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DESCRIPTION AND ANALYSIS OF S. 1780 ("RETIREMENT PROTECTION ACT OF 1993")

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JUNE 15, 1994

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 a description and analysis of the provisions contained in S. 1780 ("Retirement Protection Act of 1993"). S. 1780 was introduced on November 23, 1993 by Senator Moynihan (by request) as the Administration's proposal. The bill was referred to the Committee on Finance. S. 1780 contains the Administration's recommendations generally to modify the funding and plan termination rules applicable to single-employer defined benefit pension plans. The Committee on Finance has scheduled a public hearing on June 15, 1994, to review the impact of underfunded defined benefit pension plans on the Pension Benefit Guaranty Corporation (PBGC), plan retirees, and plan sponsors and to consider the proposals relating to the PBGC contained in S. 1780.

Part I of the pamphlet is an overview. Part II discusses present law and background of the Federal pension insurance program and the financial condition of the PBGC. Part III describes the provisions of S. 1780. Part IV discusses issues relating to defined benefit pension plan funding, the financial condition of the PBGC, and other issues raised by S. 1780.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of S. 1780 ("Retirement Protection Act of 1993")*. (JCS–4–94), June 14, 1994.

I. OVERVIEW[2]

A defined benefit pension plan is a type of employer-sponsored retirement plan that provides benefits to participants based on a formula specified in the plan and without regard to the level of assets in the plan or the level of employer contributions to the plan. To provide benefit security to plan participants, the Internal Revenue Code (the Code) and title I of the Employee Retirement Income Security Act of 1974 (ERISA) impose minimum funding requirements on the sponsor of a defined benefit pension plan.

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

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 to protect plan participants in the event a defined benefit pension plan terminates with insufficient assets. The PBGC guarantees basic retirement benefits, up to a current dollar maximum benefit of $2,556.82 per month (for 1994).

In its most recent annual report (for the fiscal year ending September 30, 1993), the PBGC reported a deficit of $2.9 billion. The PBGC also disclosed in its 1993 annual report that approximately $53 billion in estimated unfunded liabilities existed in single-employer defined benefit pension plans in 1992. Approximately 72 percent of this underfunding, about $38 billion, consists of large underfunded plans of financially troubled companies. These companies are concentrated primarily in the steel, airline, tire, and automobile industries. The PBGC forecasts that, depending on the level of future losses, its deficit could increase to between $1.9 billion and $13.8 billion by the end of fiscal year 2003.

Despite recent changes in plan funding rules designed to improve the funding of defined benefit pension plans, increases in the amount of underfunding in single-employer defined benefit pension plans have increased the risk of additional liabilities being placed on the PBGC. Unless the funding of such plans is improved or PBGC premiums are increased, the PBGC may not be able to pay guaranteed benefits. The Administration has proposed comprehensive changes to the single-employer defined benefit funding and benefit guarantee systems to reduce the risk to the PBGC and to plan participants. These changes are reflected in S. 1780, which was introduced by Senator Moynihan on November 23, 1993.

Among other things, S. 1780 would (1) modify the special funding rules for underfunded single-employer defined benefit pension

[2] This pamphlet is limited to a discussion of single-employer defined benefit pension plans. Other rules apply to multiemployer plans (i.e., plans maintained by more than one employer pursuant to a collective bargaining agreement).

plans, (2) increase PBGC premiums for certain underfunded plans, (3) improve PBGC enforcement capabilities and plan sponsor compliance, (4) increase plan participant benefit protections, and (5) prohibit defined contribution plans from using cross testing to satisfy the Code's nondiscrimination rules. A detailed description of the provisions of S. 1780 is in Part III of this pamphlet.

II. THE FEDERAL PENSION INSURANCE PROGRAM

A. Present Law and Background

Defined benefit pension plans

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

In order to help ensure that the promised benefits are paid to plan participants, defined benefit pension plans are subject to minimum funding requirements under both the Code and title I of ERISA, which require the employer sponsoring the plan to make certain contributions to fund the plan. These requirements are discussed in detail below.

The PBGC

As enacted in ERISA, as well as under present law, the minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits earned by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the PBGC, a corporation within the Department of Labor, was created in 1974 by ERISA to provide an insurance program for benefits under most defined benefit pension plans maintained by private employers. According to the PBGC's annual report for fiscal year 1993, the single-employer insurance program covers more than 32 million participants in about 64,000 defined benefit pension plans.

Termination of underfunded pension plans

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

Under these rules, employers that wanted to rid themselves of underfunded liabilities could simply terminate the plan, and the

PBGC would be liable for benefits. The PBGC was in some cases prevented from recouping its liability from the employer, even if the employer was financially sound. The plan termination rules were amended to prevent such transferring of liabilities to the PBGC by the Single Employer Pension Plan Amendments Act of 1985 (SEPPAA) and were modified further by the Pension Protection Act of 1987.

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

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

Guaranteed benefits

The PBGC guarantees vested retirement benefits (other than those that vest solely on account of the plan termination), up to a maximum benefit of $2,556.82 per month in 1994. The dollar limit is indexed annually for inflation. The guarantee is reduced for benefits starting before age 65, and does not apply to certain types of ancillary benefits. In the case of a plan or a plan amendment that has been in effect for less than 5 years before a plan termination, the amount guaranteed is generally phased in by 20 percent a year.

Sources of PBGC funding

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings. All covered plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional variable premium based on the level of the underfunding.

As initially enacted in ERISA, covered plans were required to pay a flat premium to the PBGC of $1.00 per plan participant. The flat-rate per-participant premium has been increased several times since the enactment of ERISA, and is currently $19 per participant in 1994.

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

B. Financial Status of the PBGC

In general

As of September 30, 1993, the PBGC reported a deficit of $2.9 billion. This is an increase over the $2.7 billion deficit reported as of the end of the prior fiscal year. The PBGC experienced its largest losses in the history of the termination insurance program in the fiscal year ending September 30, 1991. The PBGC attributes these losses primarily to lower expected recoveries from employers in bankruptcy for plans added to PBGC's liabilities in 1990. The PBGC also disclosed in its 1993 annual report that approximately $53 billion in estimated unfunded liabilities existed in single-employer defined benefit pension plans in 1992. Approximately 72 percent of this underfunding, about $38 billion, consists of large underfunded plans of financially troubled companies. These companies are concentrated primarily in the steel, automobile, tire, and airline industries.

The PBGC has estimated its future financial status under a variety of assumptions. The deficit could range from about $1.9 billion by the end of 2003 if losses are relatively low, to about $13.8 billion by the end of 2003 if losses are high.

Hidden liabilities

In a study released by the U.S. General Accounting Office (GAO) in December 1992,[3] GAO reported that the 44 plans with the largest claims against the PBGC for calendar years 1986–88 had aggregate unfunded liabilities at termination of $2.7 billion. These unfunded liabilities were $990 million, or 58 percent, higher than the $1.7 billion in unfunded liabilities reported by the 44 plans on their last, pretermination annual filing with the Internal Revenue Service (IRS). GAO termed this additional unfunded liability a "hidden liability" to the PBGC because it was not reported by plans before termination.

Hidden liabilities can result from several causes. Most of the $990 million in hidden liability reported in the GAO study was due to PBGC's higher estimate of plan liabilities as a result of PBGC's use of actuarial assumptions that were different than the assumptions used by plan sponsors. Hidden liabilities also can result because of the payment of shutdown[4] or special early retirement benefits, earlier-than-anticipated retirements, and PBGC's receipt of fewer assets than reported by the plans.

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[3] U.S. General Accounting Office, *Hidden Liabilities Increase Claims Against Government Insurance Program* (GAO/HRD–93–7), December 30, 1992.

[4] Shutdown benefits are benefits payable only upon termination of the plan sponsor's business operations. Since this is generally assumed by plan actuaries to have a very small probability of occurring, shutdown benefits are only partially funded, at best.

III. DESCRIPTION OF S. 1780

("RETIREMENT PROTECTION ACT OF 1993")[5]

A. Summary of the Bill

In general

The bill (S. 1780) would make changes in four major areas: the special funding rules for underfunded single-employer defined benefit pension plans, PBGC premiums for underfunded plans, PBGC enforcement capabilities and the obligations of plan sponsors to the PBGC, and protections for plan participants and beneficiaries. The bill would also make a number of miscellaneous changes to the Code and ERISA.

Special funding rules

The bill would change the special funding rules that apply to underfunded single-employer defined benefit pension plans. In general, the bill would require sponsors of underfunded plans to fund pension liabilities more rapidly than under present-law rules. Specifically, the bill would (1) modify the calculation of the minimum required funding contribution applicable to underfunded plans, (2) change the permissible range of interest rates and require uniform mortality assumptions for the purpose of determining an underfunded plan's current liability for deficit reduction contribution purposes, and treat any increase in current liability due to the new interest and mortality assumptions as "unfunded old liability", (3) accelerate the funding of a plan's "unfunded new liability", (4) change the calculation of the additional funding contribution required on account of an unpredictable contingent event, (5) provide an elective transition rule for sponsors of underfunded plans to protect against possibly large increases in their minimum required contributions on account of the proposed changes in the special funding rules, and (6) change the manner in which the full funding limit is determined.

The bill would also waive the excise tax on nondeductible contributions in certain cases. This change would permit companies to fund fully an underfunded defined benefit pension plan while making other qualified plan contributions without incurring the excise tax.

PBGC premiums

The bill would increase PBGC premiums for certain underfunded plans by phasing out the cap on the additional PBGC premium for

[5] For a description of other proposals, see Joint Committee on Taxation, *Issues and Proposals Relating to the Financial Condition of the Pension Benefit Guaranty Corporation (PBGC)* (JCS-3-93), February 3, 1993.

underfunded plans over three years beginning with plan years beginning on or after July 1, 1994.

