

**PRESENT LAW AND BACKGROUND  
RELATING TO EMPLOYER-SPONSORED DEFINED  
BENEFIT PENSION PLANS AND THE PENSION BENEFIT  
GUARANTY CORPORATION (“PBGC”)**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on March 1, 2005

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 1, 2005, on issues relating to defined benefit pension plan funding and the Pension Benefit Guaranty Corporation (“PBGC”). This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background with respect to defined benefit plans and PBGC.

This document begins with an executive summary. Following the executive summary, Part I of this document discusses the present-law rules relating to defined benefit pension plans generally, including the rules applicable to qualified plans generally, special rules applicable to defined benefit plans. Part II describes the present-law funding and deduction rules applicable to defined benefit plans. Part III discusses the pension insurance system and the financial status of the PBGC. Part IV describes the President’s fiscal year 2006 budget proposal relating to funding and the PBGC. Part V contains data relating to qualified retirement plans. Part VI provides a discussion of policy issues relating to defined benefit plans and retirement income security, as well as the funding rules and the PBGC insurance program.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation* (“PBGC”) (JCX-03-05), February 28, 2005.

## EXECUTIVE SUMMARY

### Overview of present law relating to defined benefit pension plans

#### In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (“a qualified retirement plan”) is accorded special tax treatment under present law. Employers are allowed a current deduction for plan contributions, but employees do not include plan benefits in gross income until the benefits are distributed. Assets in such plans accumulate on a tax-free basis, and benefits are not includible in gross income until distributed to plan participants. Most qualified retirement plan contributions are not subject to employment taxes. These special tax benefits are provided to make qualified retirement plans attractive to both employers and employees and thereby enhancing retirement income security.

Qualified retirement plans are subject to regulation both under the Internal Revenue Code and the Employee Retirement Income Security Act (“ERISA”). Among other things, the rules relating to qualified plans define the rights of plan participants, impose limits on the amount of benefits that can be received, and impose nondiscrimination requirements that are designed to help ensure that a plan benefits a broad cross section of employees and not just highly compensated employees.

Qualified retirement plans are classified generally into two types: defined contribution plans and defined benefit pension plans. Under a defined contribution plan, each plan participant has his or her own individual account and the benefits are required to be based solely on the account balance, including investment gains and losses. Thus, participants bear the risk of investment loss under a defined contribution plan. In contrast, defined benefit pension plans provide benefits in accordance with a formula set forth in the plan.<sup>2</sup> In order to help ensure that assets in defined benefit pension plans are sufficient to pay promised benefits, present law imposes minimum funding rules which require employers to make a minimum level of contributions to the plan. Within limits, benefits under a defined benefit pension plan are insured by the Pension Benefit Guaranty Corporation (“PBGC”).

Defined benefit pension plans are sometimes classified as either single-employer plans or multiemployer plans. A single-employer plan is a plan maintained by one employer. A multiemployer plan is maintained pursuant to one or more collective bargaining agreements and to which more than one employer contributes (and which meets other requirements as specified by the Secretary of Labor).

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<sup>2</sup> In recent years, certain types of “hybrid” plans have developed, which have features of both a defined benefit pension plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit pension plan; however, participants’ plan benefits are defined by reference to hypothetical account balances that resemble accounts maintained for participants under a defined contribution plan.

## Funding and deduction rules applicable to defined benefit pension plans

In general, a large portion of the benefits provided under defined benefit pension plans are payable in the future, and employers make contributions to fund the benefits over many years. In order to ensure that plan assets are sufficient to pay plan benefits when due, the minimum funding rules require employers to make annual plan contributions. The amount of contributions required for a plan year is generally the amount that is actuarially determined to be needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods.

An additional contribution may be required under special funding rules (referred to as the "deficit reduction contribution" rules). These rules apply to single-employer defined benefit pension plans covering over 100 participants if the funded status of the plan is below certain levels. These additional funding requirements were enacted in 1987 and amended in 1994 to address demands on the PBGC insurance system as a result of terminations of underfunded plans.

In general, the additional contribution required under the deficit reduction contribution rules is determined by reference to the amount that would be needed to fund benefits under the plan if the plan terminated, that is, the excess of the present value of the benefit liability under the plan (referred to as "current liability") over the value of the plan's assets. Generally, any reasonable actuarial assumptions may be used in calculating required contributions under the minimum funding rules. However, in determining current liability, specific statutory interest and mortality assumptions must be used.

For plan years beginning before 2004 and after 2005, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is generally from 90 percent to 105 percent (90 percent to 120 percent for plan years beginning in 2002 and 2003, and 90 percent to 100 percent for plan years beginning in 2004 and 2005). The Pension Funding Equity Act of 2004 ("PFEA 2004") changed the interest rate used in determining a plan's current liability for plan years beginning after December 31, 2003, and before January 1, 2006, to a rate based on rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds.

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the Internal Revenue Service ("IRS").

Employer contributions to qualified retirement plans are deductible subject to certain limits.

Employers are required to provide plan participants and beneficiaries with certain information relating to the funded status of the plan.

### **The PBGC pension insurance system**

The PBGC was created in 1974 to guarantee benefits under most defined benefit plans in the event the plan is terminated with assets insufficient to pay promised benefits. The PBGC guarantees benefits under both single-employer plans and multiemployer plans. The maximum annual guaranteed benefit for single-employer plans terminating in 2005 is approximately \$45,600 per year. As of September 2004, the PBGC insured about 44.4 million participants in more than 31,200 defined benefit plans (including both multiemployer and single-employer plans).

An employer may voluntarily terminate a single-employer plan in a standard or a distress termination. In a standard termination, assets are sufficient to pay plan benefits. If assets are insufficient to pay plan benefits, the employer may terminate the plan only if the employer meets one of four criteria relating to financial distress of the employer (a “distress termination”). These criteria are designed to ensure that only employers in financial distress can terminate an underfunded plan and that other employers do not terminate plans and thereby transfer benefit liabilities to the PBGC. An underfunded plan may also be terminated by the PBGC.

The PBGC is funded by premiums paid by sponsors of covered plans, assets recovered from terminating plans, amounts recovered from employers that terminate plans, and investment earnings. The single-employer plan premium for all covered plans is \$19 per participant. In addition, plans with unfunded vested benefits are required to pay an additional premium equal to \$9 per \$1,000 of unfunded vested benefits. The additional premium reflects the concept that underfunded plans pose a greater risk to the PBGC insurance system.

Different rules apply to multiemployer plans under the PBGC insurance system. For example, a different premium structure applies, and the guarantee structure is different.

As of September 30, 2004, the PBGC reported a total deficit of \$23.5 billion, more than double the 2003 fiscal year end deficit of \$11.5 billion. The PBGC has noted that its financial state is a cause for concern. The Government Accountability Office (“GAO”) has placed the PBGC on its high risk list.

### **Summary of President’s budget proposal**

The President’s fiscal year 2006 budget contains a series of proposals designed to address underfunding in defined benefit pension plans and the financial condition of the PBGC. The budget proposal repeals the present-law funding rules (including the deficit reduction contribution rules) and replaces them with a set of rules based on funding targets. In general, the budget proposal would:

- Measure a plan’s funding shortfall by reference to the excess of the plan’s funding target (generally the present value of previously earned benefits) over the market value of the plan’s assets, and require any shortfall to be amortized over seven years;

- Require benefits earned during a year to be currently funded, by requiring an additional contribution based on the present value of the benefits;
- Determine present value using interest rates drawn from a corporate bond yield curve and other assumptions that reflect the financial status of the employer;
- Increase the amount of deductible contributions that employers may make;
- Place restrictions on benefit increases, accelerated distributions (such as lump sums), additional benefit accruals, and the funding of executive compensation in the case of underfunded plans;
- Provide more timely reporting as to a plan's funding status to the Treasury Department, the Department of Labor, the PBGC, and plan participants;
- Increase PBGC flat-rate premiums to \$30 per participant (with annual indexing) and replace PBGC variable-rate premiums with risk-based premiums;
- Freeze the level of benefits guaranteed by the PBGC if an employer enters bankruptcy proceedings and allow the PBGC to establish and perfect a lien against such an employer for required contributions that were not made; and
- Prohibit plans from providing unpredictable contingent event benefits (such as plant shutdown benefits).

### **Data relating to qualified retirement plans**

The recent U.S. Department of Labor's National Compensation Survey found that 57 percent of private sector employees had access to a qualified retirement plan and that 49 percent participated in such a plan in 2003. Among full-time employees, 67 percent had access to a plan and participation was 55 percent. Participation rates are higher among public sector employees. In the private sector, more employees have access to and participate in defined contribution plans (51-percent access rate, 40-percent participation rate) than in defined benefit pension plans (20-percent access rate, 20-percent participation rate). Some employees have access to and participate in both types of plans. There has been growth in defined contribution plan coverage, and a decline in defined benefit pension plan coverage.

### **Policy issues relating to defined benefit pension plans**

Almost all changes to the Federal pension laws require a balancing of competing policy objectives, including concerns regarding retirement income security, simplification, reduction of administrative burdens, and fiscal and tax policy. The relative decline in defined benefit pension plan coverage compared to defined contribution plan coverage has caused some to be concerned about a possible decline in retirement income security. Defined benefit pension plans are often thought to be more secure because of the minimum funding requirements and the PBGC guarantee. The reasons for decline in defined benefit plan coverage are not entirely clear, and may be the result of changing demographics, applicable legal restrictions, the desire of employers to control costs, as well as other factors.

Concerns have also been raised that the minimum funding requirements have not proved sufficient to ensure that benefits promised under defined benefit pension plans are adequately funded. To the extent that promised benefits are not funded, other PBGC premium payers may bear some of the burden. In addition, some promised benefits may be lost, which could reduce retirement income security.

The budget proposal seeks to increase the funded status of plans, reduce the risk of future underfunding, and increase the solvency of the PBGC insurance system.

Evaluating proposals relating to funding of defined benefit pension plans involves a variety of issues, including: what is an appropriate level of funding for an on-going plan; the potential burdens placed on employers and the extent to which excessive burdens may cause a further shift toward defined contribution plans; providing adequate protection to employees; and concerns of possible overfunding of plans and the potential for the use of defined benefit pension plans as a source of tax-free funding for other purposes.

## I. PRESENT-LAW RULES RELATING TO QUALIFIED RETIREMENT PLANS GENERALLY<sup>3</sup>

### A. Overview

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (“a qualified retirement plan”) is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee’s income. Qualified retirement plan assets are held in a tax-exempt trust. The special tax benefits for qualified retirement plans are provided in order to make such plans attractive to both employers and employees in order to enhance retirement income security.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions include elective deferrals to a qualified cash or deferred arrangement (a 401(k) plan) or contributions to similar arrangements made by salary reduction. Pre-tax employee contributions are generally treated the same as employer contributions for tax purposes.<sup>4</sup> Benefits under a qualified retirement plan are includible in gross income when received, except to the extent that the amount received represents a return of the employee’s after-tax contributions (i.e., basis).

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.<sup>5</sup> For example, minimum participation, coverage, and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer’s rank-and-file employees as well as highly compensated employees.<sup>6</sup> The plan qualification standards also define the rights of plan participants and beneficiaries.

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<sup>3</sup> Except as otherwise indicated, this discussion refers to rules in the Internal Revenue Code. ERISA also contains rules relating to qualified plans, including defined benefit pension plans. Some, but not all, of the ERISA provisions are described here.

<sup>4</sup> A main difference is the treatment of elective deferrals and other pre-tax employee contributions for social security tax purposes. Employer contributions to a qualified retirement plan are not includible in wages for social security tax purposes. Elective deferrals and other salary reduction contributions are subject to social security taxes.

<sup>5</sup> See sec. 401(a). In some cases, special provisions apply to qualified retirement plans maintained by State and local governments and churches. This document discusses the rules applicable to qualified retirement plans without regard to such special provisions, except as specifically mentioned.

<sup>6</sup> An employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had

Present law provides some limits on the tax benefits for qualified retirement plans. A limit of \$210,000 (for 2005) applies to the amount of a participant's compensation that may be taken into account for qualified retirement plan purposes.<sup>7</sup> Limits also apply to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.<sup>8</sup>

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, a 10-percent early withdrawal tax applies to premature distributions from qualified retirement plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans, including defined benefit pension plans, is restricted.

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

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compensation for the preceding year in excess of \$95,000 (for 2005) or (b) at the election of the employer had compensation for the preceding year in excess of \$95,000 (for 2005) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee. Sec. 414(q).

<sup>7</sup> Sec. 401(a)(17).

<sup>8</sup> Secs. 415, 402(g), and 404. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

## **B. Types of Qualified Retirement Plans; Risk of Investment Loss**

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

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

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

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

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit pension plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit pension plan; however, participants’ plan benefits are defined by reference to hypothetical account balances that resemble accounts maintained for participants under a defined contribution plan.<sup>9</sup>

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit pension plan or a defined contribution plan. In a defined benefit pension plan, plan benefits are funded with the general assets of the plan, which are invested by plan fiduciaries in accordance with plan terms. Investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits. The minimum funding rules also require periodic valuation of defined benefit pension plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.<sup>10</sup>

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<sup>9</sup> Because cash balance plans are legally defined benefit pension plans, they are guaranteed by the PBGC.

<sup>10</sup> The funding rules are discussed further in Part II.A., below.

Benefits under defined benefit pension plans are guaranteed (within limits) by the PBGC. In the event a plan terminates with assets insufficient to pay promised benefits, the PBGC pays benefits up to the maximum guaranteed amount. For plans terminating in 2005, the maximum benefit guaranteed by the PBGC for an individual retiring at age 65 generally is \$3,801.14 per month or \$45,613.68 per year.<sup>11</sup>

In a defined contribution plan, the benefit the participant is entitled to is the vested account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Defined contribution plans are not insured by the PBGC.

Qualified retirement plans, particularly defined benefit plans, are sometimes classified as either single-employer plans or multiemployer plans. A single-employer plan is a plan maintained by one employer (including controlled group members). A single-employer plan may be established pursuant to a collective bargaining agreement. A multiemployer plan is a plan that is established pursuant to a collective bargaining agreement and to which more than one employer contributes with respect to work performed for that employer that is covered by the terms of the bargaining agreement.<sup>12</sup> In the case of multiemployer plans, the bargaining agreement typically specifies a contribution required by each employer (e.g., so much per hour of work). Benefits are typically set by the plan trustees; such plans are governed by a board of trustees that consists of members representing employees and employers. Defined benefit single-employer plans and defined benefit multiemployer plans are often subject to different rules designed to reflect the varying nature of such plans.

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<sup>11</sup> The PBGC insurance program is discussed further in Part III, below.

<sup>12</sup> A multiple employer plan is to be distinguished from a multiemployer plan, which is a plan to which more than one unrelated employer contributions and which is not established pursuant to bargaining agreement. A multiple employer plan is generally treated as a single-employer plan.

## C. Common Defined Benefit Pension Plan Designs

### **In general**

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

### **Final average pay plans**

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

The formula used to determine an employee's normal retirement benefit under a final average pay plan may be a unit credit formula or a flat benefit formula.<sup>13</sup> A unit credit formula provides a specified rate of benefit for each year of service, often with a limit on the years of service taken into account. For example, a plan may provide a normal retirement benefit of 1.5 percent of final average pay for each year of service up to 30 years.<sup>14</sup> A flat benefit formula provides a normal retirement benefit of a specified percentage without regard to years of service, for example, 50 percent of final average pay.

