of these rules, an entity is a contributing sponsor if it (1) is responsible for funding the plan or (2) is a member of the controlled group of an entity that is responsible for funding or formerly was responsible for funding, and has employed a significant number of participants under the plan while it was so responsible. The term "controlled group" means a group of entities under common control. A "substantial member" of a controlled group is generally any entity whose assets comprise at least 5 percent of the assets of the controlled group.

Liability to plan participants.—In a distress termination, if there are benefit commitments in excess of PBGC guaranteed benefits that cannot be paid out of current plan assests ("outstanding benefit commitments"), the PBGC is required to appoint an independent fiduciary with respect to a special termination trust maintained for the benefit of participants. The term "outstanding amount of benefit commitments" under a plan is defined as the excess of (1) the actuarial present value of the benefit commitments of each participant and beneficiary over (2) the actuarial present value of the benefits of each participant and beneficiary that are guaranteed by the PBGC or to which assets of the plan have been allocated under the distribution procedures of section 4044 or ERISA.

Each contributing sponsor of the plan and each member of the controlled group of a contributing sponsor is jointly and severally liable to the termination trust for the lesser of (1) 75 percent of the outstanding benefit commitments, or (2) 15 percent of the total benefit commitments. Amounts paid to the termination trust are to be distributed to the participants as collected, after payment of the trust's administrative expenses, without regard to the usual allocation priorities of ERISA.

In general, payment of this liability to the termination trust is to be made under commercially reasonable terms, with deferrals of certain amounts in years in which no person liable for the tax has pre-tax profits. Such deferred amounts are only payable after similar deferrals with respect to liability to the PBGC have been paid in full.

If payment is not deferred, then payment to the termination trust occurs contemporaneously with payment to the PBGC. Thus, additional amounts may be paid to plan participants even if the full liability to the PBGC has not been discharged.

Liability to PBGC.—In a distress termination, if the plan assets are insufficient to fund guaranteed benefits, each contributing sponsor and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the outstanding balance of any accumulated funding deficiency, and (2) the balance of the amount of any waived funding deficiencies. The full amount of such liability is due and payable to the PBGC as of the date of plan termination.

In addition, upon the termination of a plan pursuant to a distress termination, each contributing sponsor of the plan and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the collective net worth of the entities that are liable, (2) the excess of 75 percent of the unfunded guaranteed benefits over 30 percent of the collective net worth of the entities that are liable, and (3) interest on such amounts from the date of termination. Payment of this liability is generally to be made under commercially reasonable terms, with deferrals of certain amount in years in which the liable entities have no pre-tax profits.

The rules described above apply without regard to whether the employer or any member of the controlled group also maintains one or more plans that have assets in excess of termination liabilities.

PBGC claims in bankruptcy

Under present law, up to the 30 percent of net worth limit, the PBGC's claim has the status of a Federal tax lien for bankruptcy purposes; the priority status of the remainder of the PBGC's claim is determined under generally applicable bankruptcy rules.

The typical PBGC claim generally will be based on underfunding that accrued prior to the date that a petition is filed in bankruptcy court. This is generally the case even if the PBGC's claim occurs as a result of a plan termination occurring after the petition date. Under generally applicable bankruptcy law, liens on property are to be perfected prior to the petition date and are not granted after that date without the consent of the bankruptcy court. Consequently, the PBGC's claims are almost never perfected prior to the petition filing date and the PBGC, therefore, will normally retain the status of an unsecured creditor in a bankruptcy proceeding.

Termination by PBGC

The PBGC is authorized to commence proceedings to terminate a plan under certain circumstances and is required to do so if the plan does not have assets available to pay benefits that are currently due under the terms of the plan.

Administration Proposal

Under the Administration proposal, the required plan asset level for a standard termination would be increased from the present-law requirement of benefit commitments to the full level of the plan's termination liability to participants. For this purpose, the plan's termination liability would include all fixed and contingent accrued benefits that would be provided if the plan had sufficient assets.

A defined benefit pension plan with assets insufficient to provide its termination liability to participants would be unable to terminate unless the employer (and controlled group) could satisfy the criteria for a distress termination. Following a distress termination, the employer's (and controlled group's) liability to participants would be increased from the present law percentage of benefit commitments to the full amount of the plan's unfunded termination liability. (This would not change the priority status of the pension claims in bankruptcy.) Assets collected to satisfy the employer's liability would be allocated in accordance with the present-law priority rules, except that the value of PBGC's claim for 30 percent of net worth would be allocated exclusively to unfunded guaranteed benefits.

If a plan terminates with assets less than the plan's termination liability, assets would have to be transferred from other plans of the controlled group to the terminating plan, under allocation rules to be developed, to the extent necessary to cover the termination liability of the terminating plan. However, assets may not be transferred from an ongoing plan to the terminating plan to the extent that the transfer would reduce the assets in the ongoing plan to less than the termination liability of such plan. A transfer of a plan with assets less than its termination liability to a sponsor outside of the controlled group would be treated as a termination of the transferred plan for purposes of this rule. (Special provisions would be developed to take into account the relative benefit levels of the underfunded and overfunded plans and to protect against manipulation of this rule through benefit increases.)

Except to the extent permitted by the PBGC, an employer (and its controlled group) would be precluded from establishing retirement programs which, in whole or in part, provide substantially similar benefits within 5 years after termination of a plan that did not have adequate assets to provide PBGC guaranteed benefits.

General Accounting Office Report

The GAO report recommended raising the priority of the PBGC's claims against the employer in bankruptcy, and reducing the benefits guaranteed by the PBGC. For example, instead of phasing in PBGC guarantees over 5 years, guarantees might be made inapplicable to benefit improvements within 5 years of plan termination.

Analysis of Issues

Employer liability upon termination

The Administration argues that the proposal relating to termination of underfunded plans would improve the likelihood that employers will adequately fund their defined benefit pension plans and would prevent employers from improperly shifting their liabilities to the PBGC.

Arguably, it is inappropriate to allow an employer that is not in financial distress to deny participants promised benefits. Employers may have promised pension benefits in lieu of current compensation. On the other hand, some would argue that requiring the ongoing operation of the plan until termination liabilities are satisfied could contribute to an employer entering into a distress situation and could contribute to additional liabilities being shifted to the PBGC.

Similar arguments apply with respect to the proposal to make employers liable for termination liabilities without limitations. Those who favor it question the appropriateness of allowing financially distressed employers to escape liability to the PBGC or to participants unless they are insolvent. Those who oppose the proposal argue that it makes recovery of the distressed employer less likely.