PBGC enforcement and sponsor compliance

The bill would add to the list of events that must be reported to the PBGC by employers, authorize the PBGC to apply to district court for relief other than involuntary plan termination in certain circumstances, impose additional PBGC reporting obligations on plan sponsors, authorize the PBGC to bring suit to enforce the minimum funding standards if the amount of missed contributions exceeds $1 million, and generally prohibit an employer in bankruptcy from adopting a plan amendment increasing benefits.

Participant protections

The bill would require plan administrators of underfunded defined benefit pension plans to disclose to their participants the plan's funded status and the limits on the PBGC's guarantee should the plan terminate while underfunded. The bill also would impose additional requirements on plan sponsors of terminating plans that would protect the pension benefits of participants who cannot be located.

Miscellaneous

The bill would make a number of additional changes to the Code and ERISA. These changes would include modifications to the actuarial assumptions used to calculate lump-sum distributions, adjustments to the lien for missed contributions, adjustments to the rounding rules for cost-of-living adjustments, and a prohibition on cross testing of defined contribution plans under the Code's nondiscrimination rules.

B. Title I—Pension Plan Funding

1. Minimum funding requirements (secs. 101 and 121 of the bill, secs. 412(c), (l), and (m) of the Code, and secs. 204, 302(d), and (e) of ERISA)

Present Law

In general

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

The maximum funding limitations are designed to limit and allocate efficiently the loss of Federal tax revenue associated with the special tax treatment afforded qualified retirement plans. Thus, annual deductible contributions to a defined benefit pension plan are limited to an amount that is not significantly greater than the amount that would normally be necessary under the employer's long-term actuarial funding method.

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

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

The minimum and maximum funding requirements, and the special rules for underfunded defined benefit pension plans, are discussed in detail below.

Minimum funding standard

In general

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Accumulated funding deficiencies

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

For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer would be subject to an excise tax equal to 10 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).

Funding methods

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

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

Supplemental cost.—The supplemental cost for a plan year is the cost of future benefits allocated to the year that would not be met by normal costs and employee contributions. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

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

Acceptable methods.—Normal cost and supplemental cost are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under 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 supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is required once every plan year. More frequent valuations may be required by the IRS.

Charges and credits to the funding standard account

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

Normal cost.—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability.—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, 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 determined as of the first day of the plan year of which the funding standard applied to the plan (generally the plan year beginning in 1976). In the case of a single-employer plan, the amount of the liability with which the account is charged for a year is based on amortization of the past service liability over a period of 40 plan years. The liability is required to be amortized (in much the same manner as a 40-year mortgage) in equal annual installments over the 40-year funding period unless the plan becomes fully funded.

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

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

For example, assume that a plan uses the calendar year as the plan year. Further assume that during 1987 the plan is amended to increase benefits and that the net result of plan amendments for 1987 is that the past service liability under the plan is increased by $500,000. In addition, the plan's actuary uses an interest rate of 8 percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.

Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid an accumulated funding deficiency unless the plan becomes fully funded.

Gains and losses from changes in assumptions.—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years, 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, both individually and in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period.

Waived funding deficiencies.—Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 5 plan years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

Switchback liability.—ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. ERISA prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

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

Reasonableness of actuarial assumptions

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

Special rules for underfunded plans

In general

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted in the Pension Protection Act of 1987 due to concerns about the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

Calculation of minimum required contribution

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

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount.

Calculation of these amounts is based on the plan's current liability.

Current liability

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

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

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

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

Unfunded old liability amount

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years (beginning with the first plan year beginning after December 31, 1988). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to certain collective bargaining agreements).

Unfunded new liability amount

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

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent. For example, if a plan's funded current liability percentage is 39 percent, 29 percent of the plan's unfunded new liability for the plan year must be included in the calculation of the deficit reduction contribution for the plan year.

Unpredictable contingent event benefits

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

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

The amount of the additional contribution is generally equal to the greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

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

Small plan rule

The special rules for underfunded plans do not apply to plans with 100 or fewer employees. In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction and unpredictable contingent amount benefit contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100.

Full funding limit

To limit and allocate efficiently the loss of Federal tax revenue associated with the special tax treatment afforded qualified plans, ERISA and the Code limit the amount of annual contributions that can be made to a defined benefit pension plan.

One limitation is the full funding limit, under which no contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limit. Before 1988, the full funding limit was 100 percent of an employer's accrued liability, as determined under the plan's funding method. However, because of concerns that employers could manipulate the limit by changing actuarial assumptions, the Pension Protection Act of 1987 amended ERISA and the Code to create a new full funding limit. The new full funding limit is equal to the lesser of the old funding limit (accrued liability) or 150 percent of the employer's current liability. Current liability is all liabilities to participants and beneficiaries under the plan determined as if the plan terminated. It represents only benefits accrued to date, and is not dependent on actuarial funding assumptions. As a result, the new full funding limit can be lower than the old full funding limit.

If the employer contributes an amount equal to the full funding limit, the funding standard account is credited so that the employer is not subject to the underfunding excise tax, even though the funding standard account would otherwise be left with a deficit for the year. In addition, the full funding limit affects the deductibility of employer contributions to qualified plans.[6]

Time for making contributions

Under present law, the required minimum funding contribution for a plan year must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year. In the case of single-employer defined benefit pension plans, 4 installments of estimated contributions are required during the plan year with the total contribution due within 8-1/2 months after the end of the plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year. If a plan sponsor fails to make a required installment, additional interest is charged to the funding standard account.

Description of Provision

Special funding rules for underfunded plans

In general

The bill would change the special funding rules that apply to underfunded single-employer defined benefit plans (other than plans with no more than 100 participants on any day in the preceding plan year) that were adopted in the Pension Protection Act of 1987.

[6] The effect of the full funding limit on the deductibility of employer contributions is described in Part III.B.5., below.

In general, the bill would amend ERISA and the Code to require sponsors of underfunded plans to pay off pension liabilities more rapidly than under present-law rules. Specifically, the bill would (1) modify the calculation of the minimum required contribution applicable to underfunded plans, (2) change the permissible range of interest rates and require uniform mortality assumptions for the purpose of determining an underfunded plan's current liability for purposes of the deficit reduction contribution, and treat any increase in current liability due to the new interest and mortality assumptions as "unfunded old liability", (3) accelerate the funding of a plan's "unfunded new liability", (4) change the calculation of the additional funding contribution required on account of an unpredictable contingent event, (5) provide an elective transition rule for sponsors of underfunded plans to protect against possibly large increases in their minimum required contributions on account of the proposed changes in the special funding rules, and (6) change the manner in which sponsors of defined benefit pension plans determine the full funding limit of their plans.

Calculation of minimum required contribution

The bill would change the manner in which underfunded plans calculate their minimum required contribution for a plan year. Under the bill, amounts necessary to amortize experience gains and losses and gains and losses resulting from changes of actuarial assumptions would no longer be considered in the calculation of the minimum required contribution for underfunded plans. According to the PBGC, one reason that the minimum required contribution for underfunded plans adopted in the Pension Protection Act of 1987 has not been effective in increasing contributions to underfunded plans is because experience gains or gains from changes in actuarial assumptions are counted twice under present law, i.e., to reduce the minimum required contribution for underfunded plans and as a credit to the funding standard account under the normal funding rules. Thus, under the bill, the minimum required contribution for underfunded plans would be, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the deficit reduction contribution plus the amount required with respect to benefits that are contingent on unpredictable events.

Further, the bill would add a third component to the calculation of the deficit reduction contribution under present law. Under the bill, the deficit reduction contribution would be the sum of (1) the unfunded old liability amount, (2) the unfunded new liability amount, and (3) the expected increase in current liability due to benefits accruing during the plan year. The third component replaces the normal cost component of the calculation under present law.

In addition, the bill would provide that the amount of the minimum required contribution for underfunded plans could not exceed the amount necessary to increase the funded current liability percentage of the plan to 100 percent taking into account all charges and credits to the funding standard account and the expected increase in current liability attributable to benefits accruing during the plan year.

Changes in interest rates and mortality assumptions

Under present law, the calculation of the deficit reduction contribution for underfunded plans is based on the plan's current liabilities. Under the bill, a plan's current liability would be determined as under present law, except that the bill would (1) limit the permissible range of interest rates used to determine the current liability, and (2) require all underfunded plans to use the same mortality table to determine current liability.

The bill would limit the interest rate to no more than 100 percent of and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year. Under the bill, the mortality table used to determine current liability would be the "prevailing commissioners' standard table" used to determine reserves for group annuity contracts issued on the date as of which current liability is determined. The prevailing commissioners' standard table means, with respect to any contract, the most recent commissioners' standard table prescribed by the National Association of Insurance Commissioners which is permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued (sec. 807(d)(5)(A) of the Code). Currently, the prevailing commissioners' standard table used to determine reserves for annuity contracts is the GAM 83 mortality table.

Under the bill, increases in current liability attributable to changes in interest rates and mortality assumptions would be treated as an "additional unfunded old liability amount" and would be amortized in equal annual installments over 12 years beginning with the 1995 plan year. The additional unfunded old liability amount would be the difference between the current liability of the plan as of the beginning of the 1995 plan year using (1) the interest and mortality assumptions contained in the bill and (2) the interest and mortality assumptions used to determine current liability for the 1993 plan year.

Acceleration of unfunded new liability

Under present law, if a plan's funded current liability percentage is less than 35 percent, 30 percent of the plan's unfunded new liability for the plan year must be included in the calculation of the deficit reduction contribution for the plan year. The bill would increase the 35 percent threshold under present law to 60 percent. Thus, under the bill, if a plan's funded current liability percentage is less than 60 percent, 30 percent of the plan's unfunded new liability for the plan year would be included in the calculation of the deficit reduction contribution for the plan year. Like present law, the 30 percent amount would decrease by .25 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent.