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

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<sup>13</sup> The benefit formula describes the benefit payable under the plan at normal retirement age. However, the benefit payable to an employee in the case of termination of employment (or termination of the plan) before normal retirement age depends on the portion of the normal retirement benefit that has accrued, which is determined under the plan's accrual method, as discussed below. In addition, the amount of the accrued benefit payable to the employee depends on the extent to which the employee's right to the accrued benefit is vested.

<sup>14</sup> A unit credit formula may provide different benefit rates for different years of service (e.g., one percent of final average pay for each year of service up to 15 years and 1.25 percent of final average pay for each year of service from 16 to 30 years), subject to the accrual rules discussed below.

## **Career average pay plans**

Under a career average pay plan, an employee's normal retirement benefit consists of the sum of separate benefits determined for each year of service, based on compensation for the year of service. For example, a career average plan may provide a benefit of 1.5 percent of compensation for each year of service, with the total normal retirement benefit consisting of the sum of the separate benefits determined for each year of service. This plan design is also referred to sometimes as an "accumulation" plan. Under a career average plan, an increase in an employee's compensation does not affect the portion of the employee's normal retirement benefit attributable to previous years of service.<sup>15</sup>

## **Permitted disparity**

The permitted disparity rules allow a defined benefit pension plan to provide a higher rate of benefit with respect to compensation above a certain amount without violating the prohibition on discrimination in favor of highly compensated employees.<sup>16</sup>

The rationale for permitted disparity lies in the design of the Social Security system, under which an employer pays Social Security taxes on an employee's compensation and, as a result, is considered to provide a portion of the employee's Social Security benefits.<sup>17</sup> Because Social Security benefits are based on an employee's compensation only up to the wage base, permitted disparity allows the employer to provide higher (that is, disparate) benefits with respect to the portion of an employee's compensation that is not taken into account under the Social Security system.<sup>18</sup> The amount of disparity that is permitted under a defined benefit pension plan is based roughly on the rate at which Social Security benefits replace earnings.

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<sup>15</sup> An employer maintaining a career average plan may periodically amend the plan to provide a one-time benefit adjustment under which the employee's benefit is the greater of (1) the benefit determined under the career average formula for the employee's completed years of service, and (2) the benefit determined under a final average pay formula, based on final average compensation as of the year in which the amendment applies and the employee's completed years of service. For subsequent years (i.e., years after the year in which the amendment applies), the employee's benefit consists of the sum of (1) the benefit determined under the amendment and (2) the benefit determined under the career average formula for years of service in subsequent years.

<sup>16</sup> Secs. 401(a)(5)(C) and 401(l). The permitted disparity rules also allow a defined contribution plan to provide a higher rate of contribution with respect to compensation above a certain amount.

<sup>17</sup> The employee also pays Social Security taxes on his or her compensation at the same rate as the employer.

<sup>18</sup> Before 1989, the methods by which contributions or benefits under a qualified retirement plan were integrated with the Social Security system were provided in Rev. Rul. 71-446, 1971-2 C.B. 187. Permitted disparity is sometimes referred to as "Social Security integration," and a plan that uses permitted disparity is referred to as an "integrated" plan.

Two statutorily prescribed methods may be used for applying permitted disparity under a defined benefit pension plan.

### **Cash balance plans**

A cash balance plan is a defined benefit pension plan under which benefits are defined by reference to a hypothetical account balance maintained for each participant. An employee's hypothetical account is determined by reference to hypothetical annual allocations to the account (generally called "pay credits" or "service credits"), such as a specified percentage of the employee's compensation for the year, and hypothetical earnings on the account (generally called "interest credits").

Hypothetical earnings on the account may be determined in the form of interest on the account at a rate specified in the plan or based on a specified market index, such as the rate of interest on certain Treasury securities. Alternatively, hypothetical earnings on the account may be based on hypothetical assets held in the account, similar to earnings on an account under a defined contribution plan, which are based on the assets held in the account. In that case, the plan may permit the employee to designate the hypothetical assets on which hypothetical earnings are based or permit the employee to choose from hypothetical investment options.<sup>19</sup>

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

### **Contributory defined benefit pension plans**

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

Generally, employee contributions to a defined benefit pension plan are made on an after-tax basis.<sup>20</sup> However, under a special rule, employee contributions to a plan maintained by a

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<sup>19</sup> The assets of the cash balance plan may or may not include the assets or investments on which hypothetical earnings are based. As in the case of other defined benefit pension plans, a plan fiduciary would be responsible for making investment decisions with respect to cash balance plan assets.

<sup>20</sup> Employee elective deferrals under a qualified cash or deferred arrangement (i.e., a 401(k) plan) are made on a pre-tax basis. Under a qualified cash or deferred arrangement, benefits (other than employer matching contributions) must not be contingent on the employee's election to make deferrals. This rule prevents employee contributions to a defined benefit

State or local government employer may be “picked up” by the employer and made on a pre-tax basis.<sup>21</sup>

A defined benefit pension plan may be designed to provide for mandatory or voluntary employee contributions. In the case of mandatory contributions, an employee must make the contributions in order to be covered by the defined benefit pension plan and receive employer-provided benefits (or additional employer-provided benefits) under the plan. Depending on the plan design chosen by the employer, an employee may be given the choice (generally at the start of employment or after completing a year of service) of whether to make mandatory contributions and participate in the plan, so that employee contributions are a condition of participation in the plan. Alternatively, employee contributions may be required as a condition of employment, i.e., all employees must make contributions and participate in the plan.<sup>22</sup>

Voluntary employee contributions to a defined benefit pension plan are maintained in a separate account, to which income, expenses, gains, and losses are allocated. Benefits attributable to the employee contributions are based on the balance of the separate account. This separate account is treated as a defined contribution plan for certain purposes.

### **Cost-of-living adjustments**

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

### **Insurance contract plans**

An insurance contract plan is a defined benefit pension plan that meets the following requirements: (1) the plan is funded exclusively by the purchase of individual insurance contracts;<sup>23</sup> (2) the contracts are paid for by level annual premiums over the period beginning with each individual’s participation in the plan and ending not later than the retirement age of each individual; (3) benefits under the plan equal the benefits provided under the contracts at normal retirement age under the plan and are guaranteed by the insurance carrier; (4) premiums payable for the plan year, and all prior plan years, have been paid; (5) no rights under the

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pension plan, even if voluntary, from being treated as pre-tax elective deferrals because benefits under a contributory defined benefit pension plan depend in part on employee contributions.

<sup>21</sup> Sec. 414(k).

<sup>22</sup> Employee contributions required as a condition of employment are a common feature in governmental defined benefit pension plans.

<sup>23</sup> Group insurance contracts may be used if certain requirements are met.

contracts have been subject to a security interest at any time during the plan year; and (6) no policy loans are outstanding at any time during the plan year. Special accrual and funding rules apply to insurance contract plans.

## **D. Application of Certain Qualification Requirements to Defined Benefit Pension Plans**

### **In general**

As discussed above, many qualification rules apply to both defined contribution plans and defined benefit pension plans. In some cases, however, the rules vary based on the type of plan.

### **Accrual rules**

#### **In general**

Defined benefit pension plans must satisfy certain requirements relating to a participant's accrued benefit. In addition, a plan amendment may not have the effect of reducing a participant's accrued benefits.

In general terms, a participant's accrued benefit represents the benefit that the participant has earned under the plan as of a given time. For example, if a participant terminates employment before reaching normal retirement age, the benefit to which the participant is entitled is the accrued benefit. In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan. In the case of a defined benefit pension plan, a participant's accrued benefit is generally defined as the accrued benefit determined under the plan, expressed in the form of an annuity commencing at normal retirement age under the plan. (The annuity commencing at normal retirement age is sometimes referred to as the "normal retirement benefit.") The plan must specify the accrual method used to determine participants' accrued benefits.

Under the accrual rules, participants' accrued benefits under a defined benefit pension plan must be determined under one of three permissible accrual methods.<sup>24</sup> These rules relate to the pattern in which a participant's normal retirement benefit (i.e., the benefit payable at normal retirement age under the plan's benefit formula) accrues over the participant's years of service. The accrual rules prevent benefit accruals from being "backloaded," i.e., delayed until later years of employment, which could undercut the vesting requirements.

#### **Notice of significant reduction in rate of future accruals**

If an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy, the plan administrator must furnish a written notice concerning the amendment.<sup>25</sup> The notice must be provided in a manner calculated to be

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<sup>24</sup> Sec. 411(b). Governmental plans and most church plans are not subject to the accrual requirements.

<sup>25</sup> Sec. 4980F.

understood by the average plan participant and must include sufficient information (as defined in Treasury regulations) to allow participants to understand the effect of the amendment.

#### Prohibition on plan amendments that reduce accrued benefits

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.<sup>26</sup> This prohibition applies to benefits that have already accrued. An amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, notice is provided as discussed above.

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

#### Spousal protections; optional forms of benefit

Defined benefit pension plans are required to provide benefits in the form of a qualified joint and survivor annuity (“QJSA”) unless the participant and his or her spouse consent to another form of benefit.<sup>27</sup> A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. In the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity (“QPSA”), which must provide the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these requirements include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver.

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<sup>26</sup> Sec. 411(d)(6). This restriction is sometimes referred to as the “anticutback” rule.

<sup>27</sup> Secs. 401(a)(11) and 417. These requirements also apply to money purchase pension plans, but not to other defined contribution plans if the participant does not elect an annuity as the form of payment, the surviving spouse is the participant’s beneficiary (unless the spouse consents to the designation of another beneficiary), and, with respect to the participant, the plan has not received a transfer from a plan to which the QJSA and QPSA requirements applied (or separately accounts for the transferred assets).

In the case of a participant who is not married, accrued benefits under a defined benefit pension plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form.<sup>28</sup>

Defined benefit pension plans generally provide that a participant may choose (with the consent of his or her spouse) among other forms of benefit offered under the plan, such as a lump sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.<sup>29</sup>

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

In addition, statutory actuarial assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.<sup>30</sup> That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable at normal retirement age, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the Internal Revenue Service) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of a time that is permitted under regulations.<sup>31</sup> The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant (“stability period”) and the use of averaging.

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<sup>28</sup> Governmental plans and most church plans are not subject to this requirement. See below for a discussion of the spousal protection rules (including spousal consent) for distributions in the case of a married participant. Under an exception, if a participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant’s vested accrued benefit without the consent of the participant, if the present value of the benefit does not exceed \$5,000.

<sup>29</sup> In some cases, an optional form of benefit may be “subsidized,” i.e., more valuable on an actuarial basis than the life annuity payable to the participant.

<sup>30</sup> The statutory actuarial assumptions must be used also in determining whether the present value of the benefit exceeds \$5,000.

<sup>31</sup> The interest rate on 30-year Treasury securities is used for several purposes related to defined benefit pension plans. As discussed below, PFEA 2004 changed the interest rate used for certain purposes for plan years beginning in 2004 and 2005. PFEA 2004 did not change the interest rate used in determining the minimum value of certain optional forms of benefit, such as a lump sum.

### **Limits on benefits payable under a defined benefit pension plan**

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) \$170,000 (for 2005).<sup>32</sup> All defined benefit pension plans of the employer are aggregated for purposes of this limit. The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan. The compensation limit is reduced proportionately for individuals with less than 10 years of service.

The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning no earlier than age 62. The limit is reduced if benefits commence before age 62.<sup>33</sup> In addition, if the benefit is not in the form of a straight life annuity, the benefit generally is adjusted to an equivalent straight life annuity. In making these reductions and adjustments, the interest rate used generally must be not less than the greater of: (1) five percent; or (2) the interest rate specified in the plan. However, for purposes of adjusting a benefit in a form that is subject to the minimum value rules (including the use of the interest rate on 30-year Treasury securities), such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. However, under the Pension Funding Equity Act of 2004 (“PFEA 2004”), in the case of plan years beginning in 2004 or 2005, the interest rate used in adjusting a benefit in a form that is subject to the minimum value rules must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.

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

### **Reversions of defined benefit plan assets**

Defined benefit pension plan assets generally may not revert to an employer before termination of the plan and the satisfaction of all plan liabilities. In addition, the plan must provide for the reversion. A reversion prior to plan termination may result in disqualification of the plan and may constitute a prohibited transaction. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax.<sup>34</sup> The excise tax rate is generally 20 percent, but increases to 50 percent if the employer

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<sup>32</sup> Sec. 415(b).

<sup>33</sup> If benefits begin after age 65, the dollar limit is increased so that it is the actuarial equivalent of a benefit beginning at age 65 in the amount of the dollar limit.

<sup>34</sup> Sec. 4980.

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

If certain requirements are satisfied, a qualified transfer of excess assets of a defined benefit pension plan may be made to a separate account within the plan in order to fund retiree health benefits.<sup>35</sup> Excess assets generally means the excess, if any, of the value of the plan's assets<sup>36</sup> over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.<sup>37</sup> No transfer after December 31, 2013, is a qualified transfer.

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<sup>35</sup> Sec. 420.

<sup>36</sup> The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

<sup>37</sup> In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

## **E. Enforcement of Qualified Retirement Plan Requirements**

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

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

ERISA's requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

## II. PRESENT-LAW PENSION FUNDING AND DEDUCTION RULES

### A. Funding Rules for Defined Benefit Pension Plans

#### 1. In general

Defined benefit pension plans are subject to minimum funding requirements.<sup>38</sup> The minimum funding requirements are designed to ensure that plan assets are sufficient to pay plan benefits when due. The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No contribution is required under the minimum funding rules in excess of the full funding limit (described below).

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to a defined benefit pension plan to satisfy the minimum funding requirements for a plan year. In addition, contributions in excess of the amount needed to satisfy the minimum funding requirements may be deductible, subject to certain limits.

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

#### 2. General minimum funding rules

##### **Funding standard account**

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

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<sup>38</sup> Sec. 412. The minimum funding rules do not apply to governmental plans or to church plans, except church plans with respect to which an election has been made to have various requirements, including the funding requirements, apply to the plan.

“accumulated funding deficiency.” For example, if the balance of charges to the funding standard account of a plan for a year would be \$200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

If credits to the funding standard account exceed charges, a “credit balance” results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

## **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 that would not be met by future normal costs, future employee contributions, or plan assets. 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 specified number of years, depending on the source.

### Acceptable methods

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

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefit liabilities under the plan, as described below).

### Valuation of plan assets

For funding purposes, the actuarial value of plan assets is generally used, rather than fair market value. The actuarial value of plan assets is the value determined under an actuarial valuation method that takes into account fair market value and meets certain other requirements. The use of an actuarial valuation method allows appreciation or depreciation in the market value of plan assets to be recognized gradually over several plan years.

## **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), net experience losses, and changes in actuarial assumptions, are spread (or amortized) over a period of years.<sup>39</sup>

### 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.

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<sup>39</sup> The amortization periods described herein apply to single-employer plans. Longer amortization periods generally apply to multiemployer plans.

