[JOINT COMMITTEE PRINT]

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

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON MAY 18, 1987

PREPARED BY THE STAFF

OF THE

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## INTRODUCTION

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

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

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a hearing on May 18, 1987, which will focus on the proposals to increase and revise the PBGC premium program, to modify minimum funding requirements for defined benefit pension plans, to alter the rules governing the termination of underfunded pension plan, and to revise the conditions under which employers may recover excess assets from overfunded pension plans.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Current Issues Relating to Pension Benefit Guaranty Corporation (PBGC) Premiums and Single-Employer Defined Benefit Pension Plans* (JCS-12-87), May 15, 1987.

# I. SUMMARY

## *PBGC Premiums and Funding*

### *PBGC premiums*

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

Under the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA), the annual per-participant premium was increased to $8.50 from $2.60, effective January 1, 1986.

### *Financial position of the PBGC*

As of September 30, 1985, the PBGC reported a deficit of approximately $1.3 billion. As of September 30, 1986, the PBGC's deficit nearly tripled over the prior year, reaching $3.8 billion. The substantial increase in the deficit of the PBGC is generally attributed to the termination of certain steel-industry pension plans with insufficient assets to provide guaranteed benefits. The largest increase in the PBGC's liability was a result of the termination of plans maintained by the LTV Corporation.

In 1986, pension plans of the LTV Corporation were terminated. These plans had approximately $2.2 billion in unfunded guaranteed benefits, contributing substantially to the PBGC's current deficit.

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

## *Defined Benefit Pension Plans*

### *In general*

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

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

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

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

*Minimum funding requirements*

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the minimum funding requirements, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are made for each plan year. If, as of the close of a plan year, the account does not have a balance of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

*Qualified plans*

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

An employer's contributions to a defined benefit pension plan for a year generally are not deductible if the contributions would not otherwise be deductible. Under the Code, if a contribution to a qualified plan for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contribu-

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

tions and benefits for employees. A nondeductible excise tax is imposed on an employer that makes a contribution to a qualified plan for a year in excess of the deduction limits.

*Guaranteed benefits*

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

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

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

*Termination of underfunded plans*

Prior to 1986, an employer generally could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC, the employer had no further liability to the PBGC. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

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

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

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

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

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

*Termination of overfunded plans*

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

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

*Vesting*

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

## *Administration Proposals*

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

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

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

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

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

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

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

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

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

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

*PBGC premiums.*—Further, the President's 1988 fiscal year budget proposed an increase in the revenue collected from PBGC premiums and a restructuring of the premium program to assess higher premiums on employers that are more likely to shift liabilities to the PBGC.

### *General Accounting Office Report*

On March 19, 1987, the General Accounting Office (GAO) submitted a report [3] to the Subcommittee on Oversight of the House Com-

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

mittee on Ways and Means on the causes of large claims against the PBGC and the potential effects of SEPPAA on the plan termination insurance program.

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

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

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

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

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

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

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

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

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

### *Present Law and Background*

#### *In general*

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 by ERISA to provide an insurance program for benefits under defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report, the single employer insurance program currently covers more than 30 million participants in more than 110,000 defined benefit pension plans.[4] PBGC revenues include premiums charged to private employers with defined benefit pension plans, earnings on investments, and collections from sponsors of terminated plans.

#### *Flat rate premiums*

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

#### *Alternate premium schedules*

*In general.*—The PBGC is authorized to develop premium bases and schedules other than a flat rate per-participant charge. Generally, the PBGC is not authorized to change the schedule applicable to basic benefits unless the new schedule is approved by the Congress.

*Risk related premium.*—The PBGC is authorized to develop a premium based on the risks it insures in each plan.

*Guaranteed benefits method.*—The PBGC may establish annual premiums for single employer plans composed of the sum of two charges. The first charge is based on a rate applicable to the excess, if any, of the present value of the basic benefits of the plan which are guaranteed over the value of the assets of the plan, not in excess of 1/10 of 1 percent of that amount. The additional charge is based on a rate applicable to the present value of the basic benefits of the plan which are guaranteed.

Under the guaranteed benefits method, the rate for the additional charge is to be set by the PBGC for every year at a level that the PBGC estimates will yield total revenue approximately equal to the total revenue derived by the PBGC from the first charge.