Unpredictable contingent event benefits

The bill would add a third component to the calculation of the additional funding contribution required on account of an unpredictable contingent event. Under the bill, the amount of the additional funding contribution would equal the greater of the amounts determined under present law or the additional contribution that would be required if the unpredictable contingent event benefit liabilities were included in the calculation of the plan's unfunded new liability for the plan year. Under present law, for purposes of calculating the unfunded new liability for a plan year, all unpredictable contingent event benefits are disregarded.

In addition, the bill would limit the present value of the additional funding contribution with respect to any one event to the unpredictable contingent event benefit liabilities attributable to that event.

Transition rule

The bill would provide an elective transition rule for sponsors of underfunded plans to protect against possibly large increases in their minimum required contributions on account of the proposed changes in the special funding rules. Under the transition rule, the minimum required contribution for a plan year could not be less than the minimum required contribution determined under present law. In addition, relief under the transition rule would depend on the plan's funded current liability percentage.

If the plan's funded current liability percentage as of the first day of the 1995 plan year is equal to or less than 75 percent, the plan's minimum required contribution would be limited to an amount which would increase the plan's funded liability percentage by 3 percentage points for the 1995 through 1999 plan years, 4 percentage points for the 2000 plan year, and 5 percentage points for the 2001 plan year. If the plan's funded current liability percentage as of the first day of the 1995 plan year is equal to or greater than 85 percent, the plan's minimum required contribution would be limited to an amount which would increase the plan's funded liability percentage by 2 percentage points for the 1995 through 1999 plan years, 3 percentage points for the 2000 plan year, and 2 percentage points for the 2001 plan year. Further, if the plan's funded current liability percentage as of the first day of the 1995 or a later plan year is between 75 and 85 percent, a special formula would be used to determine the limitation, if any, on the plan's minimum required contribution.

Changes in full funding limit

The bill would change the manner in which sponsors of defined benefit pension plans determine the full funding limit to conform to IRS practice. The bill would retain the present-law rules relating to the determination of a defined benefit pension plan's full funding limit but would also provide that the expected increase in current liability due to benefits accruing during the plan year are included when determining 150 percent of the employer's current liability. In addition, the bill would provide that the full funding limit for underfunded defined benefit pension plans could not be less than the plan's unfunded current liability as determined under the minimum funding rules. Further, the bill would retain present-law rules relating to the determination of current liability for purposes of the full funding limit but would allow plans to determine their current liability for full funding limit purposes without regard to the interest rate and mortality assumptions set forth in the bill.

Thus, any interest rate within the present-law corridor could be used.

Plan solvency requirement

In general, the bill would require underfunded single employer defined benefit pension plans to make quarterly contributions sufficient to maintain liquid plan assets, i.e., cash and marketable securities, at an amount approximately equal to three years worth of trust disbursements (based on disbursements made in the prior year).

Under the bill, the plan solvency requirement would apply to underfunded single employer defined benefit pension plans that (1) are required to make quarterly installments of their estimated minimum funding contribution for the plan year and (2) have liquid assets as of the last day of the last month preceding the quarterly installment due date that are less than the base amount for the quarter. Liquid assets would mean cash, marketable securities and such other assets as specified by the Secretary of the Treasury. The base amount for the quarter would be an amount equal to the product of three times the adjusted disbursements from the plan for the 12 months ending on the last day of the last month preceding the quarterly installment due date. If the base amount exceeds the product of two times the sum of adjusted disbursements for the 36 months ending on the last day of the last month preceding the quarterly installment due date, and an enrolled actuary certifies to the Secretary of the Treasury that the excess is the result of nonrecurring circumstances, amounts attributable to such nonrecurring circumstances would not be included in the base amount. For purposes of determining the base amount, adjusted disbursements would mean the amount of all disbursements from the plan's trust, including purchases of annuities, payments of single sums, other benefit payments, and administrative expenses reduced by the product of the plan's funded current liability percentage for the plan year multiplied by the sum of annuity purchases, single sum distributions, and such other disbursements as the Secretary of the Treasury shall provide in regulations.

Under the bill, the amount of the required quarterly installment for defined benefit pensions plans that do not have sufficient liquid assets for any quarter would be the greater of the quarterly installment as determined under present law or the quarterly solvency payment. The quarterly solvency payment would equal the difference between the plan's liquid assets and the base amount as of the last day of a quarter. Such quarterly installment when added to prior installments for the plan year could not exceed the amount necessary to increase the funded current liability percentage of the plan to 100 percent taking into account the expected increase in current liability due to benefits accruing during the plan year.

The bill generally would treat quarterly solvency payments in the same manner as quarterly installments are treated under present law. However, if a quarterly solvency payment is not made, then the plan sponsor would be subject to a nondeductible excise tax equal to 10 percent of the amount of the outstanding quarterly solvency payment. A quarterly solvency payment would no longer be considered outstanding on the earlier of (1) the last day of a later quarter for which the plan does not have a quarterly solvency payment obligation or (2) the date on which the solvency payment for a later quarter is timely paid. If the quarterly solvency payment remains outstanding after four quarters, the excise tax would increase to 100 percent.

The bill would amend ERISA to prohibit fiduciaries from making certain payments from defined benefit pension plans during the period in which the plan has outstanding quarterly solvency payments. Prohibited payments would include (1) plan distributions in excess of the monthly amount paid under a single life annuity (plus any social security supplements) to plan participants or beneficiaries whose annuity starting date (as defined under present law)[7] occurs during the period in which there are outstanding quarterly solvency payments, (2) purchases of benefit annuities from insurers, or (3) other payments as provided by the Secretary of the Treasury. The bill would also amend ERISA to include a civil penalty for violations of the prohibited payment rule. Under the bill, if a fiduciary makes a prohibited distribution from the plan, he or she would be subject to a civil penalty for each prohibited distribution equal to the greater of the amount of the distribution or $10,000. Finally, the bill would amend the Code to provide that compliance with ERISA's prohibited payment rules would not result in plan disqualification for tax purposes.

Effective Date

The provision would apply to plan years beginning after December 31, 1994.

2. Limitation on changes in current liability assumptions (secs. 102 and 122 of the bill, sec. 412(c) of the Code, and sec. 302(c) of ERISA)

Present Law

Under present law, in determining plan funding under an actuarial cost method, a plan's actuary 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. A plan's actuary may revise these assumptions to reflect the actual experience of the plan. Actuarial assumptions must be reasonable, both individually and in the aggregate and reflect the actuary's best estimate of experience under the plan.

Description of Provision

The bill would prohibit certain underfunded plans from changing the actuarial assumptions used to determine current liability for a plan year (other than interest rate assumptions) unless the new assumptions are approved by the Secretary of the Treasury prior to the beginning of such plan year. Under the bill, pre-approval of

[7] Under present law, an individual's annuity starting date is the first day of the first period for which an amount is payable as an annuity or in the case of a benefit not payable in the form of an annuity, the first day on which all events have occurred which entitle the individual to such benefit (Code sec. 417(f)(2)).

changes in actuarial assumptions would apply to (1) an underfunded plan if the aggregated unfunded vested benefits of all underfunded plans maintained by the employer and members of the employer's controlled group exceeds $50 million, and (2) if the change in assumptions would decrease the plan's unfunded current liability for the current plan year by (a) at least $50 million or (b) at least $5 million and at least 5 percent of the current liability.

Effective Date

The provision would be effective with respect to changes in actuarial assumptions for plan years beginning after October 28, 1993. In addition, any changes in actuarial assumptions for plan years beginning after December 31, 1992, and before October 28, 1993, that would have been subject to the pre-approval requirements set forth in the bill would not be effective for the 1995 plan year unless approved by the Secretary of the Treasury prior to the 1995 plan year.

3. Recognition of already bargained benefit increases (secs. 103 and 123 of the bill, sec. 412(c) of the Code, and sec. 302 of ERISA)

Present Law

Under final Treasury Regulations, a defined benefit pension plan's funding method is not considered reasonable if it anticipates changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year. However, the regulations contain an elective exception to this general rule for collectively bargained plans. Under the regulations, a collectively bargained plan's funding method is considered reasonable if the plan elects on a consistent basis to anticipate benefit increases scheduled to take effect during the term of the collective bargaining agreement applicable to the plan (Treas. Reg. 1.412(c)(3)–1(d)).

Description of Provision

The bill would require sponsors of collectively bargained plans to recognize for funding purposes any negotiated benefit increases scheduled to take effect in a future plan year in the plan year in which the collective bargaining agreement is entered into.

Effective Date

The provision would apply to plan years beginning after December 31, 1994, with respect to collective bargaining agreements in effect on or after January 1, 1995.

4. Modification of quarterly contribution requirement (secs. 104 and 124 of the bill, sec. 412(m) of the Code, and sec. 302(e) of ERISA)

Present Law

Under present law, the required minimum funding contribution for a plan year must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year. In the case of single-employer defined benefit pension plans, 4 installments of estimated contributions are required during the plan year with the total contribution due within 8-1/2 months after the end of the plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year. If a plan sponsor fails to make a required installment, additional interest is charged to the funding standard account.

Description of Provision

Under the bill, single-employer defined benefit pension plans with a 100-percent funded current liability percentage in the prior plan year would not be required to make quarterly estimated contributions during the current plan year.

Effective Date

The provision would be effective for plan years beginning after the date of enactment.