### Past service liability

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

For example, assume that a plan uses the calendar year as the plan year. Further assume that during 1987 the plan was amended to increase benefits and that the net result of plan amendments for 1987 was an increase in the past service liability under the plan of \$500,000. In addition, the plan's actuary uses an interest rate of eight percent in determining plan costs. The 30-year schedule requires that \$44,414 be charged to the funding standard account each year to amortize the past service liability.<sup>40</sup> Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of \$44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of \$44,414 would be required for each of the 30 years to avoid an accumulated funding deficiency unless the plan becomes fully funded.

### Gains and losses from changes in assumptions

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

### Experience gains and losses

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

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<sup>40</sup> This amount (\$44,414) when paid annually over a 30-year period, has a present value of \$500,000 when discounted using an eight percent interest rate.

gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized over a five-year period, resulting in credits or charges to the funding standard account.

#### Waived funding deficiencies

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

#### Reasonableness of actuarial assumptions

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

### **3. Special rules for multiemployer plans<sup>41</sup>**

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

Subject to certain requirements, a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC.<sup>42</sup> In order for accrued benefits to be reduced, at least six months before the beginning of the plan year in which the amendment is adopted, notice must be given

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<sup>41</sup> Secs. 418-418D. A multiemployer plan is a plan: (1) maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer; (2) to which more than one employer is required to contribute; and (3) that satisfies other requirements prescribed by the Secretary of Labor.

<sup>42</sup> The rules applicable to qualified retirement plans generally prohibit a plan amendment that reduces participants’ accrued benefits.

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

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

#### **4. Additional contribution requirements for certain plans<sup>43</sup>**

##### **In general**

Additional contributions may be required under special funding rules (referred to as the “deficit reduction contribution” rules) for certain single-employer defined benefit pension plans.<sup>44</sup> These additional funding requirements were enacted in 1987 and amended in 1994 to address demands on the PBGC insurance system as a result of terminations of underfunded plans. In general, the additional contributions required under the special funding rules to some extent reflect the amount that would be needed to fund benefits under the plan if the plan terminated.

Under the special rules, an additional contribution to a plan is generally required if the plan’s funded current liability percentage is less than 90 percent.<sup>45</sup> A plan’s “funded current liability percentage” is the actuarial value of plan assets as a percentage of the plan’s current liability. In general, a plan’s current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present value basis.

The amount of the additional required contribution is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution, over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The deficit reduction contribution is the sum of: (1) the “unfunded old liability amount;” (2) the “unfunded new liability amount;” and (3) the expected increase in

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<sup>43</sup> Sec. 412(l).

<sup>44</sup> Single-employer plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

<sup>45</sup> Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan’s funded current liability percentage for the plan year is at least 80 percent, and (2) the plan’s funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

current liability due to benefits accruing during the plan year.<sup>46</sup> The amount of the additional contribution cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

### **Unfunded old liability amount**

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

### **Unfunded new liability amount**

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

If the funded current liability percentage is less than 60 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. Thus, for example, if the plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).

### **Unpredictable contingent event benefits**

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit

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<sup>46</sup> If the Secretary of the Treasury prescribes a new mortality table to be used in determining current liability, as described below, the deficit reduction contribution may include an additional amount.

is not considered until the event has occurred. 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.

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

### **Required interest rate**

#### **In general**

A specific interest rate must be used in determining a plan's current liability for purposes of the special funding rule.<sup>47</sup> For plan years beginning before 2004, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average<sup>48</sup> of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.<sup>49</sup> The permissible range is generally from 90 percent to 105 percent

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<sup>47</sup> A mortality table prescribed by the Secretary of the Treasury must also be used in determining current liability. Under Rev. Rul. 95-28, 1995-1 C.B. 74, use of the 1983 Group Annuity Mortality Table is currently required. The Secretary of the Treasury is required to periodically review and update the required table to reflect the actuarial experience of pension plans and projected trends in such experience. The IRS and the Treasury Department have announced that they are undertaking a review of the applicable mortality table and have requested comments on related issues, such as how mortality trends should be reflected. Notice 2003-62, 2003-38 I.R.B. 576; Announcement 2000-7, 2000-1 C.B. 586.

<sup>48</sup> The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period. Notice 88-73, 1988-2 C.B. 383.

<sup>49</sup> As discussed elsewhere in this document, the interest rate on 30-year Treasury securities is also used for other purposes, including determination of the minimum value of certain optional forms of benefits (e.g., lump sums), application of the dollar limit on benefits to certain forms of benefit, and determination of variable-rate PBGC premiums.

(120 percent for plan years beginning in 2002 and 2003).<sup>50</sup> The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.<sup>51</sup> The IRS publishes the applicable rate on a monthly basis. The Department of the Treasury does not currently issue 30-year Treasury securities. As of March 2002, the IRS published the average yield on the 30-year Treasury bond maturing in February 2031 as a substitute.

#### Temporary interest rate change under PFEA 2004

PFEA 2004<sup>52</sup> changes the interest rate used in determining a plan's current liability for plan years beginning after December 31, 2003, and before January 1, 2006. For these years, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. The interest rate is determined by the Secretary of the Treasury on the basis of two or more indices that are selected periodically by the Secretary and are in the top three quality levels available. The IRS publishes the applicable rate on a monthly basis.

### **5. Full funding limitation**

No contributions are required under the minimum funding rules in excess of the full funding limitation. The full funding limitation is the excess, if any, of: (1) the accrued liability under the plan (including normal cost); over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.<sup>53</sup> However, the full funding limitation may not be less

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<sup>50</sup> If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

<sup>51</sup> Under Notice 90-11, 1990-1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

<sup>52</sup> In addition, under PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules may be elected for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

<sup>53</sup> For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (170 percent for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on

than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

## **6. Timing of plan contributions**

In general, plan contributions required to satisfy the funding rules must be made within 8-1/2 months after the end of the plan year. If the contribution is made by such date, the contribution is treated as if it were made on the last day of the plan year.

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

## **7. Required contributions in the case of a liquidity shortfall**

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

If a quarterly installment is less than the amount required to cover the plan's liquidity shortfall, limits apply to the benefits that can be paid from a plan during the period of underpayment. During that period, the plan may not make: (a) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) in the case of a participant or beneficiary whose annuity starting date occurs during the period; (b) any payment for the purchase of an irrevocable commitment from an

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170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

insurer to pay benefits (e.g., an annuity contract); or (c) any other payment specified by the Secretary of the Treasury by regulations.

## **8. Funding waivers**

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.<sup>54</sup> A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than three waivers may be granted within any period of 15 consecutive plan years (five of any 15 years in the case of multiemployer plan consecutive plan years).

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

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.

## **9. Failure to make required contributions**

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.<sup>55</sup> The excise tax is 10 percent of the amount of the funding deficiency (five percent in the case of a multiemployer plan). In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period.

If the total of the contributions the employer fails to make (plus interest) exceeds \$1 million and the plan's funded current liability percentage is less than 100 percent, a lien arises in favor of the plan with respect to all property of the employer and the members of the employer's controlled group. The amount of the lien is the total amount of the missed contributions (plus interest).

## **10. Security for certain plan amendments**

If a plan amendment increasing current liability is adopted and the plan's funded current liability percentage is less than 60 percent (taking into account the effect of the amendment, but

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<sup>54</sup> Sec. 412(d).

<sup>55</sup> Sec. 4971. An excise tax applies also if a quarterly installment is less than the amount required to cover the plan's liquidity shortfall.

disregarding any unamortized unfunded old liability amount), the employer and members of the employer's controlled group must provide security in favor of the plan. The amount of security required is the excess of: (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) \$10 million.<sup>56</sup> The amendment is not effective until the security is provided.

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

### **11. Prohibition on benefit increases during bankruptcy**

Subject to certain exceptions, if an employer maintaining a plan (other than a multiemployer plan) is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.

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<sup>56</sup> Sec. 401(a)(29).

## **B. Deduction Rules for Defined Benefit Pension Plans**

### **In general**

Employer contributions to qualified retirement plans are deductible subject to certain limits.<sup>57</sup> In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year. In order to encourage plan sponsors to fully fund defined benefit pension plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability.<sup>58</sup> In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

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

### **Excise tax on nondeductible contributions**

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.<sup>59</sup>

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<sup>57</sup> Sec. 404.

<sup>58</sup> Employers may elect not to apply the PFEA 2004 interest rate change in determining current liability for this purpose.

<sup>59</sup> Sec. 4972.

## **C. Reporting and Disclosure Requirements Related to Funding**

### **In general**

Defined benefit pension plans are required to provide certain information related to funding and the funded status of the plan to the IRS, the Department of Labor, and the PBGC. In addition, certain information and notices must be provided to participants.

Failure to comply with these requirements generally may result in the imposition of monetary penalties. In certain cases, such as a willful violation of an ERISA requirement, criminal penalties may apply.

### **Annual actuarial report**

The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan.<sup>60</sup> The annual report with respect to a plan year generally must be filed by the end of the seventh month after the end of the plan year unless an extension applies. Information provided in the annual report is generally available to the public.<sup>61</sup>

In the case of a defined benefit pension plan, the annual report must include an actuarial report.<sup>62</sup> The report must include, for example, information as to the value of plan assets, the plan's accrued and current liabilities, expected disbursements from the plan for the year, plan contributions, the plan's actuarial cost method and actuarial assumptions, and amortization bases established in the year. The report must be signed by an actuary enrolled to practice before the IRS, Department of Labor and the PBGC.

The plan administrator must automatically provide participants with a summary of the annual report within two months after the due date of the annual report (i.e., by the end of the ninth month after the end of the plan year unless an extension applies). In addition, on written request, a participant must be provided with a copy of the full annual report.

### **Information required by the PBGC**

In some cases, certain financial information with respect to the members of a controlled group and actuarial information with respect to plans maintained by members of the controlled group must be reported annually to the PBGC.<sup>63</sup> This reporting is required if: (1) the aggregate

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<sup>60</sup> Sec. 6058; ERISA secs. 103-104. The annual report is made as a single submission to the Department of Labor on the Form 5500, which forwards copies to the Internal Revenue Service and the PBGC.

<sup>61</sup> Sec. 6104; ERISA sec. 106.

<sup>62</sup> Sec. 6059; ERISA sec. 103(d). The actuarial report is provided on Schedule B of the Form 5500.

<sup>63</sup> ERISA sec. 4010.

unfunded vested benefits (determined using the interest rate used in determining variable-rate premiums) as of the end of the preceding plan year under all plans maintained by members of the controlled group exceed \$50 million (disregarding plans with no unfunded vested benefits); (2) the conditions for imposition of a lien (i.e., required contributions totaling more than \$1 million have not been made) have occurred with respect to an underfunded plan maintained by a member of the controlled group; or (3) minimum funding waivers in excess of \$1 million have been granted with respect to a plan maintained by any member of the controlled group and any portion of the waived amount is still outstanding.

Plan sponsors and plan administrators are required to notify the PBGC as to the occurrence of certain events (“reportable” events) unless the PBGC has waived the notice requirement.<sup>64</sup> These events include, for example, failure to meet the minimum funding requirements and inability to pay benefits under a plan when due.

Information provided to the PBGC in accordance with these requirements is not available to the public.

### **Participant notice of underfunding**

Plan administrators of plans required to pay variable rate premiums to the PBGC are required to provide notice to plan participants and beneficiaries of the plan’s funding status and the limits on the PBGC’s guarantee should the plan terminate while underfunded.<sup>65</sup>

### **Notice of funding waiver request**

As a condition of receiving a funding waiver, an employer must provide notice to participants that a waiver is being requested, including a description of the extent to which benefits guaranteed by the PBGC and all benefit liabilities are funded.<sup>66</sup> A waiver may not be granted if notice is not provided.

### **Notice of failure to make required contributions**

If an employer fails to make a required contribution to a plan within 60 days of the due date and fails to obtain a funding waiver, the employer must notify participants of the failure.<sup>67</sup> In addition, an employer must notify the PBGC if the total contributions the employer has failed to make to a plan (plus interest) exceeds \$1 million and the plan’s funded current liability percentage is less than 100 percent.<sup>68</sup>

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<sup>64</sup> ERISA sec. 4043.

<sup>65</sup> ERISA sec. 4011.

<sup>66</sup> Sec. 412(f)(4)(A); ERISA sec. 303(e).

<sup>67</sup> ERISA sec. 101(d).

<sup>68</sup> Sec. 412(n)(4)(A); ERISA sec. 302(f)(4)(A).

### III. THE PBGC PENSION INSURANCE PROGRAM

#### A. General Rules Relating to Plan Terminations

##### In general

The minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation (“PBGC”), a corporation within the Department of Labor, was created in 1974 under ERISA to provide an insurance program for benefits under most defined benefit plans maintained by private employers.<sup>69</sup> According to the PBGC, as of September 30, 2004, about 44.4 million participants in more than 31,200 defined benefit plans were insured under its programs. Of these, about 34.6 million participants are covered by approximately 29,600 single-employer pension plans, and about 9.8 million are covered by approximately 1,600 multiemployer plans.<sup>70</sup>

##### Termination of single-employer defined benefit plans

###### In general

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination.<sup>71</sup> The participants and the PBGC must be provided notice of the intent to terminate. The PBGC may also involuntarily terminate a plan (that is, the termination is not voluntary on the part of the employer).

###### Standard terminations

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.<sup>72</sup> Generally, benefit liabilities equal all benefits earned to date by plan participants, including vested and nonvested benefits (which automatically become vested at the time of termination), and including certain early retirement supplements and subsidies.<sup>73</sup> Benefit liabilities may also include certain contingent benefits (for example, early retirement subsidies).

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<sup>69</sup> The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

<sup>70</sup> Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2004 (Nov. 15, 2004).

<sup>71</sup> ERISA sec. 4041.

<sup>72</sup> *Id.*

<sup>73</sup> ERISA sec. 4001(a)(16).

If assets are sufficient to cover benefit liabilities (and other termination requirements, such as notice to employees, have not been violated), the plan distributes benefits to participants. The plan provides for the benefit payments it owes by purchasing annuity contracts from an insurance company, or otherwise providing for the payment of benefits, for example, by providing the benefits in lump-sum distributions.

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

### **Distress terminations and involuntary terminations by the PBGC**

#### Distress terminations

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

- The contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings;
- The contributing sponsor and every member of the sponsor’s controlled group is being reorganized in bankruptcy or similar State proceeding;
- The PBGC determines that termination is necessary to allow the employer to pay its debts when due; or
- The PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer’s work force.<sup>74</sup>

These requirements, added by the Single Employer Pension Plan Amendments Act of 1986<sup>75</sup> and modified by the Pension Protection Act of 1987<sup>76</sup> and the Retirement Protection Act of 1994,<sup>77</sup> are designed to ensure that the liabilities of an underfunded plan remain the responsibility of the employer, rather than of the PBGC, unless the employer meets strict standards of financial need indicating genuine inability to continue funding the plan.

#### Involuntary terminations by the PBGC

The PBGC may institute proceedings to terminate a plan if it determines that the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than \$10,000 (other than by

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<sup>74</sup> ERISA sec. 4041.

<sup>75</sup> Pub. L. No. 99-272 (1986).

<sup>76</sup> Pub. L. No. 100-203 (1987).