PBGC status in bankruptcy

Some contend that simply raising employers' liability in the case of distress terminations will be largely ineffective, because the low priority accorded to PBGC and participant claims in bankruptcy makes it unlikely that any significant portion of such liabilities will be satisfied. These commentators recommend raising the priority of the PBGC or the participants or both in bankruptcy. The GAO report concluded that the mere increase in an employer's liability on plan termination would not be sufficient to reduce the potential liability of the PBGC. In examining the plan terminations that increased the PBGC claims for the 1983–85 period, if SEPPAA had been in effect, the GAO found that only 4 percent of the total claims for the period could have been secured by the PBGC. However, any changes in the priority status of creditors in bankruptcy are normally subject to close scrutiny because of a concern that the rights of all creditors be appropriately balanced. Such a change in creditor status for the PBGC could have adverse consequences with respect to secured creditors and could diminish the general willingness of lenders to extend credit to finance business operations.

Certain experts question whether the PBGC should not be made whole before plan participants receive further benefits, either under the plan or under a plan providing substantially similar benefits. Giving priority to the PBGC would protect its financial condition and make it better able to provide a higher level of guaranteed benefits for more participants. Also, giving PBGC priority would be consistent with the result under present law that occurs when a plan is terminated at or above guaranteed benefits.

On the other hand, others maintain that the primary objective should be to provide benefits to participants and that the existing structure should be modified to provide participants with priority respect to termination liabilities. These commentators contend that losses by the PBGC can be spread among an appropriately large group of employers or paid for through general revenues. This argument assumes more stringent funding requirements (see Part II, above); otherwise it would allow certain employers or industries in financial difficulty to use the rules to obtain an even greater subsidy from other employers (or taxpayers generally) than is available under present law.

Controlled group rules

Critics of the Administration proposal regarding mandatory transfers within the controlled group upon termination of an underfunded plan maintain that such a rule is inconsistent with the basic principle that a plan is maintained for the exclusive benefit of the participants and beneficiaries. They argue that this principle is especially important with respect to collectively bargained plans where often a specific plan contribution (rather than a benefit) is bargained for in lieu of a corresponding amount of current wages. Moreover, some commentators contend that this same process—offsetting wages by plan contributions—takes place with respect to all plans. To the extent that this is so, they maintain that it would be inappropriate to require one plan to subsidize another.

The Administration contends that it is inappropriate to deny certain employees promised retirement benefits to the extent that other plans have more than enough assets to fund termination liabilities. What offsets wages is not plan contributions, but the present value of promised benefits and, thus, all participants should receive such promised benefits to the extent of the controlled group's plan assets. In fact, some maintain that the Administration proposal does not go far enough in this regard; all plans within the controlled group should, according to these critics, be funded at the same level in proportion to termination liabilities and transfers should be required to achieve this. This rule would prevent the problem under the Administration proposal in the case of a controlled group with two or more underfunded plans and not enough excess assets to fund them all sufficiently. The first to terminate would be funded first under the Administration proposal.

With respect to the Administration proposal to treat a transfer of a plan outside of the controlled group as a termination, critics suggest that this will inhibit sound business transactions and is unnecessary where the acquiring entity is financially sound or has overfunded plans. Supporters of the Administration proposal point out that it is difficult to administer a rule that turns on the financial condition of a business.

The Administration proposal is designed to ensure that plans are not funded at the level of termination liability. If it is appropriate to require plans to fund above the level of termination liability, it is arguably inconsistent to limit the amount of excess assets included in a transferred plan to the amount available upon a withdrawal or termination. Accordingly, one could argue that the funded level of the transferred plan should be at least equal to the funded levels of the other plans maintained by the transferring employer. Of course, such a modification of the Administration proposal would enable employer to recover assets through transfers that could not be recovered through the mechanism of a direct withdrawal on termination.

B. Plan Investment In Employer Securities

Present Law and Background

Under ERISA, an employee benefit pension plan may acquire or hold securities of the employer sponsoring the plan (or affiliates of the sponsor) only if the securities are "qualifying employer securities." In general, any stock of the plan sponsor (or an affiliate) is a qualifying employer security. Debt securities, however, are only considered qualifying employer securities if the debt security is a "marketable obligation." In general, an obligation is marketable if (1) the obligation is traded on a national securities exchange or is part of an issue a substantial portion of which is sold to investors who are independent of the sponsor, and (2) the plan holds no more than a quarter of the issue and independent persons hold at least one-half of the issue (ERISA sec. 407).

Under the Tax Reform Act of 1986, nonpublicly traded employer stock that is acquired by an employee stock ownership plan (ESOP) are required to be valued by an independent appraiser for all plan purposes. This requirement applies to employer stock acquired after December 31, 1986 (Code sec. 401(a)(28)).

Also under ERISA, defined benefit plans and money purchase pension plans may not acquire qualifying employer securities in an amount in excess of 10 percent of the assets of the plan. "Eligible individual account plans," i.e., profit-sharing, stock bonus, and ESOPs are not subject to this limit and may hold up to 100 percent of plan assets in qualifying employer securities (ERISA secs. 404(a)(2), 407).

Currently, some employers maintain a "floor-offset" arrangements, which are a combination defined contribution plan and defined benefit plan. Under such an arrangement, a participant's benefits under the defined benefit plan (the floor plan) are offset by the participant's benefits under the defined contribution plan (the offset plan). Many employers take the position that the defined contribution plan is an eligible individual account plan which qualifies for the exception to the 10-percent limit on investments in employer securities. Although the Internal Revenue Service has ruled that floor-offset arrangements may meet the qualification requirements of the Code if certain conditions are satisfied, the Department of Labor has not ruled that the defined contribution portion of these arrangements qualify for the exception to the 10-percent limit on investments in employer securities.

Administration Proposal

Under the Administration proposal, the present-law requirement that employer debt securities must be marketable obligations would be extended to all employer securities. Thus, stock of the employer would not constitute a qualifying employer security unless the stock were a marketable obligation. Eligible individual account plans would not be subject to this new rule. Thus, for example, a defined benefit pension plan maintained by a closely-held company with nontradable stock generally would not be able to hold such employer stock, but an ESOP maintained by the same company could.

In addition, the Administration proposal would extend the 10-percent limitation on holding employer securities to the defined contribution portion of a floor-offset arrangement.[5] Thus, the defined benefit pension plan and the defined contribution plan would be considered as a single plan for purposes of the limitation on qualifying employer securities and of such an arrangement could not hold more than 10 percent of its assets in qualifying employer securities. Transition rules similar to the rules provided by ERISA when the 10-percent limit was introduced would apply to plans which currently do not meet the 10-percent limit.

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[5] Under ERISA, the 10-percent limitation applies to the aggregate fair market value of employer securities and employer real property held by the plan. (Employer real property is real property and related personal property leased to the employer sponsoring the plan or an affiliate of the employer.) The Administration proposal would not change this aggregation. Thus, under the proposal, wherever the 10-percent limit applies, it would be a limit on the aggregate amount of employer securities and employer real property that could be held by a plan.

Analysis of Issues

The present-law restrictions on investments in employer securities by pension plans are designed to limit the risks to which plan participants and the PBGC would be exposed through investments in the plan sponsor. Present law may not, however, ensure adequate protection in all cases.