5. Exceptions to excise tax on nondeductible contributions (sec. 105 of the bill and new sec. 4972(c)(6) of the Code)

Present Law

The Code imposes a limit on the amount of deductible contributions that can be made annually to a defined benefit pension plan. Contributions necessary to pay normal costs (as defined under the funding rules) generally are fully deductible. Contributions necessary to fund supplemental costs generally are deductible only to the extent necessary to cover such costs amortized over 10 years. However, the amount of the deduction an employer can claim for the year cannot exceed the full funding limitation for that year, except that a special deduction rule applies to underfunded defined benefit pension plans. In the case of a single-employer defined benefit pension plan which has more than 100 participants during the plan year, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules. For purposes of determining whether a plan has more than 100 participants during a plan year, all defined benefit pension plans maintained by the same employer or any member of the employer's controlled group (within the meaning of secs. 414(b), (c), (m), and (o) of the Code) are treated as one plan but only employees of such member or employer are taken into account.

The Code also imposes limits on the amount of deductible contributions that can be made annually if an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees. Under the combined plan deduction limits, the total deduction for all plans for a plan year is generally limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year. For underfunded single-employer defined benefit pension plans with more than 100 participants for the plan year, the contribution necessary to meet the minimum funding requirements for the year is not less than the plan's unfunded current liability as determined under the minimum funding rules.

There is a 10-percent nondeductible excise tax imposed on contributions in excess of the applicable deduction limit (Code sec. 4972).

Description of Provision

Under the bill, nondeductible contributions to certain terminating single-employer defined benefit pension plans would not be subject to the excise tax on nondeductible contributions to the extent such nondeductible contributions do not exceed the plan's unfunded current liability as determined under the minimum funding rules. This provision would apply to plans with 100 participants or less that are covered by the PBGC termination insurance program.

In addition, employer contributions to a cash or deferred arrangement or employer matching contributions to a defined contribution plan that are nondeductible because they exceed the combined plan deduction limits would not be subject to the 10-percent nondeductible excise tax to the extent such contributions do not exceed 6 percent of compensation. For purposes of this rule, the combined plan deduction limits would first be applied to contributions to the defined benefit pension plan. In addition, this provision would apply only if the defined benefit pension plan is a single-employer defined benefit pension plan that has more than 100 participants.

Effective Date

The provision eliminating the excise tax for nondeductible contributions to a terminating single-employer defined benefit pension plan would be effective for taxable years ending on or after the date of enactment. The provision eliminating the excise tax for nondeductible contributions to certain defined contribution plans would be effective for taxable years ending on or after December 31, 1992.

C. Title II—Amendments Relating to Title IV of ERISA

1. Reportable events (sec. 201 of the bill and sec. 4043 of ERISA)

Present Law

Under present law, the plan administrator is required to notify the PBGC of the occurrence of certain events, called reportable events, that may indicate possible risk to the financial status of the plan or the PBGC insurance program. The plan administrator is to notify the PBGC within 30 days after the plan knows or has reason to know that a reportable event has occurred. If an employer making contributions under a plan knows or has reason to know that a reportable event has occurred, the employer is to notify the plan administrator of the reportable event.

Description of Provision

The bill would provide that a contributing sponsor that knows or has reason to know that a reportable event has occurred (as well as the plan administrator) is responsible for reporting the event to the PBGC, and would repeal the requirement that an employer notify the plan administrator of reportable events.

The bill would add a number of new events to the list of reportable events. Under the bill, a reportable event would occur: (1) when a person ceases to be a member of the controlled group; (2) when a contributing sponsor or a member of a contributing sponsor's controlled group liquidates in a case under title II, United States Code, or under any similar Federal law or law of a State or political subdivision of a State; (3) when a contributing sponsor or a member of a contributing sponsor's controlled group declares an extraordinary dividend or redeems, in any 12-month period, an aggregate of 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or an aggregate of 10 percent or more of the total value of shares of all classes of stock, of a contributing sponsor and all members of its controlled group; (4) when, in any 12-month period, an aggregate of 3 percent or more of the benefit liabilities of a plan covered by the PBGC insurance program are transferred to a person that is not a member of the contributing sponsor's controlled group or to a plan maintained by a person that is not a member of the contributing sponsor's controlled group.

Controlled groups with plans with more than $50 million in unfunded vested benefits would be required to notify the PBGC of the new reportable events at least 30 days in advance of the effective date of the event.

Any information provided to the PBGC with respect to a reportable event generally would be exempt from public disclosure.

Effective Date

The provision would be effective for events occurring 60 days or more after the date of enactment.

2. Alternative to involuntary termination (sec. 202 of the bill and new sec. 4050 of ERISA)

Present Law

The PBGC is authorized to terminate a plan when the plan has not met the minimum funding requirements, the plan will be unable to pay benefits when due, certain distributions are made to substantial owners, or the possible long-run loss of the PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.

Description of Provision

Under the bill, if the PBGC determines that the occurrence of one of the new reportable events (or any other event that the PBGC determines may warrant plan termination) would unreasonably increase the PBGC's possible long-run loss if the plan is not terminated, the PBGC would be authorized to apply to district court for relief other than involuntary termination. In the case of events involving the break up of a controlled group (or other events that the PBGC determines may warrant plan termination), the PBGC's authority to seek court-order relief under the bill would be limited to situations in which, after the event, total revenues, operating income, or assets of the controlled group (as it existed before the event) are less than 90 percent of the total revenues, operating income, or assets of the controlled group (as it exists after the event).

Effective Date

The provision would be effective for events occurring on or after 60 days after the date of enactment.

3. Certain information required to be furnished to the PBGC (sec. 203 of the bill and new sec. 4010 of ERISA)

Present Law

The PBGC receives certain financial information from plans pursuant to required filings with the Department of Labor and other governmental agencies.

Description of Provision

The bill would authorize the PBGC to require certain contributing sponsors and controlled group members to submit to the PBGC such information as the PBGC may specify by regulation. The required information may include information that the PBGC determines is necessary to determine plan assets and liabilities and copies of audited financial statements. A contributing sponsor or controlled group member would be subject to these information requirements if: (1) the total unfunded vested benefits of all underfunded plans sponsored by the controlled group exceed $50 million; (2) missed funding contributions exceed $1 million and the conditions for imposing a lien for missed contributions have been met; or (3) there is an outstanding minimum funding waiver in an amount exceeding $1 million, any portion of which remains unpaid. Any information required to be provided to the PBGC under the provision would be exempt from public disclosure.

Effective Date

The provision would be effective on the date of enactment.

4. Liability upon liquidation of contributing sponsor or controlled group member where plan remains ongoing (sec. 204 of the bill and sec. 4062 of ERISA)

Present Law

Under present law, liability to the PBGC arises only when an underfunded plan is terminated. A plan is not considered terminated merely because the contributing sponsor or a member of the contributing sponsor's controlled group is liquidated. In such a case, the remaining controlled group members remain responsible for funding the plan.

Description of Provision

The bill would provide that, if one or more contributing sponsors or controlled group members liquidates all or substantially all of its assets in a Federal or state insolvency proceeding, they would be liable for plan underfunding as if the plan had terminated in a distress termination on the date on which the liquidation was initiated. The liability would be joint and several among the liquidating firms, would be owed to the plan, and could be collected either by the PBGC or the plan. The PBGC would be authorized to issue such regulations as may be necessary to implement the provision, including rules governing procedures pursuant to which a plan could assign its claim to other controlled group members as a means of collecting such payments.

Effective Date

The provision would be effective for liquidations initiated on or after the date of enactment.

5. Enforcement of minimum funding requirements (sec. 205 of the bill and sec. 4003(e) of ERISA)

Present Law

Under present law, the Secretary of the Treasury generally interprets and administers the minimum funding requirements. An excise tax applies with respect to the failure to satisfy the minimum funding requirements. In addition, plan participants and fiduciaries may bring suit under ERISA to enforce the minimum funding requirements. The Secretary of Labor may also bring suit to enforce the minimum funding requirements if requested to do so by a plan participant, fiduciary, or the Secretary of the Treasury. The PBGC enforces a lien that arises in favor of the plan if missed required contributions exceed $1 million.

Description of Provision

The bill would give the PBGC the authority to bring suit to enforce the minimum funding standards if the amount of missed required contributions exceeds $1 million. The bill would not change existing authority of the Department of the Treasury or the Department of Labor.

Effective Date

The provision would be effective for minimum funding contributions that become due on or after the date of enactment.

6. Remedies for noncompliance with requirements for standard termination (sec. 206 of the bill and sec. 4041(b) of ERISA)

Present Law

Under present law, a single-employer defined benefit pension plan can terminate in a standard termination only after the plan administrator notifies participants of the termination, issues individual benefit notices to participants, and files a notice with the PBGC that includes an enrolled actuary's certification of sufficiency. The PBGC has 60 days to review the proposed termination. If the PBGC does not issue a notice of noncompliance nullifying the proposed termination, the plan administrator may distribute plan assets.

Some plan administrators distribute assets in a standard termination before completion of the PBGC's 60-day review period. If the plan administrator fails to give all participants advance notice of how their benefits were computed or fails to fully comply with other procedural requirements designed to protect participants, the PBGC generally is required to issue a notice of noncompliance and nullify the termination.

Description of Provision

The bill would provide that the PBGC is not required to issue a notice of noncompliance (and nullify a termination) in the case of failure to meet procedural requirements with respect to the termination unless it determines that it would be inconsistent with the interests of participants and beneficiaries not to issue the notice.

Effective Date

The provision would apply with respect to standard terminations for which the PBGC has not, as of the date of enactment, issued a notice of noncompliance that has become final, or otherwise issued a final determination that the plan termination is nullified.

7. Prohibition on benefit increases where plan sponsor is in bankruptcy (sec. 207 of the bill, sec. 401(a) of the Code, and sec. 204 of ERISA)

Present Law

Under present law, there is no restriction on the adoption of plan amendments that increase benefits when a plan is underfunded.