<sup>77</sup> Pub. L. No. 103-465 (1994).

reason of death) while the plan has unfunded nonforfeitable benefits, or may reasonably be expected to increase PBGC's long-run loss unreasonably. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

#### Asset allocation

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates.<sup>78</sup> Plan assets available to pay for benefits under a terminating plan include all plan assets remaining after subtracting all liabilities (other than liabilities for future benefit payments), paid or payable from plan assets under the provisions of the plan. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories.<sup>79</sup> If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next lower priority category. This process is repeated until all benefits in the priority category are provided or until all available plan assets have been allocated.<sup>80</sup>

#### Payment of benefits

When a plan terminates in a distress termination and assets are sufficient to pay guaranteed benefits, the plan pays out benefits. When an underfunded plan terminates in a distress or involuntary termination and benefits are insufficient to pay guaranteed benefits, the plan effectively goes into PBGC receivership.<sup>81</sup> The PBGC becomes the trustee of the plan, takes control of any plan assets, and assumes responsibility for liabilities under the plan. The PBGC makes payments for benefit liabilities promised under the plan with assets received from two sources: assets in the plan before termination, and assets recovered from the employer. The balance, if any, of guaranteed benefits owed to beneficiaries is paid from the PBGC's revolving funds.

#### Employer liability to the PBGC

Additionally, following a distress or involuntary termination, the plan's contributing sponsor and every member of that sponsor's controlled group is liable to the PBGC for the excess of the value of the plan's liabilities as of the date of plan termination over the fair market value of the plan's assets on the date of termination.<sup>82</sup> The liability is joint and several, meaning that each member of the controlled group can be held responsible for the entire liability. Generally, the obligation is payable in cash or negotiable securities to the PBGC on the date of

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<sup>78</sup> ERISA sec. 4044(a).

<sup>79</sup> *Id.*

<sup>80</sup> The asset allocation rules also apply in standard terminations.

<sup>81</sup> ERISA sec. 4042(b).

<sup>82</sup> ERISA sec. 4062.

termination. Failure to pay this amount upon demand by the PBGC may trigger a lien on the property of the contributing employer's controlled group for up to 30 percent of its net worth. Obligations in excess of this amount are to be paid on commercially reasonable terms acceptable to the PBGC.

### **Restoration of a terminated plan**

ERISA authorizes the PBGC to restore a terminated pension plan to its sponsoring employer if the PBGC determines that restoration is appropriate and consistent with its duties under ERISA.<sup>83</sup> The PBGC has restored pension plans only once, in the case of an employer that set up new plans (called "follow-on plans") to provide employees with the benefits under the original plans that were not guaranteed by the PBGC.<sup>84</sup> After the restoration of those plans, Treasury regulations were issued to establish a special funding method (the "restoration method") to apply to restored plans.<sup>85</sup>

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

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

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<sup>83</sup> ERISA sec. 4047.

<sup>84</sup> See *Pension Benefit Guaranty Corporation v. LTV Corporation*, 496 U.S. 633 (1990). The opinion notes that the PBGC views follow-on plans as an abuse of the PBGC insurance program, under which the PBGC is responsible for benefits under a terminated plan. The establishment of a follow-up plan for benefits not covered by the terminated plan means that, in effect, the insurance program is being used to subsidize an ongoing retirement program.

<sup>85</sup> Treas. Reg. sec. 1.412(c)(1)-3.

## B. Multiemployer Plans

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. Accordingly, a multiemployer plan need not be terminated to qualify for PBGC financial assistance, but must be found to be insolvent. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year. If it appears that available resources will not support the payment of benefits at the guaranteed level, the PBGC will provide the additional resources needed as a loan. The PBGC may provide loans to the plan year after year. If the plan recovers from insolvency, it must begin repaying loans on reasonable terms in accordance with regulations.

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the withdrawal liability.<sup>86</sup> In general, "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.<sup>87</sup> A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.<sup>88</sup> When an employer withdraws from a multiemployer plan, the plan sponsor is required to determine the amount of the employer's withdrawal liability, notify the employer of the amount of the withdrawal liability, and collect the amount of the withdrawal liability from the employer.<sup>89</sup> The employer's withdrawal liability generally is based on the extent of the plan's unfunded vested benefits for the plan years preceding the withdrawal.<sup>90</sup>

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<sup>86</sup> ERISA sec. 4201.

<sup>87</sup> ERISA sec. 4203.

<sup>88</sup> ERISA sec. 4205.

<sup>89</sup> ERISA sec. 4202.

<sup>90</sup> ERISA secs. 4209 and 4211.

## C. Guaranteed Benefits

### In general

#### Single-employer plans

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump-sum benefits payable to encourage early retirement) is guaranteed.<sup>91</sup>

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

For plans terminating in 2005, the maximum guaranteed benefit for an individual retiring at age 65 is \$3,698.86 per month or \$44,386.32 per year.<sup>92</sup> The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.<sup>93</sup>

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<sup>91</sup> ERISA sec. 4022(b) and (c).

<sup>92</sup> The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

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

<sup>93</sup> The phase in does not apply if the benefit is less than \$20 per month.

### Multiemployer plans

The PBGC guarantees benefits under a multiemployer plan of the same type as those guaranteed under a single-employer plan, but a different guarantee ceiling applies. The limit for multiemployer plans is the sum of 100 percent of the first \$11 of monthly benefits and 75 percent of the next \$33 of monthly benefits for each year of service.<sup>94</sup>

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<sup>94</sup> ERISA sec. 4022A(c).

## D. Sources of PBGC Funding

### In general

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

### Single-employer plans

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

As originally enacted in ERISA, covered plans were annually required to pay a flat premium to the PBGC of \$1 per plan participant. The annual flat-rate per-participant premium has been increased several times since the enactment of ERISA and is currently \$19 per participant.<sup>95</sup>

Under the Pension Protection Act, additional PBGC premiums are imposed on certain plans for plan years beginning after December 31, 1987.<sup>96</sup> In the case of an underfunded plan, additional premiums are required in the amount of \$9 per \$1,000 of unfunded vested benefits (the amount which would be the unfunded current liability if only vested benefits were taken into account and if benefits were valued at the variable premium interest rate). These premiums are referred to as “variable rate premiums.”<sup>97</sup> No variable-rate premium is imposed for a year if contributions to the plan for the prior year were at least equal to the full funding limit for that year. In determining the amount of unfunded vested benefits, the interest rate used is generally 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins (100 percent of the interest rate on 30-year Treasury securities for plan years beginning in 2002 and 2003). Under PFEA 2004, in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long-term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

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<sup>95</sup> ERISA sec. 4006(a).

<sup>96</sup> Pub. L. No. 100-203 (1987).

<sup>97</sup> If variable rate premiums are required to be paid, the plan administrator generally must provide notice to plan participants of the plan’s funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.

### Multiemployer plans

The PBGC premium rate for multiemployer plans is \$2.60 per participant per plan year.<sup>98</sup> This flat-rate per-participant premium is the only premium paid to the PBGC for multiemployer plans.

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<sup>98</sup> ERISA sec. 4006(a)(3).

## **E. Financial Status of the PBGC**

### **In general**

As of September 30, 2004, the PBGC reported a total deficit of \$23.5 billion, the bulk of which is attributable to the single-employer program.<sup>99</sup> At the end of the 2003 fiscal year, a \$11.5 billion deficit was reported (the bulk of which is attributable to the single-employer program). According to the PBGC, the financial state of both the single-employer and multiemployer programs is cause for concern.

The single-employer program reported a loss of \$12.067 billion for fiscal year 2004, resulting in a deficit of \$23.305 billion. The fiscal year 2004 loss was the largest loss in the history of the single-employer program. In the previous fiscal year, the program reported a loss of \$7.6 billion and deficit of \$11.238 billion. The PBGC was in a deficit for the first 21 years of its existence. From 1996 through 2001, a surplus was reported. Since 2002, the PBGC has been in a deficit position.

The multiemployer plan program reported net income of \$25 million, resulting in a deficit of \$236 million for fiscal year 2004. For fiscal year 2003, the multiemployer program reported a loss of \$419 million, resulting in a deficit of \$261 million. This was the multiemployer program's first deficit in more than 20 years and its largest deficit ever.

As of September 30, 2004, the value of the PBGC's assets in the single-employer and multiemployer programs was approximately \$40 billion. This is an increase from approximately \$35 billion as of September 30, 2003. According to the PBGC, the assets in the single-employer program and multiemployer program provide sufficient liquidity to pay benefits for a number of years, but neither program has the assets to satisfy the long-term obligations to plan participants. The PBGC had an overall investment gain for fiscal year 2004 of eight percent compared with a gain of 10.3 percent in 2003. Investment income of \$3.25 billion was reported in 2004, compared with investment income of \$3.39 billion in 2003.

The PBGC paid over \$3 billion in benefits in fiscal year 2004, which was a new record for annual benefit payments. The previous record was \$2.489 billion of benefits paid in 2003. At the end of 2004, the PBGC was responsible for the pensions of more than one million people.

Table 1 and Table 2, below, summarize the PBGC's financial position and net income for fiscal year 2003 and fiscal year 2004.

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<sup>99</sup> Information on the financial status of the PBGC for fiscal year 2004 was obtained from the Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2004 (Nov. 15, 2004). Information on the financial status of the PBGC for fiscal year 2003 was obtained from the Pension Benefit Guaranty Corporation 2003 Annual Report (Jan. 15, 2004).

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

	<b>Fiscal year 2003</b>	<b>Fiscal year 2004</b>
Single-employer program surplus/(deficit) <sup>100</sup>	(\$11,238)	(\$23,305)
Multiemployer program surplus/(deficit)	(\$261)	(\$236)
Combined surplus/(deficit)	(\$11,499)	(\$23,541)

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

	<b>Fiscal Year 2003</b>	<b>Fiscal Year 2004</b>
Single-employer program income/(loss)	(\$7,600 )	(\$12,067)
Multiemployer program income/(loss)	(\$419)	\$25
Combined income/(loss)	(\$8,019)	(\$12,042)

**Single-employer program**

The single-employer program insures the pensions of 34.6 million workers and retirees in 29,600 plans. As of September 30, 2004, the single-employer program reported a deficit of \$23.3 billion, compared with an \$11.2 billion deficit at the end of fiscal year 2003.

The single-employer program loss for fiscal year 2004 of \$12.067 billion was an increase from the loss of \$7.6 billion for fiscal year 2003. The \$4.467 billion loss increase was primarily due to an increase of \$9.33 billion in losses from completed and probable terminations and actuarial adjustments of \$1.417 billion due to a one-time change in mortality assumptions. The PBGC changed the mortality table to reflect its most current actual experience over the period 1994 through 2001. At the end of fiscal year 2004, the total liability for guaranteed benefits exceeded \$62 billion compared to \$45 billion at the end of fiscal year 2003.

In fiscal year 2004, the PBGC had the largest losses from completed and probable terminations in its history. The loss from completed and probable terminations increased from a loss of \$5.377 billion in 2003 to a loss of \$14.707 billion in 2004. The loss was primarily due to plans newly classified as probable as well as the termination of underfunded pension plans.

The PBGC's estimate of total underfunding in plans sponsored by companies with credit ratings below investment grade and classified as reasonably possible of termination as of

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<sup>100</sup> The program's surplus is its assets less liabilities.

September 30, 2004, was \$96 billion. The reasonably possible exposure as of September 30, 2003, was calculated at \$82 billion compared to \$35 billion for fiscal year 2002. For 2004, the exposure is concentrated in the manufacturing, transportation, communication and utilities, and wholesale and retail sectors. As of September 30, 2004, total underfunding in single-employer plans is estimated to exceed \$450 billion. As of the end of 2003, underfunding in the single-employer plan was estimated to exceed \$350 billion.

As of September 30, 2004, the single-employer program reported \$38.993 billion in assets to cover \$62.298 billion in liabilities. As of September 30, 2003, the single-employer program reported \$34.016 billion in assets to cover \$45.254 billion in liabilities.

The Government Accountability Office (GAO) has placed the PBGC single-employer program on its high-risk list.<sup>101</sup> The program was added to the high-risk list in 2003. The PBGC was originally designated high risk in 1990 when the GAO began reporting on government operations that it identified as high risk and was removed from the list in 1995. According to GAO, “the program remains threatened by structural weaknesses in pension funding rules, the program’s premium structure, and the potential for large bankruptcies among sponsors in weak industries that have underfunded plans.”<sup>102</sup> GAO believes that comprehensive reform will be needed to stabilize the finances of the single-employer program.

Table 3, below, summarizes the financial position of the single-employer program.

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

	<b>Fiscal Year 2003</b>	<b>Fiscal Year 2004</b>
Single-employer program assets	\$34,016	\$38,993
Single-employer program liabilities	\$45,254	\$62,298
Single-employer program surplus/(deficit)	(\$11,238)	(\$23,305)

<sup>101</sup> *High Risk Series, An Update*. GAO-05-207. Washington, D.C.: January 2005. Since 1990, GAO periodically reports on government operations that it has designated as high risk. GAO’s audits and evaluations identify Federal programs and operations that are high risk due to their greater vulnerabilities to fraud, waste, abuse and mismanagement. GAO also identifies high-risk areas to focus on the need for broad-based changes to address major economy, efficiency, or effectiveness challenges.

<sup>102</sup> *Id.*

## **Multiemployer program**

The multiemployer program covers 9.8 million participants in more than 1,600 plans. For fiscal year 2004, the multiemployer program reported a gain of \$25 million, compared with a financial loss of \$419 million for fiscal year 2003. For fiscal year 2004, the multiemployer program reported a deficit of \$236 million, with total assets of \$1.070 billion and liabilities of \$1.306 billion. For fiscal year 2003, the multiemployer program reported a deficit of \$261 million, with total assets of \$1 billion and liabilities totaling \$1.261 billion. The fiscal year 2003 deficit was the largest deficit ever and the first in 20 years for the multiemployer program. It was largely due to a decline in interest rates and the recording of new probable losses for plans projected to become insolvent and require financial assistance from the PBGC to pay benefits.

Total underfunding of multiemployer plans is estimated to exceed \$150 billion as of September 30, 2004, and was estimated to be \$100 billion at the end of 2003. The PBGC estimates that, as of September 30, 2004, it is reasonably possible that multiemployer plans may require future financial assistance in the amount of \$108 million.

Table 4, below, summarizes the financial position of the multiemployer program.

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

	<b>Fiscal year 2003</b>	<b>Fiscal year 2004</b>
Multiemployer program assets	\$1,000	\$1,070
Multiemployer program liabilities	\$1,261	\$1,306
Multiemployer program surplus/(deficit)	(\$261)	(\$236)

#### IV. SUMMARY OF THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL RELATING TO FUNDING AND THE PBGC<sup>103</sup>

##### A. Proposals Relating to Funding and Deductions

###### In general

In the case of single-employer plans, the proposal repeals the present-law funding rules and provides a new set of rules for determining minimum required contributions.<sup>104</sup> Under the proposal, the minimum required contribution to a defined benefit pension plan for a plan year is generally the sum of two amounts: (1) the payments<sup>105</sup> required to amortize over seven years the amount by which the plan's funding target exceeds the market value of the plan assets; and (2) the plan's normal cost for the plan year.

The plan's funding target is generally the present value of benefits earned as of the beginning of the plan year. The plan's normal cost is generally the present value of benefits expected to be earned during the plan year. Under the proposal, present value is determined using interest rates drawn from a corporate bond yield curve and a mortality table prescribed by the Secretary of Treasury.<sup>106</sup> However, other assumptions used to determine the plan's funding target and normal cost depend on the financial status of the employer.