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

*Unfunded benefit method.*—The PBGC may establish an annual premium based on the level of unfunded guaranteed basic benfits. Under the unfunded benefit method, however, the premium rates are not to exceed 1/10 of 1 percent of the excess of (1) the present value of the guaranteed basic benefits of the plan, over (2) the value of the assets of the plan.

*Total guaranteed benefits method.* Under the total guaranteed benefits method, the PBGC may establish an annual premium determined by reference to the total guaranteed basic benefits under a plan. The rate determined under the total guaranteed benefits method is not to exceed the rate for the additional charge determined under the guaranteed benefits method.

*Combinations of methods.*—Under ERISA, if the PBGC uses a combination of two or more of the flat rate per capita method, the unfunded benefit method, or the total guaranteed benefits method, then the premium rates are to be designed to produce approximately equal amounts of aggregate premium revenue from each of the rate bases used.

## *Administration Proposal*

### *In general*

The Administration proposal provides that the annual premium payable by a single-employer plan would consist of two elements. Under the proposal, one element would consist of a minimum flat per-participant charge applicable to all single-employer plans. The flat per-participant charge would be indexed annually. The other proposed element would be a funding charge based on the excess of a funding target over the level of plan assets. The proposal provides that the total of the two premium elements would not exceed a maximum of $100 per participant for the 1988 plan year. The $100 annual limit would be indexed.

The Administration proposes that the funding charge rate be reviewed at three-year intervals and revised without the need for Congressional action.

The Administration also proposes that a surcharge should be imposed for missed contributions (e.g., contributions for which a funding waiver has been granted). The surcharge would be equal to a percentage of the funding charge otherwise due. The surcharge would not be taken into account in applying the annual limit on per-participant premiums ($100 for the 1988 plan year).

### *Flat rate charge*

Under the Administration proposal, the flat rate per-participant charge would be $8.50 for plan years beginning in 1988, corresponding to the $8.50 premium imposed under present law. The flat rate charge is intended primarily to cover the administrative expenses of the PBGC ($1.00) and to retire its deficit ($4.75). The Administration projects that a portion of the flat rate premium could be applied toward the cost of new claims ($2.75). Under the proposal, the flat rate per-participant charge would be indexed for wage growth.

### *Funding charge*

#### *In general*

Under the Administration proposal, the funding charge element of the annual premium would be imposed only on a plan that has a funding target insufficiency for the year. Under the proposal, a plan's funding target insufficiency would be computed on a per-participant basis. For a year, the per-participant funding target insufficiency would be equal to (1) the excess (if any) of 125 percent of its liability for vested benefits over the level of the plan's assets, divided by (2) the number of plan participants. The funding charge would be imposed at the rate of $6.00 per $1,000 of per-participant funding target insufficiency. The funding charge would, however, be subject to certain limitations.

#### *Limitations*

*Small plans.*—The Administration proposal provides that the funding charge would not apply to a plan with fewer than 100 participants.

*Certain items excluded.*—Under the Administration proposal, certain liabilities would be disregarded in calculating the funding charge. Under the proposal, liability for a benefit would be disregarded if the plan has purchased an annuity contract providing an irrevocable commitment to pay the benefit and the contract is owned by the plan. The contract would also be disregarded if the employer has provided a security interest to the PBGC equal to the amount of underfunding plus a cushion. The proposal does not describe the computation of the required cushion.

*New plans.*—The Administration proposal provides that the funding charge would not apply to a newly covered plan for its first three plan years. Under the proposal, this exemption for newly covered plans would not apply to a plan that is, in effect, a continuation of another plan.

#### *Computations*

Under the Administration proposal, the amount of plan assets and liabilities shown on the annual report of a plan (Form 5500) would be taken into account in determining the funding charge except that liabilities would be standardized on the basis of the PBGC's closeout interest rate (the interest rate applied by the PBGC for the valuation of liabilities under a terminated plan). The proposal would require that the PBGC provide simple valuation adjustment procedures for plan with more than 5,000 participants and conversion tables that would be used by smaller plans.

#### *Maximum per-participant charge*

Under the Administration proposal, the total of the flat per-participant charge ($8.50 for 1988) and the funding charge would not exceed $100 per participant for the 1988 plan year. The proposal provides that the $100 annual limit would be indexed to 1.5 times wage growth.