For example, because employer stock held by a plan is not required to be a marketable obligation, many employers have issued stock to their employee benefit plans that is not readily tradable and that has features that are substantially different from stock issued by the employer to other investors. Proper valuation of such stock is extremely difficult. Moreover, because this stock may never have been subject to a market test (i.e., confirmation of valuation by independent investors), plan investment in such stock may involve increased risks to plan participants and the PBGC.

To the extent that employers have floor-offset arrangements where the offset plan holds substantial amounts of employer securities, the protections intended to be provided to participants in defined benefit plans by the 10-percent limitation may be undercut. In such situations, the security of the participant's defined benefit promise may be substantially weakened. In addition, the risk of loss to plan participants and the PBGC may be greatly increased.

Those who favor the Administration proposal argue that it would reduce the risk to plan participants and the PBGC associated with investments in the plan sponsor by adding additional restrictions on the holding of employer securities by defined benefit plans and plans related to such plans. They also believe that, to further achieve this goal, it would also be appropriate to provide (or clarify) that the marketable obligation requirement applies to stock held by an eligible individual account plan which is part of a floor-offset arrangement. In addition, it should be clarified that, in the case of floor-offset arrangements, the defined contribution plan could hold no more qualifying employer securities than can the defined benefit plan. They argue that these further modifications would prevent employers from increasing the amount of employer securities a defined benefit pension plan can hold by utilizing a floor-offset arrangement.

Those who oppose the proposal are primarily concerned about the effect of the proposal on ESOP of closely held companies. Those who favor the proposal argue that such plans will not be affected unless they are part of a floor-offset arrangement.

Some commentators question why any employer securities should be held under a retirement plan. Prohibiting such investments by retirement plans would prevent an employee's retirement security from being linked to the same entity on which the employee relies for current income.

It could be argued that the Administration inappropriately prohibits investments in employer securities on the theory that such investments increase the risks to plan participants and the PBGC. Those who oppose the Administration proposal contend that the actual risk of an investment in employer securities should be weighed rather than applying a mechanical rule that presumes that employer securities are high-risk investments. Such a rule reduces the status of employer securities relative to other investments without regard to the financial stability and earnings record of the employer.

They would argue further that the fiduciary responsibility standards of ERISA prevent any plan trustee from investing disproportionate amounts of plan assets in any investment vehicle if such investment would increase the risk of loss to plan participants.

IV. EMPLOYER ACCESS TO ASSETS OF OVERFUNDED PLANS

Present Law and Background

Exclusive benefit rule

Under the Code, a trust forming part of a pension plan is not qualified unless under the trust instrument it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (Code sec. 401(a)(2)). However, upon termination of the plan and after satisfaction of all fixed and contingent liabilities of the participants and beneficiaries (termination liability), the employer may recover any excess assets remaining in the trust that are due to erroneous actuarial computations (Treas. reg. sec. 1.401-2(b)(1)).

Similarly, under ERISA, the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan (ERISA sec. 403(c)). However, as under the Code, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution (ERISA sec. 4044(d)).[6]

Under present law, upon the termination of the plan, all accrued benefits must become 100 percent vested and nonforfeitable. In addition, the accrued benefits must be distributed or annuitized, that is, annuities providing for the payment of accrued benefits must be purchased and distributed to participants.

Under present law, whether the employer has the right to the excess assets or must share such assets with plan participants is generally determined under the plan document. Thus, if the plan document provides that the employer is entitled to the reversion of excess assets, the employer is not required to share the reversion with participants. Case law generally provides that, subject to any applicable collective bargaining agreements, the plan can be amended at any time prior to termination of the plan to provide that the excess assets may revert to the employer, even if, prior to the amendment, the plan provided that any excess was to be distributed to employees.[7]

Under present law, the determination of whether there are excess assets is made on a plan-by-plan basis. Thus, if an employer

[6] Both ERISA and the Code also permit the return of contributions to the employer in certain limited situations prior to the termination of the plan, for example, contributions made by mistake of fact, contributions conditioned on the initial qualification of the plan, and contributions conditioned on the deductibility of the contribution. ERISA sec. 403(c)(2), Code sec. 401(a)(2), Rev. Rul. 77-200, 1977-1 C.B. 98.

[7] See, e.g., *Washington-Baltimore Newspaper Guild Local 35* v. *Washington Star,* 555 F.Supp. 257 (D.D.C. 1983), aff'd 729 F.2d 863 (D.C. Cir. 1984).

maintains more than one defined benefit pension plan, the employer is permitted to recover excess assets in the overfunded plan, regardless of whether the other plans have sufficient assets to satisfy the benefits of the employees in such plan. The present-law rules provide an incentive to employers to maintain multiple plans funded at different levels in order to maximize their access to tax-favored plan assets at the expense of benefit security. Some employers have received asset reversions from their overfunded plans and then terminated their underfunded plans, thereby depriving employees of their full benefits and, in some cases, shifting the unfunded liabilities to the PBGC.

Access to plan assets prior to termination

Although an employer technically is not permitted to recover excess assets except upon termination of a plan, present law permits certain transactions that in effect permit the withdrawal of assets from an ongoing plan. Typical examples of such transactions are termination-reestablishment and spinoff-termination transactions.

In a termination-reestablishment transaction, the employer terminates a defined benefit plan, recovers the excess assets, and then establishes a "new" plan that covers the same employees and provides the same or substantially similar benefits as the old plan. In a spinoff-termination transaction, a single plan is split into two plans, one plan covering retirees and one covering active employees. The excess assets are allocated to the plan covering retirees. That plan is then terminated, allowing the employer to recover the excess assets.

In response to concern that reversions can reduce the security of participants' benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans" or the "Implementation Guidelines," were issued by the Administration as a news release on May 24, 1984.

The Implementation Guidelines set forth administrative procedures for processing certain terminations of qualified defined benefit pension plans involving reversions of excess assets to the plan sponsor. The guidelines generally provide that a bona fide termination of a defined benefit pension plan will be recognized as having occurred under either a spinoff-termination or a termination-reestablishment transaction only if certain conditions are met.

A spinoff-termination is considered bona fide under the guidelines only if (1) the benefits of all employees are vested as of the date of the termination, (2) all benefits accrued by all employees as of the date of the termination are provided for by the purchase of annuity contracts, (3) the continuing plan adopts a special funding method (with the approval of the IRS), and (4) appropriate notice is provided to employees.

Under the Implementation Guidelines, termination-reestablishment transactions are generally recognized as bona fide. If the new plan provides credit for service before that plan was adopted, however, the guidelines do not treat the transaction as bona fide unless a special funding method is adopted (with the approval of the IRS).

The guidelines note that spinoff-terminations or termination-reestablishments may affect the qualified status of plans under the tax law because the Code requires that qualified plans be permanent. The guidelines generally provide that the permanency requirement prohibits an employer that has engaged in a spinoff-termination or termination-reestablishment transaction from engaging in another such transaction for at least 15 years.