Description of Provision

The bill would amend the Code and ERISA to prohibit an employer in bankruptcy from adopting a plan amendment that increases benefits unless the benefit increase does not become effective until after the effective date of the employer's plan of reorganization. The prohibition would not apply to amendments that (1) provide reasonable, de minimis increases in liabilities for employees of the debtor, (2) repeal an amendment made within the first 2-1/2 months of a plan year that would reduce accruals for that plan year, as permitted under section 302(c)(8) of ERISA, or (3) are needed to meet the qualification requirements contained in the Code.

Effective Date

The provision would be effective with respect to plan amendments adopted on or after the date of enactment.

8. Substantial owner benefits (sec. 208 of the bill and sec. 4022(b)(5) of ERISA)

Present Law

Under present law, the PBGC guarantee is generally phased in over 5 years from the date of plan adoption or plan amendment. However, in the case of substantial owners, the guarantee is generally phased in over 30 years. Plan amendments are separately phased in over 30 years. The combined guarantee of benefits under the terms of the original plan and all amendments to the plan cannot exceed two times the guarantee of benefits under the terms of the original plan. In general, a substantial owner is a person who owns more than 10 percent of a business.

Description of Provision

Under the bill, the same 5-year phase in and asset allocation rules that apply to persons other than substantial owners would apply to substantial owners with less than a 50 percent ownership interest. For 50 percent or more substantial owners ("majority owners"), the bill would amend the phase-in rule so that the guarantee would depend on the number of years the plan has been in effect, not the number of years the owner has been a participant. In particular, the guaranteeable plan benefit would be guaranteed 1/30 for each year that the plan has been in effect. The fraction would be the same for any majority owner in the plan. A majority owner's guaranteed benefit would be limited so that it could not be more than the amount that would be guaranteed under the 5-year phase in rule applicable to other participants. The bill would also change the rules regarding allocation of plan assets on plan terminations in the case of majority owners.

Effective Date

The provision would be effective with respect to plan amendments adopted on or after the date of enactment.

9. Phase out of variable rate premium cap (sec. 209 of the bill and sec. 4006(a)(3) of ERISA)

Present Law

Plans covered by the termination insurance program are required to pay a flat per-participant premium of $19. In addition, underfunded plans are required to pay an additional premium based on the amount of underfunding. The additional premium is $9 per $1,000 of underfunding, and is capped at $53 per participant. Thus, the maximum per-participant premium for an underfunded plan is $72.

Description of Provision

The bill would phase out the cap on the additional premium for underfunded plans over three years, beginning with plan years beginning on or after July 1, 1994. For plan years beginning on or after July 1, 1994, but before July 1, 1995, the maximum additional premium would be $53 per participant, plus 20 percent of the amount of the total premium (determined without regard to the cap) in excess of $53. For plan years beginning on or after July 1, 1995, but before July 1, 1996, the maximum additional premium would be $53 per participant, plus 60 percent of the amount of the total premium (determined without regard to the cap) in excess of $53.

Effective Date

The provision would be effective on the date of enactment.

D. Title III—Participant Services

1. Disclosure to participants (sec. 301 of the bill and new sec. 4011 of ERISA)

Present Law

ERISA requires that plan participants be provided with certain information. One of these requirements is that, if the plan is less than 70 percent funded, the annual report regarding the plan must include the funded percentage of the plan. Plan administrators must also provide participants with a summary plan description (SPD) that advises participants of their rights, obligations, and eligibility for benefits under the plan. If the benefits are guaranteed by the PBGC, the SPD must include a summary of ERISA's guarantee provisions and a statement that more information may be obtained from the PBGC or the plan administrator. Department of Labor regulations include a safe harbor statement that can be included in the SPD to satisfy the requirements regarding the PBGC guarantee.

Description of Provision

The bill would amend title IV of ERISA to require that the plan administrator of a plan that must pay the additional premium applicable to underfunded plans must notify plan participants of the plan's funded status and the limits on the PBGC's guarantee should the plan terminate while underfunded. The notice would have to be provided in the time and manner prescribed by the PBGC.

Effective Date

The provision would be effective for plan years beginning after the date of enactment.

2. Missing participants (sec. 302 of the bill and new sec. 4031 of ERISA)

Present Law

Under present law, one of the requirements of a standard termination is that the plan administrator distribute plan assets by purchasing irrevocable commitments from an insurer in satisfaction of all benefit liabilities that must be in annuity form and by otherwise providing all benefit liabilities that need not be provided in annuity form. Under PBGC rules, if the plan administrator has been unable to locate participants after having made a reasonable effort to do so, the administrator must either purchase irrevocable commitments to provide benefits for each participant who has not been located or, if the benefit of any unlocatable participant is valued at $3,500 or less and would otherwise be distributed in a lump sum, the administrator may deposit the amount that would be distributed into an interest-bearing bank account opened in the participant's name at a Federally insured institution. If the plan administrator is unable to locate an institution that will open individual interest-bearing accounts for unlocatable participants, the administrator may set up a pooled interest-bearing account. Any individual or pooled account opened to hold plan benefits for unlocatable participants must be maintained by a fiduciary.

Description of Provision

The bill would provide special rules for payment of benefits in the case of participants under a plan terminating in a standard termination whom the plan administrator cannot locate after a diligent search ("missing participants"). The plan administrator would be required to (1) transfer a participant's designated benefit to the PBGC or purchase an annuity from an insurer to satisfy the benefit liability to the participant, and (2) provide the PBGC with such information and certifications with respect to such benefits or annuity as the PBGC may specify. Any amounts transferred to the PBGC under the provision would be treated as assets under a plan trusteed by the PBGC.

After a missing participant whose benefit was transferred to the PBGC is located, if the plan could have distributed the benefit to the participant in a single sum without participant or spousal consent, the PBGC would pay the participant a single sum benefit equal to the benefit paid to the PBGC, plus interest as specified by the PBGC. In other cases (i.e., if the plan could not have distributed the benefit in a single sum without consent), the PBGC would pay a benefit based on the designated benefit and the actuarial assumptions prescribed by the PBGC at the time that the PBGC received the designated benefit. The PBGC would make such payments available in the same forms and at the same times as a guaranteed benefit would be paid, except that the PBGC could make a benefit available in the form of a single sum if the plan provided such a benefit.

A designated benefit would mean the single sum benefit the participant would receive (1) under the plan's actuarial assumptions in the case of a distribution that can be made without participant or spousal consent, (2) under the PBGC assumptions in effect on the date that the designated benefit is transferred to the PBGC, in the case of a plan that does not pay any single sums other than those that can be made without consent, or (3) under the assumptions of the PBGC or the plan, whichever provides the higher single sum, in the case of a plan that does pay a single sum other than those that do not require consent.

The qualification requirements of the Code would be amended to provide that a plan would not be treated as failing to satisfy those requirements merely because it provides for benefits to missing participants as provided in the bill.

Effective Date

The provision would be effective with respect to distributions that occur in plan years beginning after final regulations implementing the provision are adopted by the PBGC.

3. Modification of maximum guarantee for disability benefits (sec. 303 of the bill and sec. 4022(b) of ERISA)

Present Law

The PBGC guarantee generally applies to a disability benefit if the benefit is in the form of an annuity payable because of permanent and total disability and the participant became disabled before the plan termination date. As is the case with other benefits, the PBGC guarantee is reduced if the benefit begins before age 65. When a disability benefit is converted to a normal or early retirement benefit, the maximum insurance limit for the normal or early retirement benefit is based on the participant's age at conversion.

Description of Provision

Disability benefits would be exempted from the age reduction in the maximum PBGC insurance amount, if the participant meets the standards for social security benefits on account of permanent and total disability.

Effective Date

The provision would be effective for terminations for which a notice of intent to terminate is filed or for which the PBGC institutes termination proceedings on or after the date of enactment.

E. Title IV—Miscellaneous Amendments

1. ERISA citation for certain deduction rules (sec. 401 of the bill and sec. 404(g)(4) of the Code)

Present Law

Under present law, contributions to tax-qualified pension plans are deductible within limits. The Code provides that amounts paid by an employer or a member of its controlled group under the following provisions of ERISA are treated as plan contributions subject to the deduction rules of the Code (Code sec. 404(g)(1): (1) section 4041(b) of ERISA (relating to standard terminations); (2) section 4062 of ERISA (relating to liability to the PBGC in the case of a distress termination); (3) section 4063 of ERISA (relating to liability of a substantial employer for withdrawal from single-employer plans under multiple controlled groups); (4) section 4064 of ERISA (relating to liability on termination of single-employer plans under multiple controlled groups; and (5) part I of subtitle E of title IV of ERISA (relating to liability upon withdrawal from a multiemployer plan). The Code provides that the references to these sections of ERISA are to these sections as in effect on the date of enactment of the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA). The amounts referred to in such sections have generally been increased since the enactment of SEPPAA.

Description of Provision

The bill would provide that the references to ERISA in Code section 404(g) are to ERISA as in effect on the date of enactment of the bill.

Effective Date

The provision would be effective on the date of enactment.

2. Definition of contributing sponsor under title IV of ERISA (sec. 402 of the bill and sec. 4001(a)(13) of the Code)

Present Law

Under present law, for purposes of the PBGC termination insurance program, the contributing sponsor of a plan is defined as a person (1) who is responsible, in connection with such plan, for meeting the funding requirements under section 302 of ERISA or under section 412 of the Code, or (2) who is a member of the controlled group of a person described in (1), has been responsible for meeting such funding requirements, and has employed a significant number (as may be defined by the PBGC) of participants under such plan while such person was so responsible. Under the Pension Protection Act 1987, all members of an employer's controlled group are responsible for the minimum funding requirements.