### *Surcharge for missed contributions*

*In general.*—The Administration proposal includes a surcharge for a plan that (1) has obtained a recent funding waiver, (2) has obtained an extention of an amortization period under the minimum funding standard, or (3) has incurred an increase in an accumulated funding deficiency. Under the proposal, the surcharge would be a percentage of the funding charge that is otherwise due. The surcharge would not be taken into account in applying the $100 limit (as indexed). The proposal provides that the surcharge would apply prospectively to waivers, extensions, and funding deficiency increases for plan years beginning after 1987. Accordingly, the first surcharge would be payable in 1989.

*Rate of surcharge.*—Under the Administration proposal, the rate of the surcharge imposed with respect to a waiver of the minimum funding standard or an extension of an amortization period would depend upon the age of the waiver or extension. The rate would begin at 50 percent of the funding charge for the first year a waiver or extension is in effect and would decline by 10 percentage points with each subsequent year until it is eliminated after 5 years.

The Administration proposal provides that the surcharges would be cumulative. For example, if a plan was granted 3 consecutive waivers of the minimum funding standard (the maximum that would be permitted by the Administration proposal in a 15-year period), the surcharge would be 120 percent.[5]

Under the proposal, if a plan failed to meet the minimum funding standard without obtaining a waiver, the surcharge would be 50 percent for the lesser of 5 years or the period for which the deficiency continues. The proposal provides that the surcharges for failure to meet the minimum funding standard without a waiver would be cumulative and that the rate of the surcharge would not be phased out during the period for which it applies.

The proposal provides that the surcharge would be doubled for plans that have unfunded vested benefit liabilities and also have large contingent benefit obligations (e.g., shutdown benefits).

### *Triennial review*

*In general.*—The Administration proposal provides for adjustments to the annual premium without action by the Congress. Under the proposal, the funding charge rate would be reviewed at 3-year intervals and revised on the basis of experience during those years. As discussed above, the proposal provides that the flat rate per-participant charge and the annual limit on per-participant premiums would be indexed annually by reference to wage growth. The flat rate per-participant charge would not be subject to the triennial review.

*Review of funding charge.*—Under the Administration proposal, the triennial adjustment of the funding charge would consist of (1) an adjustment to reflect any revision in projected annual net claims, (2) an adjustment to reflect any difference between the

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[5] The Administration proposal would reduce the maximum number of funding waivers in a 15-year period to from 5 to 3. If 5 consecutive waivers were in effect, the maximum surcharge under the Administration proposal would be 150 percent.

actual deficit at the end of the 3-year period and the deficit that had been projected for that date, and (3) an adjustment to take into account changes in the premium bases (the number of participants and the funding target insufficiency). The proposal provides that the funding charge, as previously adjusted, could not be changed by more than 50 percent by the combined adjustments as a result of a triennial review. The adjustment could not, however, cause the total premium to exceed the limit on per-participant premiums ($100 for 1988).

*Review of projected claims.*—For purposes of the proposed triennial review, average annual net claims for the 3-year period preceding the review would be adjusted for inflation. Projected annual net claims would be equal to that adjusted amount.

*Deficit adjustment.*—For purposes of the triennial review, any difference between the actual deficit at the end of the 3-year period and the deficit amount that had been projected for that date would be amortized through a further adjustment of the funding charge. The difference would be amortized by the PBGC over a period of 30 years.

### *Controlled group liability*

The Administration proposal provides that each contributing sponsor of a single-employer plan and each member of its controlled group would be liable for the payment of premiums to the PBGC.

## *General Accounting Office Report*

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

## *Analysis of Issues*

### *Variable rate features*

The Administration believes that a variable rate premium is more equitable than a flat rate premium because it would place the greatest burden on those employers whose plans present the greatest risk of potential loss to the PBGC. The Administration contends that a flat-rate increase of the magnitude needed to retire the deficit of the PBGC could encourage the termination of well-funded plans because those employers would incur a significant increase in the per-participant cost of maintaining their plans without a corresponding increase in benefits. Some who favor the Administration proposal are concerned that the termination of well-funded plans in response to premium increases would reduce the premium base of the PBGC by eliminating plans that present the least risk of loss to the PBGC. There is also concern that the termination of a defined benefit pension plan can adversely affect plan participants if the employer does not adopt a new plan with comparable benefits.