By undertaking a termination-reestablishment or a spinoff-termination, an employer is effectively able to recover all assets in excess of the plan's termination liability from an ongoing defined benefit plan. Although all benefits earned to date would have to be vested and annuitized, the ongoing plan is not required to retain an asset cushion above the level of the plan's termination liability. The absence of this cushion reduces employees' security with respect to future benefits and may also discourage employers from providing for future benefit increases.

Under present law, the extent to which a defined benefit pension plan that is overfunded on a termination basis can transfer excess assets directly to a qualified defined contribution plan of the same employer is uncertain. Because such a transfer could have the effect of satisfying the employer's obligation to make a contribution to the transferee plan, the transaction can have the effect of a reversion, diverting assets from the exclusive benefit of participants.

Tax treatment of reversions

In general, asset reversions are fully includible in the gross income of the employer receiving the reversion, and thus, are subject to income tax. In addition, under the Tax Reform Act of 1986, reversions are generally subject to an excise tax equal to 10 percent of the amount of the reversion. Asset reversions transferred to an ESOP prior to January 1, 1989, are excepted from both these rules and, therefore, are not includible in the gross income of the employer or subject to the excise tax. The excise tax was added in order to recapture the tax benefit received by the employer from plan contributions, i.e., tax-free growth. The tax may or may not be adequate to fully recapture the tax benefit depending on the length of time the assets were held by the plan.

Administration Proposal

In general

The Administration proposal permits an employer to withdraw assets from an ongoing defined benefit pension plan provided that, following the withdrawal, an asset cushion in excess of termination liability remains in the plan and in all other defined benefit plans maintained by the employer and the employer's controlled group. Similarly, in the case of a termination of a plan, the employer is generally required to leave an asset cushion in the plan. An employer is not required to leave an asset cushion and may obtain all assets in excess of plan termination liability only in the case of a plan termination and only if the employer and the employer's controlled group do not maintain another defined benefit pension plan at the time of termination and for 5 years after the termination.

The proposal retains the present-law rule that full vesting and annuitization of accrued benefits are required upon termination of a plan, but does not impose these requirements in the case of a withdrawal from an ongoing plan. The proposal provides that all withdrawals and reversions, other than transfers to another defined benefit pension plan maintained by the employer (or the employer's controlled group) and certain transfers to fund retiree health benefits are fully includible in income and subject to the 10-percent excise tax on reversions.

Asset withdrawals from ongoing plans

Under the proposal, an employer would be permitted to withdraw assets from an ongoing defined benefit pension plan to the extent that, following the withdrawal, each of the following conditions is satisfied: (1) the value of the assets in the plan of withdrawal exceeds the "minimum benefit security level" for such plan, and (2) the value of the assets in all other defined benefit pension plans of such employer and the controlled group of which the employer is a member exceeds the minimum benefit security level for all such other plans (calculated as though such other plans were a single plan). For purposes of the second requirement, multiemployer plans to which the employer or a member of the employer's controlled group contributes are disregarded.

In general, the minimum benefit security level is the greater of (1) the full funding amount for the plan, or (2) 125 percent of the termination liability of the plan.

A reduced cushion would be allowed to the extent that benefits are annuitized under the plan. The minimum benefit security level is lower for annuitized benefits because the employees and the PBGC are not at risk due to investment losses to the extent accured benefits are annuitized. Thus, a lower cushion is sufficient to protect those benefits. With respect to annuitized benefits, the minimum benefit security level would be equal to the greater of (1) the termination liability of the plan plus 40 percent of the excess of the full funding amount of the plan over the termination liability of the plan, or (2) 110 percent of the termination liability of the plan. For example, if 20 percent of the termination liabilities of a plan were annuitized, then the general formula for determining the minimum benefit security level would be applied to 80 percent of the plan's termination liabilities and the special formula would apply to 20 percent of the plan's termination liabilities.

In the case of a withdrawal, full vesting or annuitization of accrued benefits would not be required.

Asset reversions on plan termination

Employers with other defined benefit pension plans.—The proposal generally treats a reversion upon termination of a defined benefit pension plan the same as a withdrawal from a defined benefit pension plan. Thus, an employer (or a member of the employer's controlled group) would not be permitted to recover more assets through a plan termination than through an asset withdrawal if such employer (or a member of the employer's controlled group) continues to maintain a defined benefit pension plan. In such a case, the difference between the minimum benefit security level and the plan's termination liability would have to be transferred to the ongoing defined benefit pension plans maintained by the employer (or the controlled group) before the plan is terminated. The proposal anticipates that rules will be developed for allocating the transferred assets between the other defined benefit pension plans maintained by the employer and the controlled group. Following the termination, the employer could not cover the affected employees under another defined benefit pension plan (including a multiemployer plan) for 5 years.

Employers with no other defined benefit pension plans.—Under the proposal, the only time an employer could recover all assets in excess of termination liability would be when the employer (and the controlled group) does not maintain any other defined benefit pension plan. In such a case, the employer and the controlled group would be precluded from covering any employees under another defined benefit pension plan (including a multiemployer plan) for 5 years.

All terminations.—In the case of all terminations, the proposal would retain the present-law requirement that accrued benefits must be fully vested and annuitized upon plan termination.

The proposal anticipates that appropriate rules would be developed to deal with certain changes in the composition of a controlled group, e.g., the acquisition of a subsidiary or division with pre-existing defined benefit plans.

Transactions having the effect of a reversion

An employer can accomplish an economic result equivalent to a plan termination and asset reversion by transferring plan sponsorship to an employer outside the employer's controlled group. For example, assume an employer maintains a defined benefit plan for a division and that the plan is overfunded. The employer also maintains defined benefit plans that are underfunded, and therefore cannot make a withdrawal under the proposal or terminate the overfunded plan and obtain a reversion. If the employer sells the division outside the controlled group, the employer is able to realize the benefit of the excess plan assets through adjustments in the terms of the sale of the division.

In order to prevent avoidance of the restrictions on withdrawals and termination reversions in this manner, the proposal would treat a transfer of plan sponsorship outside the controlled group as a plan termination for purposes of determining the extent to which assets in excess of such plan's termination liability may be transferred with the plan.

For example, if plan sponsorship is transferred beyond the controlled group in connection with the sale of a subsidiary or division, assets in excess of the plan's termination liability would be permitted to remain in the plan only to the extent that the employer could have recovered such assets through a termination of the plan. Prior to the transfer of sponsorship, any assets not available to the employer on plan termination would have to be transferred to other defined benefit pension plans of the employer or controlled group.

To the extent that assets available for employer recovery on a plan termination remain in the plan that is being transferred to a new sponsor, such assets would be treated as having reverted to the transferring sponsor and, therefore, would be includible in the employer's gross income and subject to the 10-percent excise tax on reversions. If an employer (and controlled group) does not maintain any other defined benefit pension plans, then the amount of excess assets transferred would not be limited. Such an employer would be subject to the 5-year prohibition on maintenance of a defined benefit pension plan. Of course, the amount treated as a reversion would still be subject to income and excise taxes.