Description of Provision

The bill would define contributing sponsor for purposes of title IV of ERISA to mean the person responsible for making minimum funding contributions to the plan under section 302 of ERISA or section 412 of the Code, without regard to the controlled group rules. All members of a contributing sponsor's controlled group would remain liable for making the minimum funding contribution.

Effective Date

The provision would be effective as if included in the Pension Protection Act of 1987.

3. Recovery ratio under ERISA (sec. 403 of the bill and sec. 4022(c) of ERISA)

Present Law

Under present law, the extent to which the PBGC pays benefits under a plan terminated in a distress termination depends on the applicable recovery ratio. The recovery ratio depends on the value of the plan's unfunded benefit liabilities. If the unfunded benefit liabilities exceed $20 million, the applicable recovery ratio is based on the actual recovery by the PBGC from the employer (the "large plan" rule). In the case of other terminations, the applicable recovery ratio is based on the average recovery from employees from prior terminations with respect to which the notice of intent to terminate is provided after December 17, 1987, and within the 5 fiscal years of the Federal Government ending before the year in which the date the notice of intent to terminate the plan for which the recovery ratio is being determined was provided (the "small plan" rule).

This rule was initially enacted as part of the Pension Protection Act of 1987, and applies to distress terminations for which notices of intent to terminate are provided after December 17, 1987, and terminations instituted by the PBGC after such date.

Description of Provision

The bill would retroactively repeal the small plan rule for determining the applicable recovery ratio. Thus, under the bill, the recovery ratio for all plans would be based on the actual recovery by the PBGC from the employer.

Effective Date

The provision would be effective as if included in the Pension Protection Act of 1987. Thus, it would apply with respect to distress terminations for which notices of intent to terminate are provided after December 17, 1987, and terminations instituted by the PBGC after such date.

4. Distress termination criteria for banking institutions (sec. 404 of the bill and sec. 4041(c) of ERISA)

Present Law

Under present law, a plan may terminate in a distress termination only if the contributing sponsor and each member of the controlled group of the contributing sponsor meet one of three financial distress standards. One of the standards of financial distress is that the entity is liquidating in bankruptcy or insolvency proceedings under title 11 of the United States Code or under any similar law of a State or political subdivision of a State.

Description of Provision

The bill would provide that a proceeding under title 11 of the United States Code or any similar Federal law would qualify as a standard for distress criteria. This standard would apply, for example, to bank insolvency receivership actions.

Effective Date

The provision would be effective as if included in the SEPPAA. Thus, it would be effective with respect to notices of intent to terminate filed with the PBGC on or after January 1, 1986.

5. Single sum distributions (sec. 405 of the bill, secs. 411(a)(11), 417(e), and 415(b) of the Code, and sec. 203(e) and 205(g) of ERISA)

a. Determination of present value

Present Law

Under the Code and ERISA, if the present value of a participant's nonforfeitable accrued benefit exceeds $3,500, the benefit cannot be immediately distributed (i.e., cashed out) without the consent of the participant. In addition, if the present value of a joint and survivor annuity exceeds $3,500 it cannot be immediately distributed without the consent of the participant and the participant's spouse. For purposes of these rules, present value is calculated by using an interest rate no greater than (1) the rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump-sum distribution on plan termination if the vested accrued benefit (using such rate) is not in excess of $25,000, or (2) 120 percent of such PBGC rate if the vested accrued benefit exceeds $25,000.

Description of Provision

Under the bill, present value for purposes of the cash-out rules must be no less than the present value determined by using the mortality table used by the Commissioner of the IRS to determine reserves for group annuity contracts issued on the date as of which present value is being determined and the rate of interest on a 30-year Treasury security (as of the date of distribution).

A plan would not violate the prohibition on accrued benefits merely because it calculates benefits in accordance with the proposal.

Effective Date

The provision generally would be effective for plan years beginning after December 31, 1994, except that an employer could elect to treat the provision as being effective on the date of enactment.

Under a transition rule, until the earlier of the first plan year beginning after 1999 or the later of when a plan amendment applying the provision is adopted or made effective, the bill would require present value to be calculated as under present law, using the interest rate valuation methodology for lump-sum distributions under PBGC regulations in effect on September 1, 1993, the present-law Code and ERISA rules, and the current plan provisions (provided they are consistent with present law).

b. Limitation on maximum benefits

Present Law

The Code provides limits on contributions and benefits under tax-qualified pension plans. In the case of a defined benefit pension plan, the maximum annual benefit payable is generally the lesser of (1) 100 percent of average compensation or (2) $118,800 for 1994. The dollar limit is adjusted annually for cost-of-living increases.

If the benefit under the plan is payable in a form other than a single life annuity, then the benefit must generally be converted to the actuarial equivalent of a single life annuity for purposes of applying the limit on benefits. If the benefit is payable before social security retirement age, the dollar limit on annual benefits is reduced so that the limit is actuarially equivalent to a benefit beginning at the social security retirement age. These adjustments are made using an assumed interest rate that is not less than the greater of 5 percent or the rate specified in the plan. Similarly, if the benefit is payable after social security retirement age, then the limit is actuarially increased. This adjustment is made using an assumed interest rate that is not greater than the lesser of 5 percent or the rate specified in the plan.

Description of Provision

The bill would provide that the mortality table required to be used for purposes of adjusting any benefit or limitation in applying the limit on maximum benefits would be the prevailing standard mortality table used by the Commissioner of the IRS to determine reserves for group annuity contracts. In addition, in adjusting benefits that are payable in a form other than a single life annuity, if the benefit is subject to the spousal consent rules, the interest rate would be the same used to calculate benefits under those rules (as described above).

A plan would not be considered to violate the prohibition on reduction in accrued benefits merely because it calculates benefits in accordance with the provision.

Effective Date

The provision would be effective for limitation years beginning after December 31, 1994, except that an employer could elect to treat the provision as being effective on or after the date of enactment. Benefits accrued as of the last day of the last plan year beginning before January 1, 1995, would not have to be reduced merely because of the provision. A plan would not have to be amended to comply with the provision until a date to be specified by the Secretary of the Treasury, provided the plan complies with the proposal in operation.

6. Adjustments to lien for missed minimum funding contributions (sec. 406 of the bill, sec. 412(n) of the Code, and sec. 302(f) of ERISA)

Present Law

Under present law, in the case of a single-employer defined benefit pension plan with a funded current liability percentage of less than 100 percent, a lien arises on all controlled group property in favor of the plan within 60 days after the due date of an unpaid required contribution. The amount of the lien is the amount of the cumulative missed contributions in excess of $1 million.

Description of Provision

The bill would (1) eliminate the 60-day waiting period before the lien arises, (2) eliminate the $1 million exclusion on amounts subject to the lien, and (3) provide that the lien applies only to plans covered by the PBGC termination insurance program. Thus, among other types of plans, the lien provision would not apply to plans maintained by a professional services employer which do not have more than 25 active participants or to plans maintained exclusively for substantial owners.[8]

Effective Date

The provision would be effective for required contributions that become due on or after the date of enactment.

7. Rounding rules for cost-of-living adjustments (sec. 407 of the bill and secs. 415, 402(g), and 408(k) of the Code)

Present Law

Under present law, the dollar limit on benefits under a defined benefit pension plan ($118,800 for 1994), the limit on elective deferrals under a qualified cash or deferred arrangement ($9,240 for 1994), and the minimum eligibility requirement for participation in a simplified employee pension (SEP) ($396 for 1994) are adjusted annually for inflation. The dollar limit on annual additions to a defined contribution plan is the greater of $30,000 or 25 percent of the dollar limit for benefits under defined benefit pension plans. Thus, the dollar limit will be $30,000 until the defined benefit pension plan dollar limit exceeds $120,000.

Description of Provision

The bill would provide that the dollar limit on benefits under a defined benefit pension plan is indexed in $5,000 increments, the dollar limit on annual additions under a defined contribution plan is indexed in $5,000 increments, the limit on elective deferrals is indexed in $500 increments, and the compensation limit for SEP participation is indexed in $50 increments. In addition, the bill would provide that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year so that the adjusted dollar limits would be available before the beginning of the calendar year to which they apply.

Effective Date

The provision would be effective for years beginning after December 31, 1994.

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[8] Substantial owner is defined generally as an individual who (1) owns the entire interest in an unincorporated trade or business, (2) in the case of a partnership, is a partner who owns more than 10 percent of the capital or profits interests in the partnership, or (3) in the case of a corporation, owns more than 10 percent in value of the voting stock of the corporation or all the stock of the corporation.

8. Limitation on cross testing in defined contribution plans (sec. 408 of the bill and secs. 401(a)(4) and (5) of the Code)

Present Law

The Code provides that the contributions or benefits provided under a plan may not discriminate in favor of highly compensated employees. Treasury regulations provide that, in testing to determine whether a plan is discriminatory, a defined benefit pension plan may be tested on the basis of equivalent contributions and that a defined contribution plan may be tested on the basis of equivalent benefits. This is generally referred to as "cross-testing". In addition, two or more plans may be combined and treated as a single plan for purposes of determining whether the plans as a whole satisfy the nondiscrimination requirement. The same determination of benefits or contributions that is used for general nondiscrimination testing also applies for purposes of the average benefit percentage test under the coverage rules.

Description of Provision

The bill would provide that a defined contribution plan (other than a target benefit plan that satisfies regulations prescribed by the Secretary) would have to be tested for nondiscrimination on the basis of contributions. In addition, two or more plans of an employer, at least one of which is a defined contribution plan, would be considered as satisfying the nondiscrimination test as a single plan only if the contributions provided under the aggregated plans are nondiscriminatory.