The proposal also changes the limit on deductible contributions, requires increased reporting as to the funding status of plans, and applies certain restrictions with respect to underfunded plans.

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<sup>103</sup> The proposals described herein are contained in the President's fiscal year 2006 budget proposal, as submitted to the Congress on February 7, 2005. See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Analytical Perspectives* (H. Doc. 109-2, Vol. III), at 103-104 and 291. Additional information about the Administration's proposals is available in Department of Treasury, *General Explanation of the Administration's Fiscal Year 2006 Revenue Proposals*, February 2005, at 85-108 (available at [www.treas.gov/offices/tax-policy/library/bluebk05.pdf](http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf)); and on the Department of Labor's website at [www.dol.gov/ebsa/pensionreform.html](http://www.dol.gov/ebsa/pensionreform.html).

<sup>104</sup> The proposal does not change the funding rules applicable to multiemployer plans.

<sup>105</sup> As discussed below, different payments may be required with respect to amortization bases established for different years.

<sup>106</sup> The President's fiscal year 2006 budget also includes a proposal to use interest rates drawn from a corporate bond yield curve in determining benefits subject to the minimum value rules, such as lump sums.

## **Determination of funding target and normal cost**

### **Funding target and normal cost**

In general, under the proposal, the funding target and normal cost for a plan are the plan's "ongoing liability" and "ongoing" normal cost. However, in the case of a plan maintained by a financially weak plan sponsor, the funding target and normal cost for the plan are the plan's "at-risk liability" and "at-risk" normal cost. Different actuarial assumptions apply in determining ongoing or at-risk liability and normal cost.

A plan's ongoing liability for a plan year is the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year. Ongoing liability is determined using a corporate bond yield curve (as described below) and a mortality table prescribed by the Secretary of Treasury. The proposal generally does not require other specified assumptions to be used in determining ongoing liability, provided that other assumptions used must be actuarially reasonable based on experience for the plan. In addition, a reasonable assumption as to future benefits that will be paid in the form of a lump sum must be used. Ongoing normal cost for a plan year is the present value of future payments expected to be made to provide benefits that accrue during the plan year. Ongoing normal cost is determined using the same actuarial assumptions used to determine ongoing liability.

A plan's at-risk liability for a plan year is also the present value of future payments expected to be made from the plan to provide benefits earned as of the beginning of the plan year, determined using a corporate bond yield curve and a mortality table prescribed by the Secretary of Treasury. However, certain specified additional assumptions must be used in determining at-risk liability. Specifically, at-risk liability must be determined by assuming that participants retire at the earliest retirement age permitted under the plan and that benefits are paid in the form of a lump sum (or in whatever form permitted under the plan results in the largest present value). In addition, at-risk liability includes an additional amount (referred to as a loading factor) of \$700 per plan participant plus four percent of the amount of the plan's at-risk liability, as determined without regard to the loading factor. At-risk normal cost is the present value of future payments expected to be made to provide benefits that accrue during the plan year, determined using the same actuarial assumptions used to determine at-risk liability, including a loading factor of four percent of the amount of the plan's at-risk normal cost, as determined without regard to the loading factor. However, at-risk normal cost does not include a loading factor of \$700 per plan participant.

### **Financially weak status**

Financially weak status applies if, as of the plan's valuation date, any employer maintaining the plan has senior unsecured debt that is rated as not being investment grade by each nationally recognized rating organization that has issued a credit rating for the debt. Alternatively, if no plan sponsor has senior unsecured debt that is rated, financially weak status applies if all of the nationally recognized statistical rating organizations that have made an issuer credit rating for any employer maintaining the plan have rated the employer as less than investment grade. However, financially weak status does not apply if any significant member of

the employer's controlled group has senior unsecured debt that is rated as investment grade, regardless of whether that controlled group member is a plan sponsor of the plan.

Special rules apply in the case of employers that have neither unsecured debt that is rated nor an issuer credit rating. Such an employer is automatically treated as not being financially weak, provided that the total number of participants covered by defined benefit pension plans maintained by the employer is less than 500. If the total number of participants covered by defined benefit pension plans maintained by the employer is 500 or more, whether the plan sponsor is financially weak is determined in accordance with standards to be established under regulations.

#### Use of interest rate yield curve

The funding target and normal cost applicable to a plan are determined using a series of interest rates drawn from a yield curve for high-quality zero-coupon corporate bonds ("corporate bond yield curve"). That is, the interest rates used to determine the present value of payments expected to be made under the plan reflect the interest rates for corporate bonds maturing at the times when the payments are expected to be made. The corporate bond yield curve is to be issued monthly by the Secretary of Treasury, based on the interest rates (averaged over 90 business days) for high-quality corporate bonds (i.e., bonds rated AA) with varying maturities.

A special method of calculating a plan's funding target and normal cost applies for plan years beginning in 2006 and 2007, based on a weighted average of: (1) the plan's funding target or normal cost determined using a corporate bond yield curve; and (2) the plan's funding target or normal cost determined using an interest rate within a permissible range (from 90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. For plan years beginning in 2006, a weighting factor of 2/3 applies to the amount determined using the long-term corporate bond rate, and a weighting factor of 1/3 applies to the amount determined using a corporate bond yield curve. For plan years beginning in 2007, the weighting factors are reversed.

#### Valuation date

Under the proposal, a plan's funding target (i.e., ongoing or at-risk liability, as applicable), the plan's normal cost (i.e., ongoing or at-risk normal cost, as applicable), and the market value of the plan's assets are determined as of the plan's valuation date for the plan year. If a plan has more than 100 participants, the plan's valuation date must be the first day of the plan year. If the plan has 100 or fewer participants, the plan's valuation date may be any day in the plan year, but certain adjustments must be made in determining the plan's funding target and the market value of plan assets.

#### **Minimum required contributions**

Under the proposal, the minimum contribution required to be made to a plan for a plan year is generally the sum of: (1) the payments required (as described below) to amortize the amount by which the plan's funding target for the plan year (i.e., ongoing or at-risk liability, as

applicable) exceeds the market value of plan assets; and (2) the plan's normal cost for the plan year (i.e., ongoing or at-risk normal cost, as applicable).

Under the proposal, if the plan's funding target for the plan year beginning in 2006 exceeds the market value of the plan's assets for that year, an initial amortization base is established in the amount of the shortfall. Payments are then required in the amount needed to amortize the initial amortization base over seven years, starting with the plan year beginning in 2006. The required amortization payments are determined on a level basis, using the applicable interest rates under the corporate bond yield curve.

For each subsequent plan year, the plan's funding target is compared with the sum of: (1) the market value of the plan's assets; and (2) the present value of any future required amortization payments (determined using the applicable interest rates under the corporate bond yield curve). If the plan's funding target exceeds that sum, an additional amortization base is established in the amount of the shortfall, and payments are required in the amount needed to amortize the additional amortization base over seven years. If, for a plan year, the sum of the market value of plan assets and the present value of any future required amortization payments exceeds the plan's funding target, no additional amortization base is established for that plan year.

All required amortization payments generally must be made over the applicable seven-year period. That is, contributions in excess of minimum required contributions and better than expected return on plan investments do not create credits that can be used to offset future required contributions. However, if, for a plan year, the market value of the plan's assets is at least equal to the plan's funding target, any existing amortization bases are eliminated and no amortization payments are required. Thus, making contributions in excess of minimum required contributions increases the possibility that the plan will be sufficiently funded in the future that contributions will not be required.

If no amortization payments are required for a plan year, the minimum required contribution for the plan year is based solely on the plan's normal cost. Specifically, the minimum required contribution is the plan's normal cost, reduced by the amount (if any) by which the market value of the plan's assets exceeds the plan's funding target. Accordingly, no contribution is required for a plan year if the market value of the plan's assets is at least equal to the sum of the plan's funding target and the plan's normal cost for the plan year.

### **Timing rules for contributions**

As under present law, contributions required for a plan year generally must be made within 8-1/2 months after the end of the plan year. Under the proposal, quarterly contributions are required to be made during a plan year if, for the preceding plan year, the plan's funding target exceeded the market value of the plan's assets, determined as of the valuation date for the preceding plan year.

### **Maximum deductible contributions**

Under the proposal, the limit on deductible contributions for a year is generally the amount by which the sum of the plan's funding target, the plan's normal cost, and the plan's

cushion amount exceeds the market value of the plan's assets. The plan's cushion amount is the sum of: (1) 30 percent of the plan's funding target; and (2) the amount by which the plan's funding target and normal cost would increase if they were determined by taking into account expected future salary or benefit increases for participants. In addition, the limit on deductible contributions for a year is not less than the sum of: (1) the plan's at-risk normal cost for the year; and (2) the amount by which the plan's at-risk liability for the year exceeds the market value of the plan's assets. For this purpose, at-risk liability and at-risk normal cost are used regardless of the financial status of the plan sponsor.

### **Changes in required reporting**

Under the proposal, a plan's ongoing liability, at-risk liability (regardless of whether the employer is financially weak), and the market value of plan assets are required to be reported in the actuarial report filed with the plan's annual report. In addition, if quarterly contributions are required with respect to a plan covering more than 100 participants, the actuarial report for the plan is due no later than the 15th day of the second month following the end of the plan year (e.g., February 15 if the plan year is the calendar year).

Under the proposal, the summary annual report provided to participants must include information on the funding status of the plan for each of the last three years, based on the ratio of the value of the plan's assets to the plan's funding target. Information on the employer's financial status and on the PBGC benefit guaranteed must also be provided. The proposal replaces the requirement of notice to participants of underfunding<sup>107</sup> with the summary annual report disclosure. The summary annual report must be provided to participants no later than 15 days after the due date for filing the plan's annual report. A plan administrator that fails to provide a summary annual report on a timely basis is subject to a penalty.<sup>108</sup>

### **Restrictions related to underfunded plans**

#### Restrictions on benefit increases

Under the proposal, the present-law rule prohibiting amendments that increase benefits while the employer is in bankruptcy continues to apply. The present-law rule requiring security for amendments that increase benefits and result in a funded current liability percentage of less than 60 percent is replaced with a new rule. Under the new rule, if a plan's funding percentage (i.e., the market value of the plan's assets as a percentage of the plan's funding target, determined as of the plan's valuation date) is below certain levels, any amendment increasing benefits is prohibited unless the employer makes certain contributions in addition to the otherwise required minimum contribution. However, these restrictions do not apply for the first five years after a plan is established.

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<sup>107</sup> ERISA sec. 4011.

<sup>108</sup> Under present law, a plan administrator that fails to provide a summary annual report to a participant may be liable to the participant for a civil penalty of up to \$100 a day from the date of the failure.

### Restrictions on distributions and accruals

Under the proposal, the restrictions on distributions during a period of a liquidity shortfall continue to apply (i.e., only annuity payments are permitted). Such restrictions also apply if: (1) the plan's funding percentage does not exceed 60 percent; or (2) in the case of a financially weak employer, the plan's funding percentage does not exceed 80 percent. In addition, no benefit accruals are permitted if: (1) the employer is financially weak and the plan's funding percentage does not exceed 80 percent; or (2) the employer is in bankruptcy and the plan's funding percentage is less than 100 percent.

### Prohibition on funding nonqualified deferred compensation

The proposal amends ERISA to prohibit a financially weak employer maintaining a severely underfunded plan from funding of nonqualified deferred compensation for top executives of the employer's controlled group (or any former employee who was a top executive at the time of termination of employment). The proposal also prohibits any funding of executive compensation that occurs within six months before or after the termination of a plan, the assets of which are less than the amount needed to provide all benefits due under the plan. For this purpose, funding includes any arrangement that limits immediate access to resources of the employer by the employer or by creditors. The prohibition on funding nonqualified deferred compensation does not apply for the first five years after a plan is established.

An employer maintaining a severely underfunded or terminating plan must notify fiduciaries of the plan if any prohibited funding of a nonqualified deferred compensation arrangement occurs. The proposal provides: (1) plan fiduciaries with the right to examine the employer's books and records to ascertain whether the restriction has been complied with and employer has met its obligation in this regard; and (2) the plan with a cause of action under ERISA against any top executive whose nonqualified deferred compensation arrangement is funded during a period when funding is prohibited.

### Other rules

Under the proposal, certain presumptions as to the funding status of a plan (depending on the funding status of the plan for the preceding year) apply for purposes of determining whether restrictions apply with respect to a plan until the plan's actuary certifies the funding status of the plan for the current year. In addition, if the employer maintaining the plan enters bankruptcy, the plan's funding percentage is presumed to be less than the plan's funding target. As a result, no benefit accruals are permitted until the plan actuary certifies that the plan's funding percentage is at least 100 percent.

If a restriction applies with respect to a plan (including a plan maintained by an employer that enters bankruptcy), the plan administrator must provide notice of the restriction to affected participants within a reasonable time after the date the restriction applies (or before the restriction applies, to the extent provided by the Secretary of Labor). Notice must also be provided within a reasonable period of time after the date the restriction ceases to apply.

If restrictions on distributions and accruals apply with respect to a plan, distributions and accruals may resume in a subsequent plan year only by a plan amendment. Such an amendment

may be adopted at any time after the first valuation date as of which the plan's funding percentage exceeds the applicable threshold. However, the restrictions on amendments causing benefits to be fail to be more than 80 percent of target apply. In addition, benefits provided under the amendment are subject to the phase-in of the PBGC guarantee of benefit increases.

### **Elimination of floor-offset grandfather**

The proposal repeals the present-law exception to the limitation on investments of plan assets in qualifying employer securities or qualifying employer real property in the case of a defined contribution plan that is part of a floor-offset arrangement<sup>109</sup> established before December 18, 1987. Under the proposal, such investments must be reduced to no more than 10 percent of the total assets of the defined benefit pension plan and related defined contribution plan over a period of seven years.

### **Prohibition on unpredictable contingent event benefits**

Under the proposal, plans are not permitted to provide unpredictable contingent event benefits and such benefits must be eliminated with respect to events that occur after the effective date. The proposal allows the elimination of such benefits without violation of the anti-cutback rules. The PBGC benefit guarantee does not apply to unpredictable contingent event benefits that become payable as a result of an event that occurs after February 1, 2005, and before the effective date of the proposal.

### **Effective date**

The proposals are generally effective for plan years beginning after December 31, 2005. The proposals relating to restrictions on underfunded plans and the prohibition on unpredictable contingent event benefits are generally effective for plan years beginning after December 31, 2006. Special effective dates apply in the case of collectively bargained plans.

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<sup>109</sup> A floor-offset arrangement is an arrangement under which benefits payable under a defined benefit pension plan are reduced by benefits under a defined contribution plan.

## **B. Proposals Relating to the PBGC**

### **PBGC premiums**

Under the proposal, the flat-rate premium is increased to \$30 per participant for 2006 and is adjusted annually thereafter based on the Average Wage Index (i.e., the index of the rate of growth of average wages, which is used to adjust the contributions and earnings base under the Social Security Act).

The proposal replaces variable-rate premiums with “risk-based” premiums. Risk-based premiums apply with respect to a plan if the market value of the plan’s assets is less than the funding target applicable to the plan (i.e., ongoing liability or at-risk liability, depending on the financial status of the employer). Premiums are determined by reference to the dollar amount by which the plan’s funding target exceeds the market value of plan assets, at a rate determined by the PBGC in order to meet the PBGC’s expected revenue needs.

The proposal is effective for plan years beginning on or after January 1, 2006.