The proposal recognizes that strict rules on transfers of plan sponsorship beyond the controlled group could in some cases interfere with corporate transactions. Accordingly, the proposal states that special efforts will be made to minimize the disruptive effect of the asset recovery rules on such transactions, without undercutting the policies the proposal seeks to achieve.

The proposal would also treat all transfers of assets to a defined contribution plan of the employer or controlled group member as a reversion.

Frequency limits

After an employer has recovered assets from a plan through either a withdrawal or a reversion, neither the employer nor any member of its controlled group would be permitted to receive plan assets in a subsequent reversion or withdrawal for 10 years. However, if, through a reversion or withdrawal, an employer recovers less than the total amount available, such employer could recover assets in a subsequent reversion or withdrawal within the 10-year period provided that the subsequent reversion or withdrawal does not exceed the lesser of (1) the excess of the total amount available at the time of the initial reversion or withdrawal over the actual amount of such reversion or withdrawal, or (2) the amount available for reversion or withdrawal under the applicable rules at the time of the subsequent reversion.

In no case, however, would an employer or controlled group member be permitted to recover assets through a withdrawal or reversion on more than 3 occasions during any 10-year period. Also, an employer would be precluded from recovering a withdrawal or reversion from a newly established plan until the plan had been in effect for 10 years. An employer could at any time receive a reversion from a terminating plan if, following such reversion, neither the employer nor any member of the controlled group continued to maintain a defined benefit pension plan. Simultaneous recoveries from more than one plan within a controlled group would count as a single recovery for purposes of the application of the frequency limits.

Special rules would be applied to deal with sales and purchases of divisions and subsidiaries with defined benefit pension plans and with changes in the composition of the controlled group. For example, it generally would be appropriate to exempt an employer (and controlled group) from the 10-year limit if the employer (and controlled group) is departing entirely from the defined benefit pension plan system.

Taxation of withdrawals and reversions

All withdrawals, termination reversions and transfers of excess assets other than transfers to another defined benefit plan of the employer or controlled group and certain transfers to fund retiree health benefits (see part V, below) would be includible in gross income and subject to the 10-percent excise tax. All excess assets transferred from a defined benefit pension plan to a defined contribution plan within the controlled group would be treated as a reversion.

Government Account Office Report

In response to a request from the Chairman of the House Select Committee on Aging, the GAO issued, on April 30, 1986, a report on the termination of defined benefit pension plans involving the reversion of excess assets to employers. The purpose of the report was to obtain information on the reasons that defined benefit pension plans had excess assets on plan termination, the types of replacement plans provided for employees, and the effect of the Implementation Guidelines on employers' termination and replacement decisions.

The GAO concluded that, of the companies surveyed, the primary reason for excess assets was a higher-than-expected rate of return on plan assets. The reason cited most often for plan termination was the desire to use excess pension plan assets for nonpension purposes.

Analysis of Issues

The fundamental issues raised by the Administration proposal are whether the employer should have a right to any excess assets in a defined benefit pension plan maintained by the employer and, if so, whether the employer should be able to obtain the use of excess assets without terminating plan.

With respect to the first issue, the proposal retains present law. That is, it permits the employer to retain the right to excess assets. Those in favor of the proposal argue that requiring that the employees share in the excess assets would ultimately reduce benefit security. There are two main reasons why such a reduction might occur.

They argue that employers may be reluctant to generously fund a plan if any surplus must be shared with employees. If the flexibility in funding methods and assumptions were reduced, then restricting employers' right to the surplus might not have as much effect on funding simply because employers would not have as much choice as to how much they may contribute. To the extent employers do have a choice, however, they may be inclined to fund at a slower rate if they do not have a right to the reversion.

Supporters of the proposal also argue that, even if employers have little flexibility in funding, they may set benefits at a lower level and be more reluctant to grant benefit increases if the employees are entitled to share in the excess. Thus, employers may anticipate that the employees will be entitled to some or all of the excess by funding for a lower benefit. Reducing flexibility in funding methods and assumptions would not address this reaction. Critics of the proposal maintain that this speculative result should be weighed against the revenue costs of providing employers with a means to save on a tax-favored basis for purposes other than providing retirement benefits.

One of the main arguments advanced by critics of the proposal for entitling employees to the excess relates to the nature of the defined benefit promise, particularly in the context of plan terminations. Employees in a defined benefit pension plan may expect that they will be able to continue working and increase their service and compensation credit under the plan. If the plan is terminated before employees have reached the maximum benefit offered under the plan, then they have received all that was expected; the ability to increase service and compensation credit would be eliminated. Accordingly, in such cases it may be appropriate to provide that some of the reversion must go toward benefit increases. This argument has less application where a withdrawal is made and the plan is ongoing.

Another argument advanced by opponents of the proposal is best illustrated in the case of single-employer collectively bargained plans. In such plans, the union may bargain for a specified contribution by the employer, rather than a certain benefit. In such cases, there is an argument that the employees are entitled to whatever benefits the contributions made by the employer will provide. Even in the nonbargained area, it is argued, the salary or wage levels set by the employer may take into account the contributions made by the employer to the pension plan so that there also it may be appropriate for the employees to share in the excess.

From a tax-policy perspective, critics of the proposal also argue that permitting the employer the right to excess assets encourages the employer to use the pension plan as a means of tax-favored savings. Although the 10-percent reversion tax was designed to address this problem, and was designed to recapture, at least in part, the tax benefits received by the employer, it may not fully do so. The restrictions placed under the proposal on withdrawals and reversions may reduce the attractiveness of utilizing the plan as a means of tax-favored saving.

Even if it is determined that employers are entitled to some or all of the the excess assets, the aggregation rules of the proposal raise the issue as to which employees the excess belongs. As discussed above, in some circumstances, the proposal requires the employer to transfer excess assets from one defined benefit plan to another. Appropriate allocation rules for such transfers would have to be developed, particularly where the transferor plan or related bargaining agreement provides that the employees are entitled to some or all of the excess assets.

The second basic issue raised by the proposal is, if the employer has the right to excess assets, whether it is appropriate to allow the employer to obtain the excess while the plan is ongoing. In the past few years, the number of terminations of defined benefit plans has risen dramatically. There has been much concern about such terminations, partly because employees may be better off in an ongoing plan. There is a concern that if employers are entitled to excess assets only on termination of a plan, they will terminate the plan in order to recapture the excess. On the other hand, under the termination guidelines, employers are not required to terminate their plans in any meaningful sense to access excess assets.