The bill would also provide that in applying the average benefit percentage test, employee benefit percentages are to be determined on a basis consistent with regulations prescribed by the Secretary. Thus, the Secretary could limit the circumstances under which defined contribution plans are tested on a benefits basis under the average benefit percentage test.

Effective Date

The provision would be effective for plan years beginning after September 30, 1993, except that for defined contribution plans in existence on September 30, 1993, the provision would be effective for plan years beginning on or after January 1, 1995.

9. Funding of restored plans (sec. 409 of the bill)

Present Law

Under certain circumstances, the PBGC may restore the operation of a plan that has terminated to the sponsor of the plan. Treasury regulations set forth rules regarding the funding of plans that have been terminated and then restored by the PBGC.

Description of Provision

The bill would provide that any changes made by the bill to the funding rules of the Code or ERISA would not apply to a plan which, on the date of enactment, is subject to a restoration payment schedule order issued by the PBGC and that meets the requirements of Treasury regulations.

Effective Date

The provision would be effective on the date of enactment.

IV. ISSUES AND ANALYSIS

A. In General

The PBGC contends that, without legislative reforms, its financial condition is likely to deteriorate to the point that it will not be able to meet its obligations under ERISA. According to its calculations, premiums and other income will be insufficient to pay guaranteed benefits for terminated underfunded plans in the future.

There are a number of possible ways to strengthen the financial condition of the PBGC working within the present termination insurance program.[9] PBGC funding could be improved by increasing the amount of premiums collected by the PBGC or by giving the PBGC higher priority status in bankruptcy proceedings. Another option would be to reduce PBGC liabilities by limiting the PBGC guarantee or by improving the health of the defined benefit pension system generally, so that fewer plans will terminate with unfunded liabilities. For example, steps could be taken to increase minimum funding standards to reduce the amount of unfunded liabilities in the system. These, and other possible solutions, are discussed below.

B. PBGC Funding

One way to help ensure that the PBGC would be able to continue to meet its obligations under ERISA would be to increase the amount of funds available to pay unfunded benefits guaranteed by the PBGC. The sources of PBGC's funds are assets of terminated plans, premiums, claim recoveries from sponsors of terminated plans, and investment earnings. Since, by definition, assets of terminated plans represent funded benefits, only the latter three sources are availa ble to pay unfunded benefits.

Increase premiums

Premium rates

Because the PBGC is required by ERISA to be self-supporting--there is no annual appropriation from general revenue--most of its revenue comes from premiums collected from employers sponsoring defined benefit pension plans. An increase in premiums could be achieved either by increasing premium rates or by increasing the number of plans from which premiums are collected (base broadening).

In determining the proper way to structure PBGC premiums, a major issue is risk distribution--that is, should all premium payers pay the same premium, or should the premium be adjusted to re-

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[9] Possible options outside the termination insurance program, such as appropriations from general revenues, are not discussed here.

flect risk. Those who favor increasing the flat-rate premium charged to all covered plans focus on the social insurance aspect of the PBGC. They argue that providing retirement benefits is an important social good and that, therefore, the cost of providing benefits should be spread equally among a broad group. When the PBGC was created in 1974, this was the approach adopted--every defined benefit pension plan contributed an annual premium of $1 per participant, regardless of risk to the system.

Under a flat-rate PBGC premium, well-funded plans effectively subsidize higher-risk, poorly-funded plans. Proponents of this approach argue that this subsidization is intentional, and is inherent in the concept of the PBGC as a social insurance program.

Proponents of an increase in the flat-rate premium express concern that increased reliance on risk-based premiums could cause employers to unnecessarily limit or delay benefit increases or, in the case of newer plans, to limit the amount of past service credit. Such changes in plan benefits increase plan liabilities, and thus could cause a plan to be underfunded in the short run, even though the plan may be fully funded over time. Proponents of a flat-rate system are also concerned that a significant increase in premiums for underfunded plans could divert assets away from plan funding (or some other business purpose like research and development or expansion), and even force some companies into bankruptcy.

Those who favor risk-adjusted premiums argue that premiums should be based, at least partially, on plan underfunding because of the moral hazard that exists under the present system. The flexibility in the minimum funding rules permits plan sponsors to minimize contributions. Thus, plan sponsors can deliberately underfund plans, knowing that if the plan is terminated, other premium payers (through the PBGC) will provide the benefits.

In private insurance companies, insurance generally is priced to prevent such moral hazards. Proponents of risk-adjusted premiums argue that PBGC insurance should be priced in a similar manner. Although premiums are marginally higher for underfunded plans than for fully funded plans, the difference under present law is not sufficient to reduce the incentive to abuse the system.

Proponents of risk-adjusted premiums argue that an increase in flat-rate premiums would be unfair to healthy defined benefit pension plans. Increasing premiums for all plans could cause an exodus of premium payers from the defined benefit plan system. The more cross-subsidization that occurs between well-funded and poorly-funded plans, the more the premium structure will be perceived as unfair and the more risk there is that healthy plans will simply exit the system. A company can respond easily to the increased cost of pension insurance by switching from a defined benefit pension plan to a defined contribution plan (although such a switch could not be made unilaterally in the case of a collectively-bargained plan).

An increase in premium rates for underfunded plans also may result in overcharges to some plans because not all underfunded plans pose an equal risk to the PBGC. The degree of risk posed to the PBGC also depends on other factors, such as the health of the particular plan sponsor and its industry. In a perfect insurance setting, adjustments for this type of risk may be desirable. However, determining what the appropriate premium should be for any particular plan would likely be complicated. Plan underfunding may be an adequate proxy for risk.

Premium base

Another way to increase the amount of premiums collected by the PBGC would be to broaden the premium base. One method of accomplishing this would be to collect "premiums"[10] from all qualified pension plans, not just defined benefit pension plans. Defined contribution plans benefit from the same tax-favored treatment afforded defined benefit pension plans, and the two types of plans generally are considered to be part of the same system established and supported by the government to help ensure that individuals have adequate retirement income to supplement Social Security benefits and private savings. A modest per-participant "premium" collected from all qualified plans could increase PBGC funding substantially without increasing the cost of defined benefit pension plans relative to defined contribution plans.

On the other hand, the less connection there is between the premium payers and the beneficiaries of the PBGC's insurance, the more likely the system will be perceived as unfair, particularly if the incentive to underfund plans remains. Further, the more such connection weakens, the more difficult it is to distinguish the financing method from general fund financing and the more the program is simply a wealth transfer program rather than insurance. If wealth transfer is ultimately the objective of the pension termination insurance system, then there may be better ways to accomplish the desired result than through the existing system.

Better enforcement

Better enforcement of the premium requirements also would improve the financial condition of the PBGC. GAO found that the PBGC's efforts to identify and collect unpaid premiums, underpaid premiums, and penalties are inadequate.[11] GAO recommended civil actions, systematic past due filing notices, and systematic statements of accounts with proper follow-up.

Bankruptcy reform

Increasing the priority status of PBGC claims in bankruptcy could help to secure the financial stability of the PBGC. It would enable the PBGC to claim a larger share of the assets of bankrupt companies to help pay guaranteed benefits. Elevating the status of pension claims also would provide an additional incentive for employers to fund their pension liabilities because of the potential negative effect of unfunded liabilities on the perceived financial health of the employer.

However, increasing the priority status of the PBGC would come at the expense of other creditors. Moreover, creditors may be less

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[10] Because a defined contribution plan participant could never benefit from the PBGC guarantee, amounts collected from such plans would not technically be "premiums" for insurance. Rather, they would be more like taxes.

[11] U.S. General Accounting Office, *Pension Benefit Guarantee Corporation* (GAO/HR-93-5), January 7, 1993; *Pension Benefit Guaranty Corporation Needs to Improve Premium Collections* (GAO/HRD-92-103), June 30, 1992.

likely to loan money to firms with underfunded plans, hastening the ultimate failure of a company in dire financial condition.

C. PBGC Liabilities

Another way to help ensure the continued viability of the PBGC would be to limit its exposure to excessive liabilities.

PBGC guarantee

One way to limit the PBGC's exposure would be to eliminate or limit the PBGC guarantee in certain circumstances. For example, the PBGC guarantee could be denied to certain benefit increases promised by underfunded plans. Structured properly this might discourage financially troubled sponsors and labor representatives from shifting compensation liabilities to the PBGC by negotiating increased pension benefits in lieu of wages as it becomes apparent that the sponsor may fail. If the increased benefits were not guaranteed by the PBGC, labor would be more likely to insist that the benefits be funded by the sponsor.

However, this approach could undermine the whole purpose of the PBGC, which is to guarantee benefits. If benefit increases are not guaranteed, participants of plans that are not fully funded upon termination could receive a reduced pension. Further, participants may be misled, because they may not know that a particular benefit increase is not guaranteed. Collectively bargained flat-dollar plans would be particularly affected, because benefit increases under such plans are always at least initially unfunded.

Another way to limit PBGC's exposure to unfunded benefit promises might be simply to prohibit, or at least limit, plan improvements that increase unfunded liabilities. For example, benefit increases in underfunded plans could be prohibited unless the plan is funded to a certain level, or unless security is provided. Such a restriction could build on the present-law requirement that sponsors of plans which are less than 60 percent funded provide security for plan amendments that increase unfunded liabilities by more than $10 million.

One drawback to this latter approach is that participants in underfunded plans could be denied benefit improvements. Also, companies and labor representatives would be restricted in their ability to negotiate freely in their own best interest (although this concern should be balanced with what is best for the defined benefit pension plan system as a whole). Such an approach may also affect different types of plans differently. For example, in a plan for salaried employees, benefit increases will typically be automatic--they will increase as salaries increase. However, in collectively bargained plans, each benefit increase may have to be negotiated separately. Moreover, if plan sponsors are required to provide security for benefit increases, sponsors may find it difficult to obtain the credit necessary to keep their businesses in operation. However, if pension promises are to be recognized as significant liabilities, this may be the correct result. A plan sponsor that cannot fund an increase in benefits without jeopardizing its business operations arguably should not make that increase.