### **Freeze of PBGC guarantee during bankruptcy proceedings**

Under the proposal, if a plan terminates while the employer maintaining the plan is in bankruptcy proceedings, or during the two years after the employer emerges from bankruptcy proceedings, the amount of benefits guaranteed by the PBGC is determined as of the date the employer entered bankruptcy proceedings. That is, the amount of benefits guaranteed by the PBGC is based on plan provisions, participants’ compensation and service, and the guarantee limitations as of that date. The proposal also requires the plan administrator to provide participants with a notice explaining the guarantee limits and the possibility of receiving benefits not guaranteed if the plan terminates in the case of bankruptcy.

The proposal is effective with respect to bankruptcy or similar proceedings that are initiated on or after the date that is 30 days after the date of enactment of the proposal.

### **Perfection of PBGC liens in bankruptcy**

The proposal amends Federal bankruptcy laws to allow the creation and perfection of a lien in favor of the PBGC with respect to required plan contributions that an employer has failed to make, regardless of whether the lien is perfected before the employer enters bankruptcy proceedings.

The proposal is effective with respect to Federal bankruptcy proceedings that are initiated on or after the date that is 30 days after the date of enactment of the proposal.

### **Unpredictable contingent event benefits**

Under the proposal, unpredictable contingent event benefits, with respect to which the event has not yet occurred, are not guaranteed by the PBGC. Thus, whether such benefits are paid after termination of a plan depends on the assets in the terminating plan.

The proposal is effective with respect to benefits that become payable as a result of a plant shutdown or similar contingent event that occurs after February 1, 2005.

## V. DATA RELATING TO QUALIFIED RETIREMENT PLANS

### A. General Data on Qualified Retirement Plan Participation

The recent U.S. Department of Labor's National Compensation Survey found that 57 percent of private sector employees had access to employer-sponsored qualified retirement plans and 49 percent of private sector employees participated in employer-sponsored qualified retirement plans in 2003. The survey found that, among full-time employees, 67 percent had access to a plan and participation was 55 percent.<sup>110</sup> Participation rates are higher among public sector employees. The Bureau of Labor Statistics' 1998 survey of State and local government employees found that 98 percent of full-time employees and 62 percent of part-time employees participated in employer-sponsored retirement plans.<sup>111</sup> Eighty-eight percent of Federal government employees participated in an employer-sponsored retirement plan in 1997.

The National Compensation Survey also documented that, in 2003, full-time employees in the private sector have substantially greater access to an employer-sponsored defined contribution plan than do part-time employees. The survey revealed that, in the private sector, more employees have access to and participate in defined contribution plans (51-percent access rate, 40-percent participation rate) than in defined benefit plans (20-percent access rate, 20-percent participation rate). Some employees have access to and participate in both.

Access and participation in employer-sponsored qualified retirement plans varies with occupation and firm size. Figure 1 and Figure 2, below, document some of the variability of employee participation in employer-sponsored qualified retirement plans by occupation and firm size. Figure 3 compares access and participation rates for full- and part-time employees.

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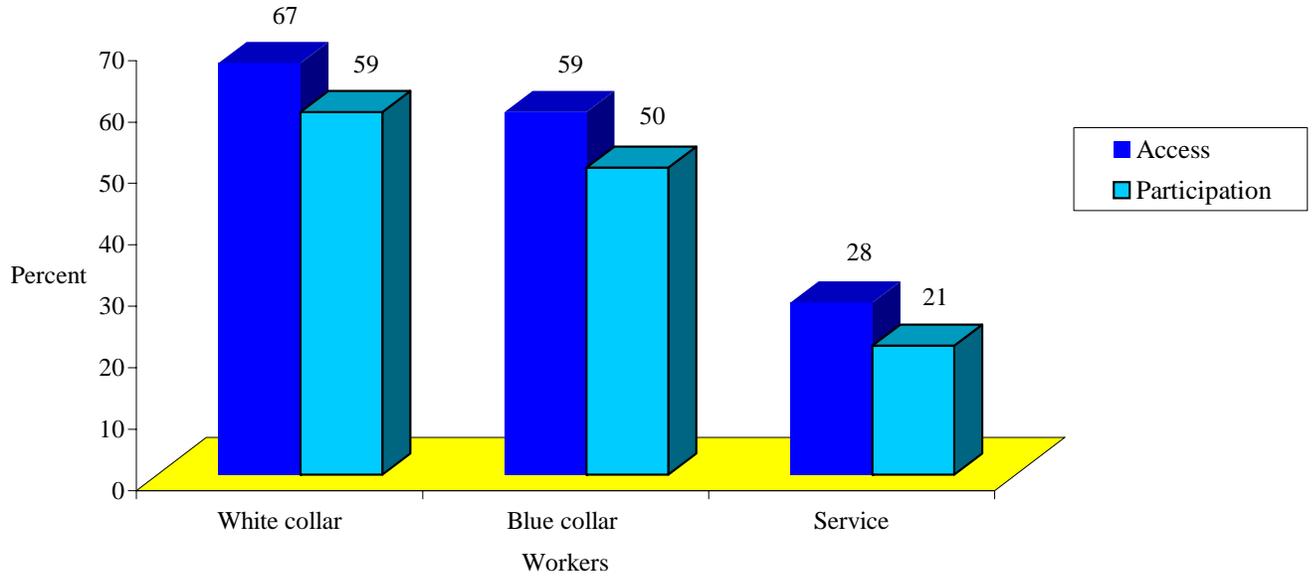
<sup>110</sup> U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey, "Employee Benefits in Private Industry in the United States, March 2003," April 2004, and U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Private Industry, 2003," September 17, 2003.

The survey defines an employee to have "access" to a plan if it is available for the employee's use. An employee is recorded as "participating" if they have paid required contributions and fulfilled any applicable service requirements. Employees in noncontributory plans are counted as participating regardless of whether they have fulfilled their service requirements.

<sup>111</sup> U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in State and Local Governments, 1998," December 2000.

**Figure 1**

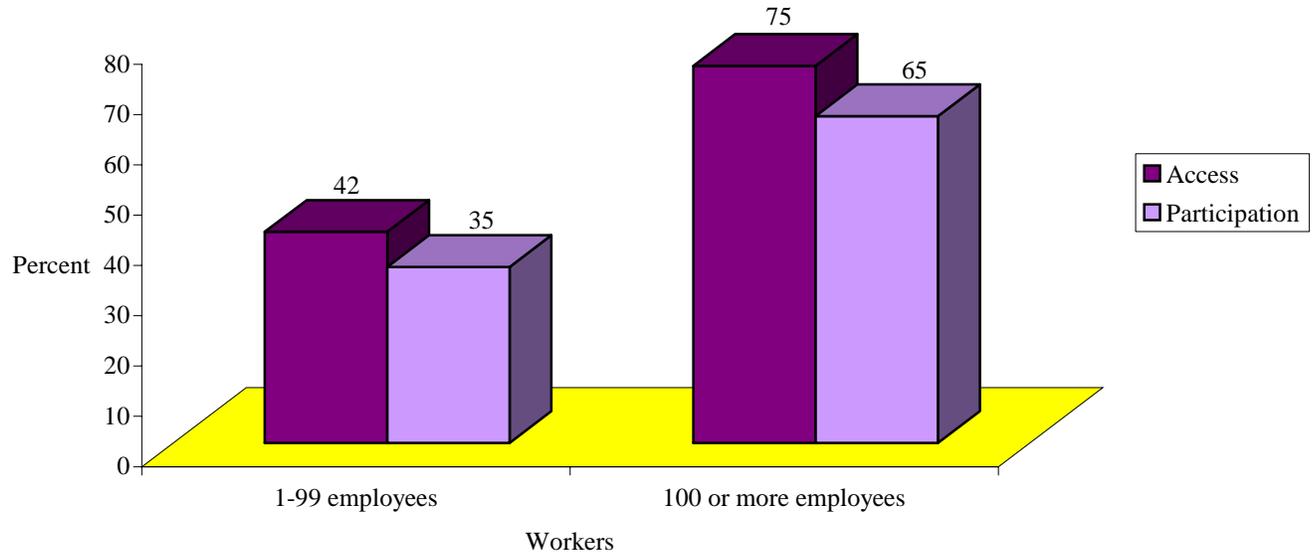
**Access and Participation Rates of Private Sector Employees  
by Occupation, 2003**



Source: Bureau of Labor Statistics, National Compensation Survey, 2003.

Figure 2

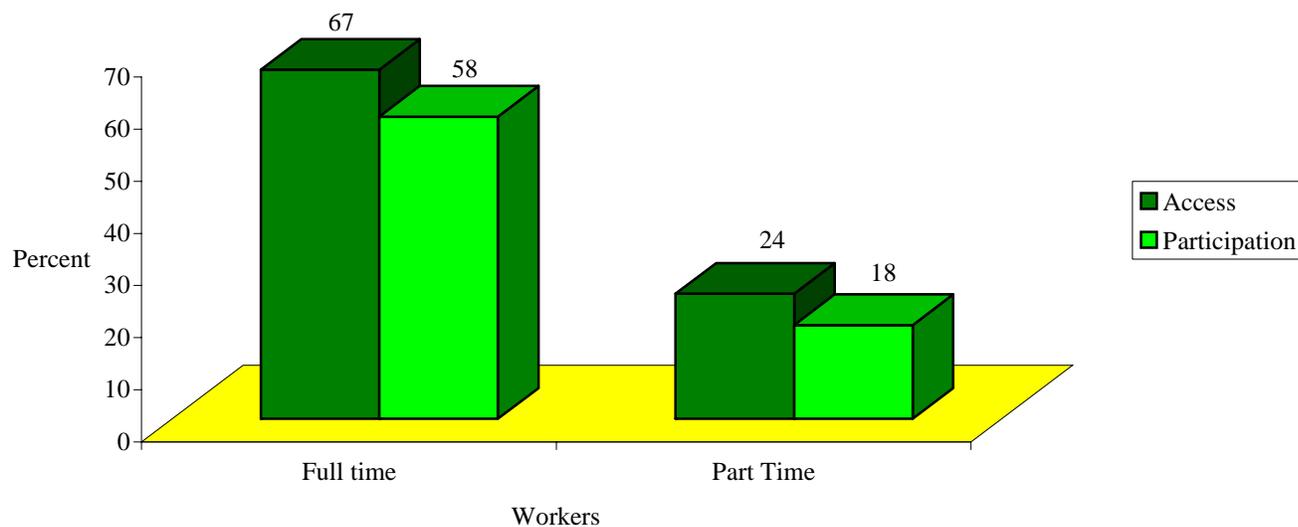
**Access and Participation Rates of Private Sector Employees  
by Firm Size, 2003**



Source: Bureau of Labor Statistics, National Compensation Survey, 2003.

Figure 3

**Access and Participation Rates of Full-Time and Part-Time Private Sector Employees, 2003**

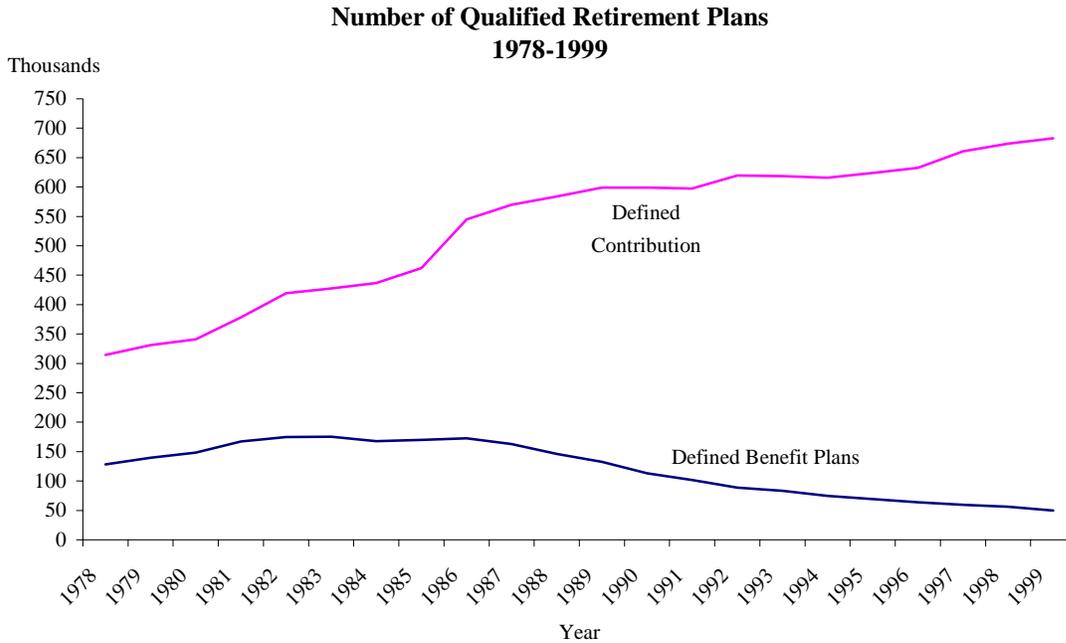


Source: Bureau of Labor Statistics, National Compensation Survey, 2003.

## B. Data Comparing Participation in Defined Benefit Pension Plans and Defined Contribution Plans

In 1999, about 58 percent of workers in the private sector who participated in a qualified retirement plan were covered only by a defined contribution plan, 28 percent were covered by both a defined benefit plan and a defined contribution plan, and 13 percent were covered only by a defined benefit plan. Figure 3, Figure 4, and Figure 5, below, document the growth of private sector defined contribution plans relative to defined benefit plans. The data presented in these figures are based on Form 5500 filings. As illustrated in the figures below, the number of defined contribution plans and active participants in those plans have increased over time, while the number of defined benefit plans and the number of active participants in those plans have decreased. As Figure 5 indicates, the number of plan participants only in defined contribution plans grew steadily over the period 1979 to 1999. The number of participants in both defined contribution and defined benefit plans grew from 1979 through 1985 and then stagnated for a decade. The number of participants only in defined benefit plans fell in almost every year. The growth in defined contribution plans and active participants has occurred almost wholly in plans containing a qualified cash or deferred arrangement (commonly referred to as “401(k) plans”).<sup>112</sup>

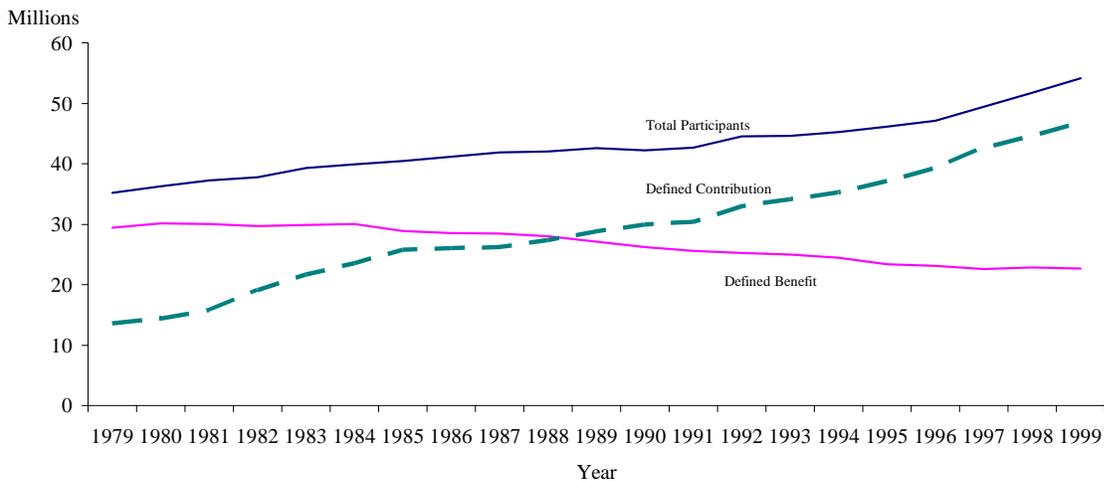
**Figure 4**



<sup>112</sup> Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* (JCX-9-02), February 25, 2002, documents the growth of 401(k) plans and the concurrent decline in defined benefit plans and other defined contribution plans.