Proponents of the proposal argue that the proposal will reduce terminations because it favors withdrawals over reversions due to plan terminations. Thus, for example, vesting and annuitization are not required for a withdrawal, but are required in the case of a plan termination. Also, in order for an employer to recover all assets in excess of termination liability, neither the employer nor the controlled group can maintain another defined benefit plan (including a multiemployer plan) for 5 years. It is argued that most employers will not be willing to exit the defined benefit pension plan system completely. On the other hand, since the asset cushion is available only on such a plan termination, it is argued by some that the proposal encourages real terminations in a way that current law does not.

Proponents of the proposal further argue that the proposal toughens the present-law rules regarding reversions while the employer maintains a plan. The cushion requirements, the controlled group rules, and the rules aggregating all defined benefit plans are more restrictive than present law. On the other hand, opponents of the proposal argue that the present-law rules regarding vesting and annuitization should apply to withdrawals or any other case in which an employer gains access to plan assets.

V. POST-RETIREMENT MEDICAL BENEFITS

Present Law and Background

Comparison with retirement plans

The tax treatment of post-retirement medical benefits differs in significant ways from the treatment of retirement benefits provided under qualified retirement plans. Subject to limits, an employer is entitled to a current deduction for a contribution to a trust under a qualified retirement plan to provide nonmedical retirement benefits to its employees. Moreover, the employees on whose behalf the contribution is made do not include any benefits in income until a distribution from the trust is received. In addition, while contributions remain in the trust, the income attributable to such contributions generally is exempt from income tax.

Different rules apply to post-retirement medical benefits. As discussed in more detail below, there are two tax-favored vehicles for prefunding post-retirement medical benefits separately from other retirement benefits. First, separate accounts in certain qualified retirement plans may be used to provide post-retirement medical benefits (Code sec. 401(h)). Although these accounts have tax treatment similar to the remainder of the qualified retirement plan, the benefits provided under such accounts are required to be incidental to the retirement benefits provided; this requirement may preclude funding the entire post-retirement medical benefit promised by the employer through such a separate account. The second vehicle that can be used to prefund post-retirement medical benefits is a welfare benefit fund (Code secs. 419, 419A). These funds generally are not subject to the contribution limits applicable to the separate accounts. In addition, medical benefits provided through a welfare benefit fund generally are excluded from the employee's income, which differs from the general rule applicable to distributions from a qualified retirement plan. However, income set aside in a welfare benefit fund to provide post-retirement medical benefits generally is subject to tax.

Although post-retirement medical benefits do not receive tax treatment comparable to retirement benefits under qualified retirement plans, they also are not subject to the same minimum standards applicable to retirement benefits. In order for a retirement plan to be qualified, it is required to provide certain rights to active employees. A nondiscriminatory class of active employees is required to be covered under the plan. In addition, contributions under the plan either have to be allocated to accounts established for those employees (defined contribution plans) or have to be made to fund a promise made to those employees to provide them with a specified level of benefits after retirement (defined benefit plans). Under a defined benefit plan, benefits are required to be earned or "accrued" according to certain standards under which the accrual is to occur over the working life of the employee, rather than simply at or near retirement. In addition, the account balances in a defined contribution plan, or the accrued benefits in a defined benefit plan, are required to become vested after a certain period of service. In general, these and the other requirements for qualification of a retirement plan are not required for tax-favored treatment of post-retirement medical benefits, even those provided under a separate account in a qualified retirement plan.

In addition, outside the tax area, the treatment of deferred cash compensation differs significantly from treatment of deferred medical benefits. Generally, any plan, regardless of whether it is tax-favored, that provides deferred cash compensation to employees other than certain highly compensated employees is required to be funded and to satisfy certain of the minimum standards applicable to qualified retirement plans. On the other hand, this requirement does not apply to deferred medical benefits which can be promised under a plan, but not funded or subject to the minimum standards.

Right to post-retirement medical benefits

As noted above, post-retirement medical benefits are not subject to the same minimum standards applicable to qualified retirement plans under which employees obtain the rights to benefits over their working lives. Thus, employees' rights to post-retirement medical benefits depend on the particular contractual arrangement between the employees and their employer. The binding nature of such arrangements, as they relate to post-retirement medical benefits, has been the subject of recent litigation. Case law has focused on the right of the employer to terminate post-retirement medical benefits with respect to current retirees. In general, courts have affirmed an employer's right to terminate such benefits if such right has been unambiguously reserved and clearly communicated to employees. However, the courts have been strict in applying these standards, looking not just at plan documents but also to oral representations.

Funding mechanisms

As noted above, under present law, employers have available two tax-favored mechanisms for prefunding post-retirement medical benefits: (1) separate accounts under a pension or annuity plan that satisfies Code section 401(h), and (2) a welfare benefit fund described in Code section 419. In addition, distributions from qualified retirement plans generally may be used by retirees to acquire post-retirement medical benefits.

Separate accounts (Code sec. 401(h)).—Under the separate account method of prefunding, a tax-qualified pension or annuity plan may provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents provided certain additional qualification requirements are met with respect to the post-retirement medical benefits. First, the medical benefits, when added to any life insurance protection provided under the plan, are required to be subordinate to the retirement benefits provided by the plan. The medical benefits are considered subordinate to the retirement benefits if, at all times, the aggregate of employer contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions made after such date, other than contributions to fund past service credits. Additional medical benefits and life insurance protection may be provided with employee contributions.

The rationale for requiring that the post-retirement medical benefits provided under section 401(h) be incidental and be provided under a separate account is that such benefits generally are not subject to the minimum standards, such as vesting and accrual, generally applicable to qualified retirement plans. Thus, it was considered important not only to limit the tax-favored treatment of such benefits but also to ensure that these relatively unrestricted benefits did not reduce the funds contributed to provide nonmedical retirement benefits pursuant to the minimum standards.

Second, a separate account is to be maintained with respect to contributions to fund such medical benefits. This separate accounting generally is determined on an aggregate, rather than a per-participant basis, and is solely for recordkeeping purposes. Third, the employer's contributions to a separate account are to be reasonable and ascertainable. Fourth, the plan is required to preclude the use of amounts in the separate account for any other purposes at any time prior to the satisfaction of all liabilities with respect to the post-retirement medical benefits. Fifth, upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets in the separate account are to revert to the employer and cannot be distributed to the retired employees. Similarly, if an individual's right to medical benefits is forfeited, the forfeiture is to be applied to reduce the employer's future contributions for post-retirement medical benefits.

The final requirement is that, in the case of an employee who is a key employee (Code sec. 416), a separate account is to be established and maintained, and benefits provided to such employee (and his spouse and dependents) are to be payable only from such separate account. This requirement applies only to benefits attributable to plan years beginning after March 31, 1984, for which the employee is a key employee. Also contributions to such a separate account are considered annual additions to a defined contribution plan for purposes of the limits on contributions and benefits applicable to retirement plans (Code sec. 415), except that the 25 percent of compensation limit (Code sec. 415(c)(1)(B)) does not apply.