Increased minimum funding rate

Minimum funding standards

Another way to limit the PBGC's exposure would be to strengthen the minimum funding standards in ERISA and the Code. Many pension experts argue that the rate of funding required under the present-law minimum funding standards exposes plan participants and the PBGC to excessive risk.

Under present law, plans with unfunded liabilities are permitted to amortize the shortfall over a number of years that varies with the cause of the underfunding. This period can be as long as 40 years. As a result, the funded status of a plan can deteriorate even if the minimum funding requirements are fully satisfied. Strengthening the minimum funding rules would limit the ability of employers to delay or avoid funding obligations.

Stricter funding rules would not come without a price, however. Stricter rules would have the greatest effect on underfunded plans in declining and troubled industries, possibly forcing some companies into bankruptcy if the increase in required funding is very large. Tighter restrictions could also affect companies that in a cyclical downturn may be unable to meet strict funding standards during an unprofitable period. (Presumably, though, IRS funding waivers could be preserved to accommodate these situations.) Even some healthy companies will object to additional restrictions on funding flexibility because of the increased costs that will sometimes result. Income tax revenues would decline because companies would be required to increase the amount of deductible contributions to their plans, and because subsequent earnings on the additional contributions would be excludable from income.

Full funding limit

In a similar vein, pension funding might be improved by easing restrictions on maximum funding levels. This way, plans might be able to contribute enough during profitable periods to make up for any shortfalls during economic downturns. Some have suggested that repeal of the limit based on 150-percent of current liability (added in 1987)[12] would be beneficial in this regard.

According to a 1991 Treasury Report,[13] however, the effect on funding levels of the current liability limit is minimal. Treasury found that the decrease in funding levels resulting from the limit does cause a small increase in the risk to plan participants and the PBGC because of lower funding rates. However, the limit affects only well-funded plans, and only by relatively small amounts. The report concludes that the current limit is likely to have an insignificant effect on employee benefit security.

Hidden liabilities[14]

The PBGC's exposure could be limited by reducing its hidden liabilities. In a study released in January 1993, GAO[15] reported that

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[12] For background on this limit, see Part III. B.1., above ("Funding limits").

[13] Department of the Treasury, *Report to Congress on the Effect of the Full Funding Limit on Pension Benefit Security*, May 1991.

[14] See Part II.B., above, for a general description of hidden liabilities.

[15] U.S. General Accounting Office, *Hidden Liabilities Increase Claims Against Government Insurance Program* (GAO/HRD-93-7), December 30, 1992.

the PBGC's exposure to unfunded liabilities is much larger than plans have indicated on their annual reports. As a consequence, when a pension plan terminates with insufficient assets, the PBGC is likely to absorb unfunded liabilities considerably greater than the plan reported (thus the term "hidden liability"). According to GAO, the PBGC has few tools under present law to control its exposure to these hidden liabilities.

Critics assert that the PBGC overstates all liabilities, including hidden liabilities, because the actuarial assumptions it uses to calculate apparent liabilities are unrealistic. Thus, one way to reduce apparent hidden liabilities would be for the PBGC to use more realistic assumptions. The PBGC acknowledged its use of a lower-than-market rate of interest, but defended this practice on the grounds that it is necessary to offset the effect of the relatively high mortality rates it assumes. The PBGC recently revised its mortality and interest rate assumptions to reflect recent actuarial practice.

Plan sponsors also could be required to use actuarial assumptions that more accurately reflect expected future liabilities. For example, interest rate assumptions used to calculate plan liabilities could be regulated more strictly. Under present law, actuaries hired by plan sponsors are free to select, within a typical range of about 2 percentage points, the interest rate to be used by the plan. GAO found that a 1 percentage point increase in the interest rate assumption will generally lead to about a 10- to 20-percent decrease in calculated plan liabilities. Thus, a rate selected from the high end of the range can result in calculated liabilities significantly lower than a rate from the low end of the range. Plan sponsors that use a higher rate can reduce the amount of required contributions, possibly leading to underfunding and a hidden liability to the PBGC.

Better reporting and internal plan audits by independent accountants also could reduce hidden liabilities. GAO has recommended that the Congress amend ERISA to require full-scope audits of pension plans, and to require plan administrators and independent accountants to report how effectively the internal controls of a plan protect plan assets.[16] These internal controls should be a key safeguard in protecting plan participants and the PBGC.

The Congress could address the problem of hidden liabilities that arise as a result of special shutdown benefits paid when an employer ceases operations. Shutdown benefits are poorly funded because they are not fully valued by plan actuaries when calculating the plan's liabilities. Because plans often terminate shortly after shutdown benefits begin, sponsors do not have time to fund the benefits once they accrue, and the PBGC receives a hidden liability.

Many observers view shutdown benefits as a particularly egregious abuse of the pension guarantee system. Since such benefits are payable only upon termination of all or a part of the sponsor's operations, sponsors know that responsibility for making payments probably will be borne by the PBGC. Critics argue that such benefits should not be insured by the PBGC. However, even if not in-

[16] U.S. General Accounting Office, *Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA* (GAO/AFMD-92-14), April 9, 1992.

sured, shutdown benefits increase plan liabilities because they drain plan assets that would otherwise be used to pay regular, guaranteed, benefits. This practice would also have to be restricted in order to limit PBGC's exposure to potential excessive liabilities.

D. Cross Testing in Defined Contribution Plans

The Code imposes general nondiscrimination standards on tax-qualified retirement plans. These standards generally provide that the contributions or benefits under a qualified plan may not discriminate in favor of highly compensated employees. The most direct approach to testing for nondiscrimination is to test a defined benefit pension plan to ensure that benefits under the plan are nondiscriminatory and to test a defined contribution plan to ensure that the contributions under the plan are nondiscriminatory. However, the IRS permits a defined benefit pension plan to be tested for nondiscrimination on the basis of equivalent contributions and a defined contribution plan to be tested on the basis of equivalent benefits. This approach to nondiscrimination testing is generally referred to as cross testing.

Employers often maintain different types of plans for different classes of employees. For example, it is not uncommon for an employer to maintain a defined benefit pension plan for a portion of its workforce and a defined contribution plan for a different portion of its workforce. Such plans are then combined for purposes of nondiscrimination testing. In order to test more than one plan under such circumstances, cross testing is employed.

The Code also has minimum coverage rules. One of the ways these rules can be satisfied is if the plan covers a nondiscriminatory classification of employees and if the average benefit percentage of employees who are not highly compensated employees is at least 70 percent of the average benefit percentage for highly compensated employees. Cross testing can be used in determining the average benefit percentage of employees under an employer's plans for purposes of this test.

Some believe that the use of cross testing has been invoked by employers who maintain what are, in fact, discriminatory plans. There has been a trend in some defined contribution plans, for example, for contributions that are based on either an employee's age, length of service, or both. To the extent that an employer's older employees are highly compensated relative to the employer's younger employees, such a plan will not satisfy a nondiscrimination test based on contributions. Thus, such a plan could only qualify if equivalent benefits under the plan are tested for nondiscrimination. The effect of cross testing in such cases is to allow substantially greater contributions to a qualified plan on behalf of highly compensated employees.

A number of criticisms of cross testing can be articulated. Some believe that the use of cross testing is inappropriate because younger employees who are not highly compensated will generally not remain employed with an employer long enough to benefit from a plan that provides contributions that are greater, as a percentage of pay, for older or longer service employees. Further, because the contributions to many defined contribution plans are not fixed, but rather may be changed at the discretion of the employer, younger employees who remain employed with an employer may never be entitled to the level of contributions that have been made on behalf of the highly compensated employees.

Some believe that testing for nondiscrimination on the basis of benefits is appropriate only in the case of defined benefit pension plans, which are subject to greater restrictions with respect to plan amendments and terminations than are defined contribution plans. Further, it is alleged that the use of cross testing of defined contribution plans may discourage employers from adopting or maintaining defined benefit pension plans because cross testing enables an employer to use a defined contribution plan to provide benefits similar to a defined benefit pension plan without the additional costs associated with maintaining a defined benefit pension plan. This also could disadvantage plan participants because benefits under defined benefit pension plans are guaranteed by the PBGC, whereas benefits under defined contribution plans are not.

Those who support the use of cross testing argue that it must be allowed so that an employer can structure its retirement plans in a manner that reflects its legitimate business needs. They believe that competition in the market for employees will ensure that there will be adequate retirement benefits provided on behalf of employees generally. Further, they argue that employees may benefit from the use of different plans for different groups of employees and that there is inadequate evidence that the use of cross testing has resulted in discrimination in favor of highly compensated employees in most cases.

Some point out that defined benefit pension plans are likely to provide substantially greater contributions on behalf of highly compensated employees than any defined contribution plan and that such plans are deemed to be nondiscriminatory so long as the benefits under such plans are nondiscriminatory. That is, the same result could be reached under a defined benefit pension plan as under a cross-tested defined contribution plan. They argue that it is inappropriate to impose a greater standard for nondiscrimination on defined contribution plans than is imposed on defined benefit pension plans. On the other hand, as mentioned above, defined benefit plans are subject to additional rules not applicable to defined contribution plans, so it may be appropriate to have different nondiscrimination rules.

Finally, some argue that the IRS has the authority under present law to address abusive uses of cross testing by regulation and ruling because the ability to cross test is set forth in regulations. They believe that legislation is both unnecessary and more likely to result in rules that fail to take account of the legitimate business practices of some employers.

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