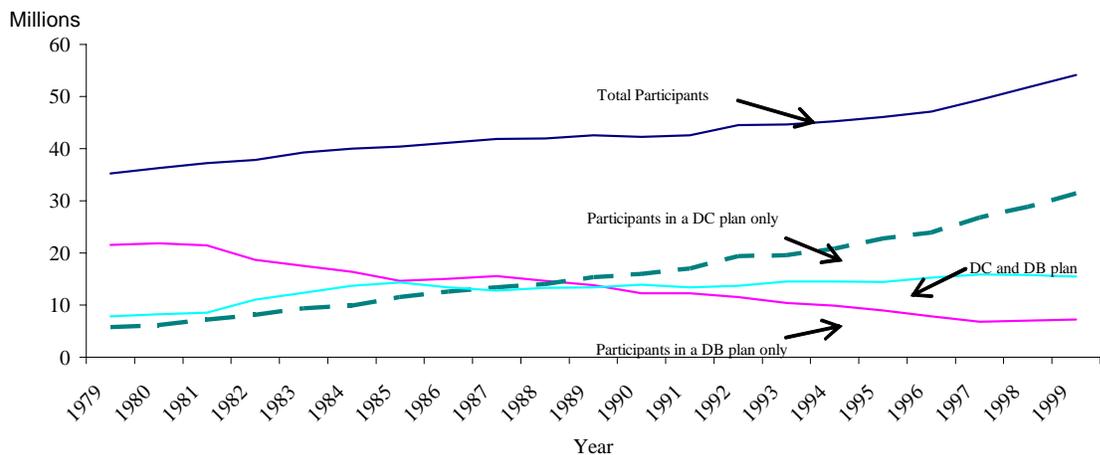
**Figure 5**

**Qualified Retirement Plan Active Participants  
By Type of Plan,  
1979-1999**



**Figure 6**

**Qualified Retirement Plan Active Participants  
By Type of Plan,  
1979-1999**



The data for Figures 4 through 6 are from the United States Department of Labor, Employee Benefits Security Administration's Abstract of 1999 Form 5500 Annual Reports. Private Pension Plan Bulletin, No. 12, Summer 2004, Washington D.C.

### C. Data on Qualified Retirement Plan Assets

Figure 4 and Figure 5, above, document the increase in the number of defined contribution plans and the number of participants in defined contribution plans, as well as the concomitant decline in the number of defined benefit plans and the number of participants in defined benefit plans. However, the assets held in both types of plans increased substantially from 1985 through 2003. As of December 31, 1985, data from the Federal Reserve Board of Governors showed that defined benefit plans held assets valued at \$795.4 billion and defined contribution plans held assets valued at \$430.9 billion. As of December 31, 2003, these data showed that defined benefit plans held assets valued at \$1.8 trillion and defined contribution plans held assets valued at \$2.4 trillion.

Despite the declining number of plans and participants, the market value of assets held in defined benefit plans increased every year throughout the period 1985 through 1999 except in 1990. The value of assets in defined benefit plans has declined in each of 2000, 2001, and 2002. The market value of assets held in defined contribution plans increased in every year throughout the period 1985 through 1999. As with defined benefit plans, the value of assets in defined contribution plans declined in each of 2000, 2001, and 2002. Figure 7, below, shows the increase in market value of assets held in defined benefit plans. Figure 8, below, shows the more rapid increase in the market value of assets held in defined contribution plans that would be expected with the growth in number of participants in such plans.<sup>113</sup> In addition to retirement assets held in defined benefit and defined contribution plans, between 1985 and 2003 the market value of assets held by individuals in individual retirement arrangements and Keogh plans (i.e., qualified retirement plans for self-employed individuals), increased from \$241 billion at the end of 1985 to \$3.0 trillion at the end of 2003.<sup>114</sup>

As noted above, a high percentage of employees of State and local governments participate in employer-sponsored pension plans. These plans have significant holdings of financial assets. As of the end of 2003, State and local government pension plans held \$2.3 trillion in financial assets. Figure 9, below, documents that the value of assets in State and local

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<sup>113</sup> Data for Figure 7 and Figure 8 are from the Board of Governors, United States Federal Reserve System, *Flow of Funds*, June 10, 2004. The data reported on defined contribution plans include balances in the Federal Retirement System Thrift Savings Plan. Data for defined contribution plans also include assets of State and local government plans that are funded solely by employee contributions. The data reported in Figure 7 and Figure 8 do not include the value of direct holdings of real estate by private pension plans and thereby understate the total value of private pension fund assets. The Federal Reserve reported this understatement to be less than \$100 billion as of the end of 2001.

<sup>114</sup> Board of Governors, United States Federal Reserve System, *Flow of Funds*, June 10, 2004. Like the value of assets in defined contribution plans, the value of assets in IRAs increased every year from 1988 through 1999, and declined in 2000 and 2001.

plans has more than doubled over the last decade. As was the experience for private plans, the value of assets in State and local government pension plans declined in 2001 and 2002.<sup>115</sup>

The Federal government also maintains retirement fund assets, many of which are nonmarketable Federal government bonds held by the retirement funds.

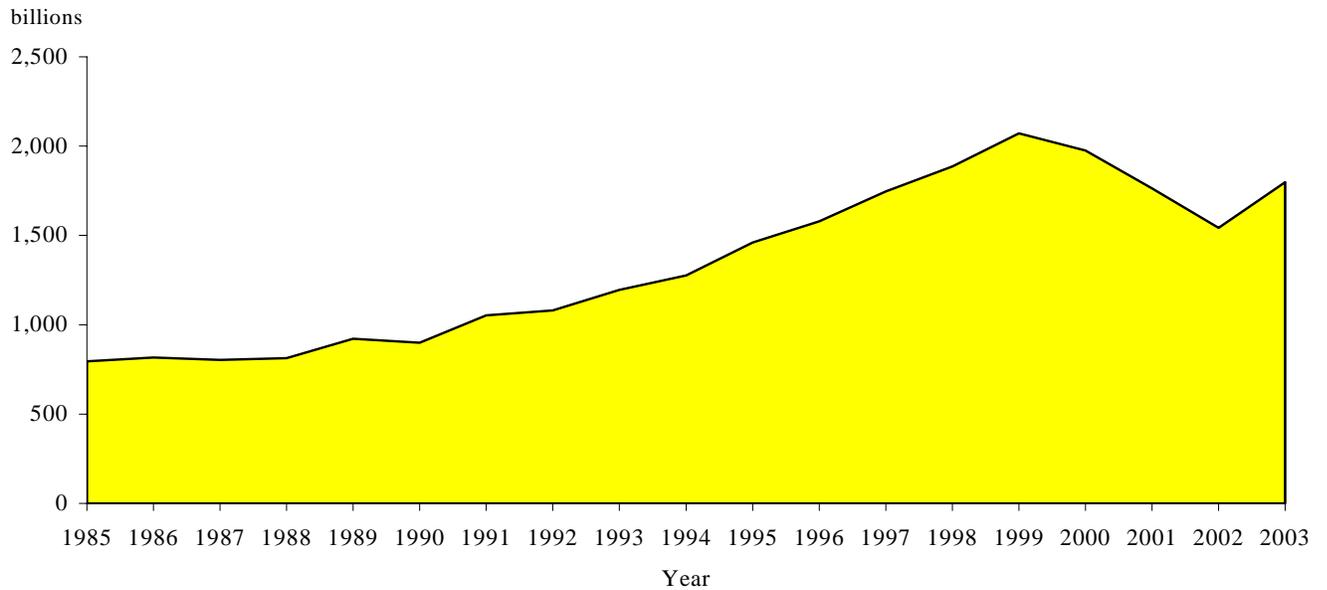
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<sup>115</sup> Data for Figure 8 from Board of Governors, United States Federal Reserve System, *Flow of Funds*, June 10, 2004. These data exclude the assets of those State and local government plans that are funded solely by employee contributions. Assets of such plans are included in the data on defined contribution plans in Figure 8. As with the data reported above for private pension plans, the data in Figure 9 do not include direct holding of real estate. The Federal Reserve estimated that direct holdings of real estate by State and local pension plans to be less than \$50 billion in value at the close of 2002. Board of Governors, United States Federal Reserve System, *Flow of Funds*, March 6, 2003.

Figure 10 reports on the growth of assets held by Federal retirement plans other than the Federal Thrift Savings Plan.<sup>116</sup>

**Figure 7**

**Market Value of Assets Held In Defined Benefit Plans,  
1985-2003**



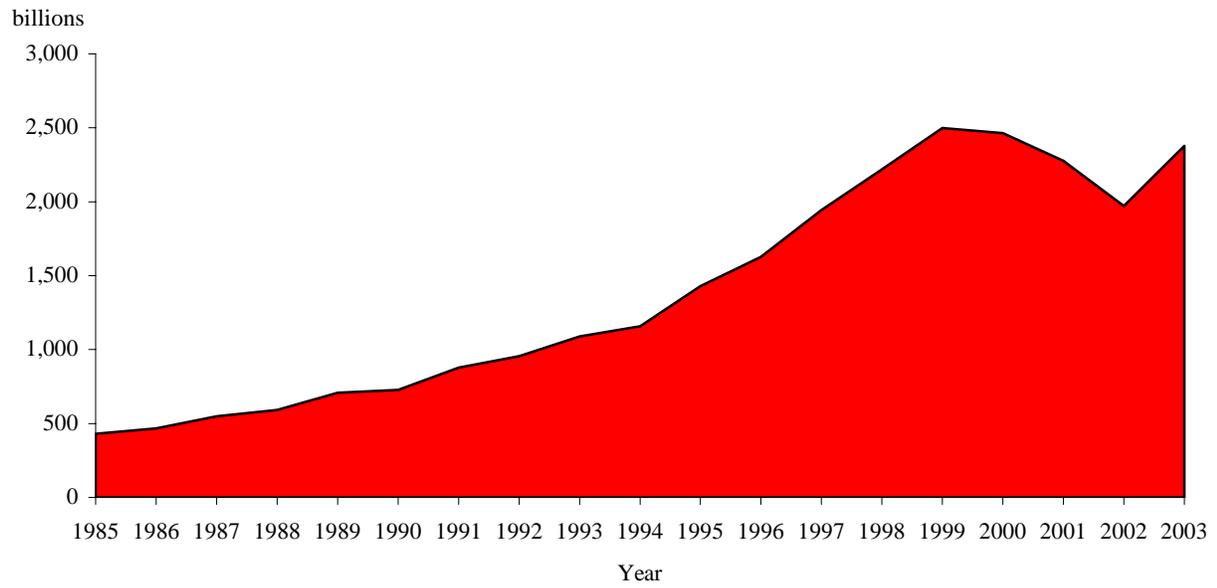
Source: Board of Governors, Federal Reserve, *Flow of Funds*.

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<sup>116</sup> Board of Governors, United States Federal Reserve System, *Flow of Funds*, June 10, 2004, and audited financial statements of the Thrift Savings Plan. Assets in the Thrift Savings Plan are included in the data on defined contribution plans Figure 8. At the close of 2003, the value of assets in the Thrift Savings Plan totaled \$129 billion.

**Figure 8**

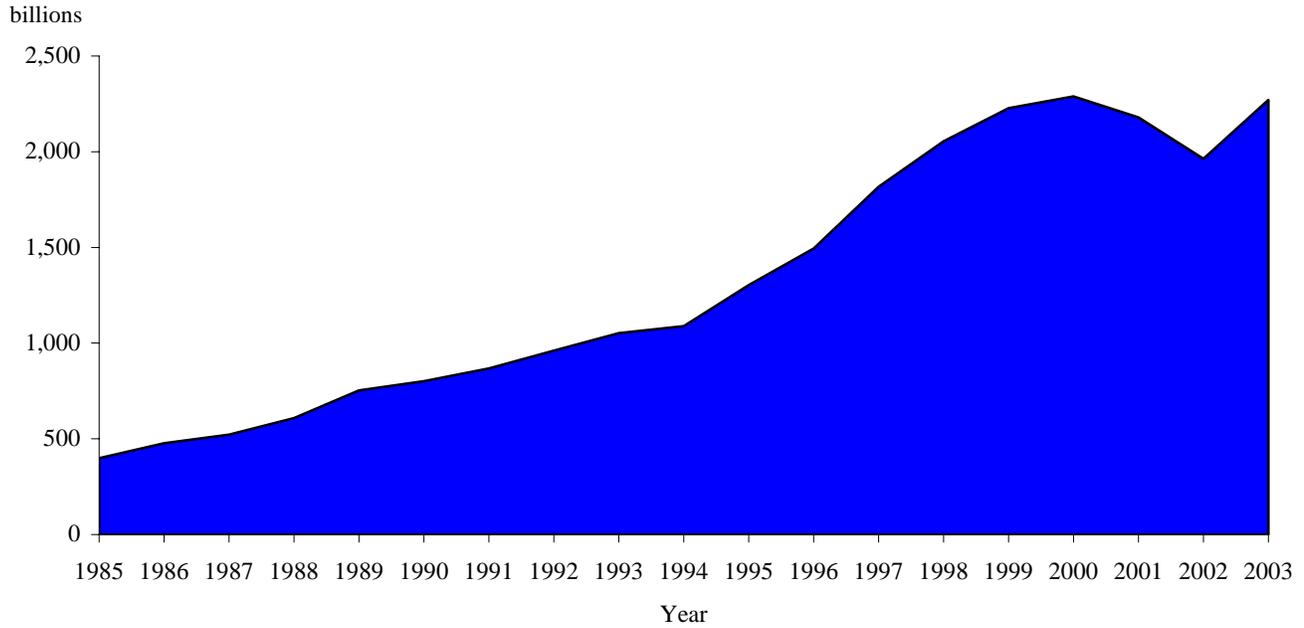
**Market Value of Assets Held in Defined Contribution Plans,  
1985-2003**



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

**Figure 9**

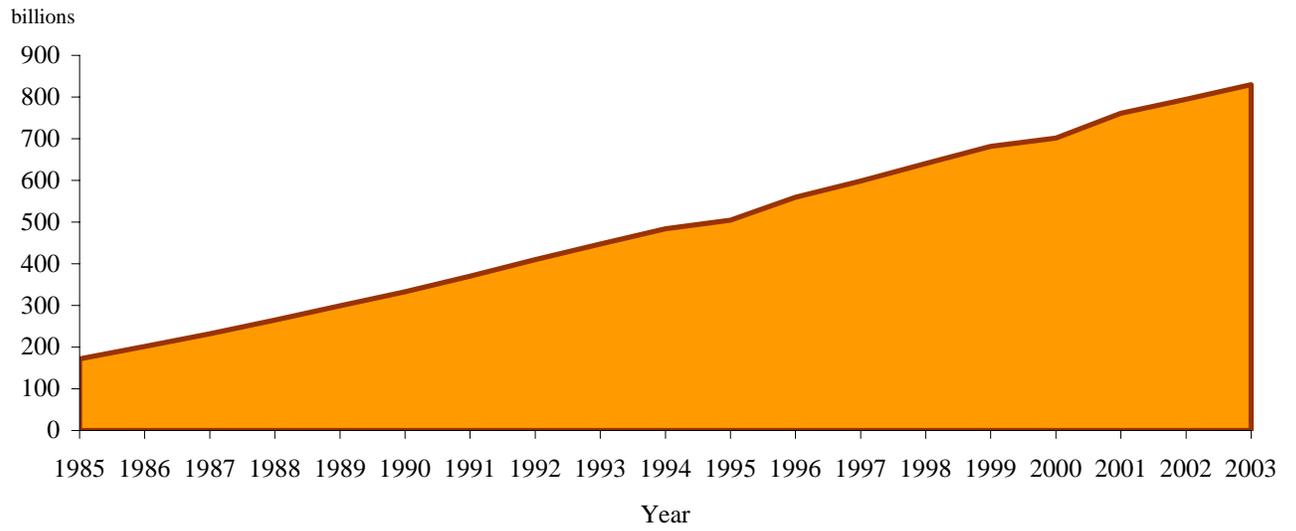
**Market Value of Assets Held in State and Local Government  
Employees Retirement Fund 1985-2003**



Source: Board of Governors, Federal Reserve; *Flow of Funds* and Federal Retirement Thrift Investment Board.