If the requirements with respect to post-retirement medical benefits are met, the income earned in the separate account currently is not taxable. Also, employer contributions to fund these benefits are deductible under the general rules relating to the timing of deductions for contributions to qualified retirement plans. The deduction for such contributions is in addition to the deductions provided for contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee, or (2) 10 percent of the cost that would be required to fund or purchase such medical benefits completely. Certain contributions in excess of the deductible limit may be carried over and deducted in succeeding taxable years.

Welfare benefit funds (Code sec. 419).—An employer may establish a fund to provide for post-retirement medical benefits. If such fund satisfies certain requirements, it generally will be exempt from income tax. In general, to be tax-exempt, the fund is required to be a voluntary employee's beneficiary association (VEBA) (Code sec. 501(c)(9)) providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, and no part of the net earnings of such association may inure (other than through such payments) to the benefit of any private shareholder or individual. In addition, the VEBA generally is required to satisfy certain rules prohibiting the provision of benefits on a basis that favors the employer's highly compensated employees (as defined in Code sec. 414(q)).

Although a VEBA generally is exempt from tax, it is taxable on its unrelated business taxable income (UBTI). Generally, income set aside to provide for post-retirement medical benefits is considered UBTI, although this rule does not apply to a VEBA if substantially all of contributions to it are made by employers who are exempt from income tax throughout the 5-taxable-year period ending with the taxable year in which the contributions were made.

Certain special rules apply to the deductibility of employer contributions to a welfare benefit fund without regard to whether the fund is a VEBA. Under these rules, contributions by an employer to such a fund are not deductible as a business expense (Code sec. 162) or as an expense for the production of income (Code sec. 212), but if they otherwise would be deductible under either of those sections, the contributions will be deductible within limits for the taxable year in which such contributions are made to the fund.

The amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to the qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.

In general, the qualified direct cost of a fund is the aggregate amount expended (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided, assuming the benefits were provided directly by the employer and the employer was using the cash receipts and disbursements method of accounting.

A qualified asset account under a welfare benefit fund is an account consisting of assets set aside to provide for the payment of disability payments, medical benefits, supplemental unemployment compensation benefits or severance pay benefits, or life insurance benefits. Under present law, an account limit is provided for the amount in a qualified asset account for any year.

The account limit with respect to medical benefits for any taxable year may include a reserve to provide certain post-retirement medical benefits. This limit allows amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits with respect to an employee can be completed upon the employee's retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee. Funding is considered level if it is determined under an acceptable funding method so that future post-retirement medical benefits and administrative costs will be allocated ratably to future preretirement years.

Each year's computation of contributions with respect to post-retirement medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is computed on the basis of the current year's medical costs, neither future inflation nor future changes in the level of utilization may be taken into account until they occur.

The Deficit Reduction Act of 1984 (DEFRA) directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees. The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary was required to report to the Congress with respect to the study by February 1, 1985, with suggestions for minimum standards where appropriate. The Tax Reform Act extended the due date for the study to October 22, 1987. This study has not yet been completed.

Qualified retirement plans.—Under a profit-sharing plan, a participant's account may be used to acquire post-retirement medical benefits under the rules generally applicable to distributions from a profit-sharing plan. Although this rule does not apply to pension plans, a retiree can use the amounts distributed to acquire post-retirement medical benefits.

Administration Proposal

Under the Administration proposal, an employer would be permitted to transfer all or a portion of the assets available for withdrawal from a defined benefit pension plan to a welfare benefit fund to provide medical benefits to current retirees. Such a transfer would not be subject to the 10-percent excise tax on asset withdrawals and reversions and would be exempt from current income tax. However, such a transfer would be counted as a withdrawal for purposes of the frequency limit on withdrawals and reversions.

Defined benefit pension plan assets that are transferred to a retiree health fund would be subject to various restrictions. First, the transferred assets only could be used to provide medical benefits to employees who had retired and were covered by an employer-maintained health plan at the time of the transfer. Second, the transferred assets would not be permitted to exceed the present value of the employer's liability for medical benefits for such current retired employees. Appropriate rules for calculating such present value would be developed to prevent inappropriate overfunding of the post-retirement medical benefit fund. Special rules also would assure that an employer's liability to provide a particular type or level of post-retirement medical benefits is not altered by such a transfer.

Income on assets transferred under this rule to a post-retirement medical benefit fund would be exempt from both income tax and unrelated business income tax if such assets are held in a segregated welfare benefit fund to which no other amounts are added (other than transfers of Code section 401(h) assets).

Accounts maintained under Code section 401(h) would be eliminated. Thus, tax-favored employer funding of post-retirement medical benefits would be permissible only under welfare benefit funds in accordance with the rules of Code section 419. Existing assets in Code section 401(h) accounts could be transferred without adverse tax consequences, however, to a post-retirement medical benefit fund of the type of which excess defined benefit plan assets could be transferred, including a post-retirement medical benefit fund to which such excess assets had been transferred. Such transferred Code section 401(h) assets would be subject to the same rules applicable to transferred defined benefit plan assets.

Analysis of Issues

The rationale for the Administration proposal is that it will increase the likelihood that retirees will receive medical benefits. The availability of a tax-exempt trust for post-retirement medical benefits will allow employers to establish or increase post-retirement medical benefits or, in other cases, not to reduce or eliminate such benefits. In addition, to the extent that liabilities for post-retirement medical benefits are funded, it is much more likely that employees will receive their promised benefits. Further, the availability of a tax-exempt funding arrangement for post-retirement medical benefits permits an employer to reduce its cost of such benefits by the amount of the tax benefits provided.

The Administration states that its proposal does not fully address the problem of funding post-retirement medical benefits. The Administration rejected broader proposals to allow tax-favored prefunding of a welfare benefit fund over the lifetime of active employees. The reasons that such broader approaches were rejected include: (1) the revenue cost, and (2) such tax-favored prefunding is not appropriate unless the public costs are matched by the public benefits, such as through the application of minimum standards similar to those applicable to qualified retirement plans.

Critics of the Administration proposal maintain that, to some extent, the proposal itself grants significant tax-favored prefunding without imposing minimum standards. The Administration proposal does not prevent an employer from creating a surplus in a defined benefit pension plan through excessive contributions. The flexibility that employers have with respect to their funding methods and their actuarial assumptions enable them to create a surplus. To the extent that this is true, the Administration proposal allows tax-favored prefunding of post-retirement medical benefits through excessive contributions to a defined benefit pension plan.

Other commentators question why tax-favored prefunding needs to be linked to the application of minimum standards. These commentators point out that any reversion from a welfare benefit fund to an employer is subject to a 100-percent tax. Thus, amounts contributed to a welfare benefit fund almost certainly will be used to provide benefits to employees. In light of this fact, they maintain that tax-favored prefunding should be allowed. These commentators argue that minimum standards are inappropriate restraints on an employer's ability to modify its post-retirement medical benefit plans to adjust to changing practices in the medical insurance area.

In response to these arguments, others contend that the minimum standards are essential to providing active employees security with respect to their retirement. If post-retirement medical benefits do not accrue or vest prior to retirement, and may not accrue or vest even on retirement, then an employee essentially cannot rely on the likelihood of receiving a benefit and cannot make reasonable plans with respect to retirement. Moreover, in many cases in which the employer enjoyed significant tax benefits with respect to post-retirement medical benefits, many long-service employees who were taken into account for funding purposes will receive no benefits. This can occur for any of several reasons: (1) the employee separating from service prior to retirement, (2) the employer terminating the benefit with respect to a class of employees, or (3) the plan being insufficiently funded (there being no PBGC-type guarantee of medical benefits). In short, some maintain that it is incongruous to provide tax benefits to an employer with respect to employees who are provided no rights. These same commentators also point out that minimum standards, if applicable to a dollar value of benefits, would not affect an employer's ability to modify its post-retirement medical benefit plans to adjust to changing practices in the medical insurance area.

Some employee benefit experts maintain further that minimum standards generally should apply to any deferred medical benefits regardless of whether such benefits receive tax-favored status, as is the case with respect to deferred cash compensation. The rationale is that even where tax benefits are not provided, it is inappropriate for an employer to establish a plan of deferred compensation if such plan is not structured to ensure satisfaction of the reasonable expectations of employees covered under the plan.

Some commentators contend that no legislative action is necessary with respect to post-retirement medical benefits because qualified retirement plans currently allow tax-favored prefunding of post-retirement medical benefits through higher levels of retirement benefits and minimum standards already apply to qualified retirement plans. One drawback to this approach that has been noted by some employers is that it will not allow them to fund for their highly compensated employees who are already entitled to the maximum benefit allowed under a qualified retirement plan (Code sec. 415).

With respect to separate accounts under Code section 401(h), supporters of the proposal to repeal the section point out that the accounts provide tax-favored prefunding without applying many of the minimum standards applicable to qualified retirement plans generally. They further argue that it is inappropriate to have two different sets of standards for the funding of post-retirement medical benefits. Such benefits should not be funded through a qualified retirement plan, but rather should be funded through a mechanism designed to address the specific characteristics and problems associated with the funding of health benefits. Other commentators argue that the section 401(h) limits should simply be lifted because an employer's ability to fund fully its post-retirement medical benefits are unduly limited by the requirement that they be subordinate to the retirement benefits.

Certain commentators raise health policy concerns regarding the effect of post-retirement medical benefits. They point out that such benefits often serve to pay for the Medicare deductibles and copayments. Such benefits may thus undermine the cost-containment function served by deductibles and copayments, raising the cost of Medicare and of health benefits generally. These commentators maintain that this effect should be taken into account in providing tax-favored treatment to post-retirement medical benefits, possibly by restricting the tax benefit to certain types of medical benefits. Other commentators argue that cost containment concerns should not override the needs of the elderly for benefits to supplement Medicare.

VI. PBGC SINGLE-EMPLOYER INSURANCE PROGRAM: VARIABLE RATE PREMIUM PROPOSAL

Present Law and Background

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 by ERISA to provide an insurance program for benefits under defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report, the single employer insurance program currently covers more than 30 million participants in more than 110,000 defined benefit pension plans.[8]

The single employer insurance premium was instituted to pay for claims not recovered from employers who terminate underfunded plans. In addition to premiums, PBGC revenues include earnings on investments and collections from sponsors of terminated plans.

Since its inception, the pension insurance program has charged a flat rate premium based on the number of plan participants. ERISA initially authorized an annual per participant premium of $1.00. The premium rate was raised to $2.60 for plan years beginning in 1978. SEPPAA increased the rate to $8.50 effective January 1, 1986.

Despite the dramatic increase in premiums in 1986, the PBGC's finanicial position is expected to continue to weaken due to recent claims experience and expected low recoveries from financially distressed employers. As of September 30, 1985, the PBGC reported a deficit of approximately $1.3 billion. As of September 30, 1986, the PBGC's deficit nearly tripled over the prior year, reaching $3.8 billion.

In 1986, LTV Corporation filed for reorganization in bankruptcy and, as a result, terminated a number of underfunded plans. These plans had approximately $2.2 billion in unfunded guaranteed benefits, contributing substantially to the PBGC's current deficit of over $4 billion.

The PBGC deficit has not affected its immediate ability to pay pensions to retired participants in terminated plans. However, PBGC officials estimate that the expected increase in asset drain could cause the program not to have enough funds to pay annual costs in approximately 15 years.

Administration Proposal

In order to improve the financial position of the PBGC and enable it to reduce its deficit, in addition to the proposals modifying the minimum funding rules, the Administration intends to propose legislation to provide for a premium increase. The premium

[8] The insurance program also covers multiemployer pension plans.

increase would be based on the funded status of the plan, so that plans that are underfunded would pay a higher premium than well-funded plans. No details of the proposal have been released at this time.

Government Accounting Office Report

The Government Accounting Office estimates that annual premium revenues of $446 million would be needed to retire a $4 billion deficit over 15 years at the PBGC's current interest rates. Projected annual premium revenue, however, is only $298 million, or 33 percent less than $446 million. Further, additional revenues would be needed to pay future expected claims and the program's administrative expenses. The report recommends that Congress consider an increase in PBGC provisions. The report also recommends that Congress consider reducing guaranteed benefits.

Analysis of Issues

Detailed analysis of the proposal is not possible until the proposal is released.

In general, PBGC premiums can be increased in three basic ways: (1) an across-the-board increase with respect to all plan participants; (2) a variable rate; or (3) combination of the two.

A variable rate premium could be structured in a number of ways. For example, it could be based on the risk of uncompensated liability presented to the PBGC. In that case, the rate would reflect the solvency of the employer and, possibly, the employer's controlled group. Alternatively, a variable rate could be based solely on the liability (exposure) of the PBGC in the event the plan were terminated. In such a case, the rate would depend on the underfundedness of the plan.

Proponents of the variable rate structure argue that it is the most fair approach, as it places the greatest burden on the employers whose plans present the greatest risk or potential exposure to the PBGC. They contend that a flat-rate increase of the magnitude that would be necessary to retire the PBGC deficit would encourage employers of well-funded plans to terminate their plans, thereby reducing the total number of plans subject to the premium. Terminations of plans could also adversely affect plan participants if the employer did not adopt a new plan with comparable benefits.

There is some argument as to whether, if a variable rate is adopted, it should be based on risk or exposure. Those who oppose a rate based on risk argue that a risk-related premium may place too big a burden on an employer that is already experiencing financial difficulties. They also point out the administrative difficulties of determining risk.

Those who oppose a variable rate are concerned that some employers will pay an excessively high rate at a time when the employer may already be in financial difficulties. Moreover, there is some feeling that employers who are having difficulty making plan contributions should not have their assets diverted from the plan to the PBGC.

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