**Figure 10**

**Market Value of Assets Held in Federal Retirement Funds  
(Other Than the Thrift Savings Plan),  
1985-2003**



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

## **VI. POLICY ISSUES RELATING TO DEFINED BENEFIT PENSION PLANS**

### **A. General Policy Issues Relating to the Defined Benefit Pension Plan System**

#### **In general**

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

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

#### **Retirement income security**

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

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

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

The reasons for the decline in defined benefit pension plan coverage are not entirely clear. A number of possible reasons have been cited, including changing worker demographics,

administrative burdens on employers, applicable legal restrictions, worker preferences, and employer cost. The need for and design of any legislative changes relating to the defined benefit pension plan system depend in part on what is viewed as the source of the decline in coverage. For example, EGTRRA made a variety of changes with respect to the rules relating to employer-sponsored retirement plans with a stated goal of expanding coverage. The changes relating to defined benefit pension plans include increases in the amount of benefits that can be provided, provisions designed to reduce administrative burdens, and greater flexibility in funding rules. The EGTRRA changes may make defined benefit pension plans more attractive to employers, owner-employees, and highly compensated employees, thus leading to the establishment of new plans or the expansion of existing arrangements.<sup>117</sup>

Some view the decline in defined benefit pension plan coverage as part of a natural shift toward defined contribution plans. Some suggest that, in today's business environment, the long-term costs associated with defined benefit pension plans makes them impractical for many employers. In addition, some argue that many employees prefer defined contribution plans to defined benefit pension plans and are better off under such plans. For example, traditional defined benefit pension plans provide the greatest level of benefits to longer-service employees; employees who terminate employment after only a few years of service may have a very low accrued benefit under a traditional defined benefit pension plan. Workers who change jobs relatively frequently may prefer the portability typically offered by a defined contribution plan; their account balance can be rolled over and continue to accumulate earnings. While some defined benefit pension plans may offer lump-sum benefits that would provide the same portability opportunities, not all do. Thus, in some cases, defined contribution plans may enable employees to accrue greater benefits than under a defined benefit pension plan, thereby increasing retirement security.<sup>118</sup> Employees often find defined contribution plans easier to understand than defined benefit pension plans, and also often like the opportunity provided by some defined contribution plans to make their own investment decisions. Some argue that legislative changes addressing retirement income security should adapt to the shift toward defined contribution plans, and focus on ways in which to enhance security with respect to such plans.

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

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<sup>117</sup> On the other hand, some have raised concerns that some of EGTRRA's changes may serve merely to increase benefits for highly compensated employees without any change in benefits for rank and file workers.

<sup>118</sup> On the other hand, some argue that this increased retirement security may not materialize if the individual incurs investment losses or low investment earnings on his or her account balance.

flexibility to adopt new plan designs, such as cash balance plans, helps to make defined benefit pension plans more attractive to employers and thus to preserve the defined benefit pension plan system.

## **B. Issues Relating to Funding and the Solvency of the PBGC Insurance Program**

### **General issues**

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

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

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

The limits on deductible contributions, the excise tax on nondeductible contributions, and the rules relating to reversions of defined benefit pension plan assets have as a major objective preventing the use of defined benefit pension plans as a tax-favored funding mechanism for the business needs of the employer. They also serve to limit the tax expenditure associated with defined benefit pension plans. Some argue that if the maximum limits on plan funding are too low, then benefit security will be jeopardized. They argue that employers need flexibility to make greater contributions when funds are available, in order to ensure adequate funding in years in which the business may not be as profitable. Others note that such flexibility is available as a result of the increases in the deduction limits under EGTRRA, but the full effect of the increases may not be apparent yet because of recent economic conditions. With respect to reversions, some argue that if restrictions on reversions are too severe, employers may be discouraged from making contributions in excess of the required minimums.

Some criticize the present-law funding rules as being both overly complex and ineffective in light of the large unfunded liabilities that the PBGC has had to assume in recent years. Some suggest that certain aspects of the present-law funding rules enable financially troubled companies with underfunded plans to make minimal plan contributions and at the same time to

increase benefits, thus increasing the financial risk to the PBGC and to companies with adequately funded plans. Some raise concerns that changes to the funding rules that have the effect of increasing required contributions or making required contributions more unpredictable will discourage employers from continuing to maintain defined benefit pension plans.

Some have suggested that PBGC premiums applicable with respect to a plan should better reflect the risk presented by the plan. Some have also suggested that better and more timely information about the funded status of plans should be available to employees and the public.

The desire to achieve the proper balance between these competing policy objectives has resulted in a variety of legislative changes to address the concerns arising at particular times. For example, the Omnibus Budget Reconciliation Act of 1987 made comprehensive changes to the minimum funding rules promoted by concerns regarding the solvency of the defined benefit pension plan system. That Act also added the current liability full funding limit. Legislation enacted in 1990 allowed employers access to excess assets in defined benefit pension plans in order to pay retiree health liabilities. The Retirement Protection Act of 1994 again made comprehensive changes to the funding rules. Recent changes to the funding rules have focused on increasing the maximum deductible contribution, and on the interest rate that must be used to determine current liability for purposes of calculating required contributions. For example, EGTRRA increased the current liability full funding limit and repealed the current liability full funding limit as of 2004. Temporary increases in the interest rate used to determine current liability were included in the Job Creation and Worker Assistance Act of 2002 and the Pension Funding Equity Act of 2004.

### **Issues related to the interest rate used to value benefits under a plan**

#### **In general**

Recent attention has focused on the issue of the rate of interest used to determine the present value of benefits under defined benefit pension plans for purposes of the plan's current liability (and hence the amount of contributions required under the funding rules) and the minimum amount of lump-sum benefits under the plan. For plan funding purposes, the use of a lower interest rate in determining current liability results in a higher present value of the benefits and larger contributions required to fund those benefits. Alternatively, the use of a higher interest rate results in a lower present value of future liabilities and therefore lower required contributions. Because minimum lump-sum distributions are calculated as the present value of future benefits, the interest rate used to calculate this present value will affect the value of the lump-sum benefit. Specifically, the use of a lower interest rate results in larger minimum lump-sum benefits; the use of a higher interest rate results in lower minimum lump-sum benefits.

Under present law, the theoretical basis for the interest rate to be used to determine the present value of pension plan benefits for funding purposes is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits. Some studies have shown that it is not practicable to identify such a rate accurately because of variation in the

manner in which prices of private annuity contracts are determined.<sup>119</sup> As a result, the interest rate used to value pension benefits (specifically, the 30-year Treasury rate) is intended to approximate the rate used in pricing annuity contracts.<sup>120</sup> Some have described this standard as a rate comparable to the rate earned on a conservatively invested portfolio of assets.

Under present law, the interest rate used to determine current liability and minimum lump-sum benefits has been based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently in part because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate, and statutory changes are necessary to reflect this. In addition, as discussed below, concerns have been raised that the 30-year Treasury rate has been too low and use of the 30-year Treasury rate has therefore caused inappropriate results.

Some have argued that the 30-year Treasury rate has been too low compared to annuity rates, resulting in inappropriately high levels of minimum funding requirements on employers that are not necessary to maintain appropriate retirement income security.<sup>121</sup> In addition, some argue that the 30-year Treasury rate has been so low as to make lump-sum benefits disproportionately large in comparison with a life annuity benefit payable under the plan, thus providing an incentive for employees to take benefits in a lump sum rather than in the form of a life annuity. Some argue that lump sums should not be favored as a form of benefit, because they can cause a cash drain on the plan. In addition, an annuity assures the individual of an income stream during retirement years, which may not be available in the case of a lump-sum payment, depending on what use the individual makes of the payment (e.g., whether the individual spends the lump sum currently or uses the funds to purchase an annuity).

Some have pointed out that a variety of policy issues relating to the funding requirements may arise in the context of the interest rate discussion, and that some of these issues are better resolved through means other than the interest rate. For example, recent declines in defined benefit pension plan assets have adversely affected the funded status of many plans, resulting in what some view as unduly burdensome funding requirements on employers. Some in favor of funding relief believe it should be provided through interest rate adjustments. Others argue that, if funding relief is desired, it would be better to prescribe a more theoretically correct interest rate, and make other changes in the minimum funding requirements. They suggest that this type of approach would provide relief to employers without resulting in potentially inappropriate results in other cases, e.g., in determining lump-sum benefits. On the other hand, some argue

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<sup>119</sup> See, e.g., Victor Modugno, *30-Year Treasury Rates and Defined Benefit Pension Plans* (2001), Commissioned for Society of Actuaries, <<http://www.soa.org/sections/dbpp.pdf>>.

<sup>120</sup> In practice, the price of an annuity contract encompasses not only an interest rate factor but also other factors, such as the costs of servicing the contract and recordkeeping. Under present law, the interest rate used for determining current liability is intended to embody all of these factors. See H.R. Rpt. No. 100-495, at 868 (1987).

<sup>121</sup> As discussed above, temporary increases in the permissible interest rate for purposes of determining current liability were enacted in 2002 and 2004.

that funding relief is not appropriate at all, and that higher contributions should be required in order to increase funding levels, thereby enhancing retirement security and reducing potential PBGC liabilities.

Other issues that arise in the context of the interest rate discussion include employer flexibility in making contributions and the appropriate level of tax benefits for defined benefit pension plans.<sup>122</sup> For example, a given employer may prefer a lower interest rate that enables the employer to make large deductible contributions and thereby maximize the tax benefit from maintaining the plan. Alternatively, another employer may prefer a higher rate that would reduce required contributions, thus freeing up funds for other business uses. Some argue that the degree of flexibility in contributions to be provided to employers should be addressed through means other than the choice of interest rate.

#### Possible replacement interest rate

Recent proposals for replacing the interest rate used to determine pension liabilities have involved the use of an interest rate based on corporate bonds. In addition, under PFEA 2004, the interest rate used in determining current liability for plan years beginning in 2004 and 2005 is based on long-term corporate bond rates. Some believe that, compared with the rate of interest on 30-year Treasury securities, an interest rate based on long-term corporate bonds better approximates the rate that would be used in determining the cost of settling pension liabilities, i.e., by purchasing annuity contracts to provide the benefits due under the plan.<sup>123</sup>

Some have suggested that use of an interest rate based solely on long-term corporate bonds is inappropriate, and rather that multiple interest rates should be used to reflect the varying times when benefits become payable under a plan, because of, for example, different expected retirement dates of employees. The rationale for this approach is that interest rates differ depending, in part, on the term of an obligation. In general, longer term bonds pay a higher rate, and shorter term bonds a lower rate. (A graph of this relationship is known as the “yield curve.”) Because plan liabilities may be payable both in the short term and the long term, this approach would determine the present value of these liabilities with multiple interest rates, chosen to match the times at which the benefits are payable under the plan. Thus, in general, a shorter-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the nearer term, and a longer-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the more distant future.

Some have raised concerns that a yield-curve approach is more complicated than the use of a single rate, particularly for smaller plans and for purposes of determining lump-sum distributions. Some have suggested that this could have the effect of increasing administrative costs associated with maintaining a defined benefit pension plan and discourage the continuation

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<sup>122</sup> A tax benefit results from the prefunding of the retirement benefit, which produces tax-free inside buildup on the earnings from the assets held by the plan.

<sup>123</sup> Some also argue that the interest rate used for funding purposes should be based on the expected return on plan investments, rather than on annuity purchase rates.

and establishment of such plans. Some have also suggested that the use of a yield curve to determine minimum and maximum lump-sum distributions may make it more difficult for plan participants to understand and evaluate their distribution options under the plan. Some have suggested that the use of a single rate, such as the long-term corporate bond rate, with an appropriate adjustment factor can produce results similar to the use of a yield curve, but much more simply.

Others have responded to these concerns by suggesting that, although a single interest rate is used to determine required contributions under the present-law funding rules, a yield-curve approach is commonly used for other purposes, such as corporate finance. Some also note that the determination of current liability and lump-sum values already involve the application of complicated actuarial concepts (particularly the determination of current liability) and the proposal does not add significant complexity. They argue moreover that any additional complexity is outweighed by the importance of measuring pension liabilities accurately, including the timing of benefit payments from the plan. In addition, it has been suggested that simplified methods (such as the use of a single composite rate) can be provided for smaller plans and for purposes of determining lump-sum distributions.

#### Miscellaneous issues

Other issues also arise in connection with the interest rate used to determine the present value of pension plan benefits. One such issue relates to the fact that the interest rate used for pension purposes is not the 30-year Treasury rate per se, but is based on that rate. For example, in determining current liability, the present law uses a weighted average of 30-year Treasury rates and an interest rate corridor that allows plans to adjust the otherwise applicable rate higher or lower. Some have suggested that such an averaging period is necessary to prevent rapid interest rate changes from causing corresponding changes in current liability, which in turn may result in volatility in the amount of minimum required and maximum deductible contributions. Others believe that the interest rate used to value pension liabilities should be designed to measure those liabilities as accurately as possible and that volatility in required contributions and deductible contributions should be addressed through modifications to the funding and deduction rules.

An issue arises also as to whether the same interest rate should be used for purposes of determining current liability and for purposes of determining minimum lump sum benefits. Although an interest rate based on the 30-year Treasury rate has applied for both purposes under present law (except for 2004 and 2005), the rules for calculating the applicable rate (such as the measurement period and averaging rules) are quite different and the rate that applies for the two purposes can be quite different. In addition, some have suggested that a rate that is appropriate for purposes of determining current liability (such as an interest rate that would be used in setting the price for group annuity contracts) might be higher than the rate that is appropriate in determining minimum lump-sum benefits.

Another issue that arises is whether transition rules are appropriate, e.g., because employers or employees have relied on present-law rules, and, if so, what transition rules should be provided.