Those who oppose a variable rate premium structure argue that it would unduly burden financially distressed plans and employers. They believe that the guarantee program should not be evaluated under the same standards that would apply to a commercial insurance company. They refer to the tax exempt status of the PBGC as an indication that the Congress does not consider the PBGC as a commercial insurer, but as a program with important social aspects.

Some pension experts have expressed concern that the high variable-rate premium proposed by the Administration could have the effect of diverting funds from plans to the PBGC. Others have determined that, in some cases, the variable-rate per-participant premium could exceed the level of a participant's benefit because the funding target insufficiency is determined on an average (rather than an individual) basis.

Some of those who favor a risk-related premium believe that the variable-rate premium proposed by the Administration does not appropriately measure the PBGC's risk with respect to a plan because it does not measure the financial condition of the employer who maintains the plan. They believe that the PBGC's risk of loss with respect to a plan cannot be measured without taking account of the financial condition of the employer.

In rebuttal, those who favor a risk-related premium argue that although the premium proposed by the Administration does not directly measure the financial condition of the employer, the financial condition of a plan generally reflects the financial condition of the employer. They also believe that it would not be appropriate or practical to provide a premium that requires the PBGC to assess the financial strength of each employer that maintains a covered plan.

*Surcharges*

The Administration believes that employers who have obtained funding waivers present greater risks to the PBGC than employers who maintain underfunded plans but have not obtained funding waivers. Accordingly, the Administration believes that premiums payable by employers who have obtained funding waivers should be subject to surcharges.

The Administration believes that it is appropriate to impose surcharges on premiums paid by riskier employers (e.g., those who have obtained funding waivers). Those who favor surcharges contend that a similar approach is taken by private insurance companies under comparable circumstances. Those who oppose surcharges are concerned that the additional cost burden would make plan termination, and benefit loss, more likely.

*Inflation adjustments*

Those who favor an inflation-adjusted premium, as proposed by the Administration, believe that it is appropriate because an inflation adjustment is provided for the level of benefits guaranteed by the PBGC. Further, they believe that an inflation-adjusted premi-

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um would provide a more equitable allocation of the cost of providing guarantees.

Those who oppose an inflation-adjusted premium believe that premium increases for a program as significant as the guarantee of pension benefits should not be made without action by the Congress.

*Triennial review*

The Administration supports an administrative adjustment of the premium to reflect past and projected loss experience (the proposed triennial review) because it believes that an automatic adjustment feature is necessary to keep the program solvent. The Administration believes that employers and employees will have more confidence in the program if they understand that it is managed as a private insurance program. They argue that employers expect a private insurer to adjust its premium rates to take account of unanticipated losses that have been incurred and of projected future losses.

Those who oppose administrative adjustment of the premium believe that the premium should be regarded as a tax because guarantees are provided under the program whether or not the premium is paid. On that basis, they argue, the guarantee program is more similar to Social Security than a commercial insurance program. Because they regard the premium as a tax, opponents of an administrative adjustment believe that it is inappropriate, and possibly beyond the power of the Congress, to permit an administrative agency to determine the rate.

*Controlled group liability*

Supporters of controlled group liability for premiums believe that a controlled group of employers should be treated as a single economic unit. They argue that an economic unit should not be allowed to avoid payment of the premium because of its legal structure. They believe, for example, that in determining liability for premiums, an economic unit that is structured as a parent corporation with subsidiaries should be treated under the same principles that apply to an economic unit consisting of a single corporation.

# III. MINIMUM FUNDING STANDARD AND DEDUCTIONS

## *Present Law and Background*

### *Minimum funding standard*

#### *In general*

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

#### *Accumulated funding deficiencies*

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

For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution in that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer (or employers) responsible for contributing to the plan would be subject to an excise tax equal to 5 percent of the deficiency for the year. If the deficiency were not corrected within the specified period, then the 100-percent excise tax would be imposed on such employer (or employers).

### *Controlled group liability*

The funding requirements applicable to a plan are imposed only on an employer who is responsible for contributing to that particular plan in which the deficiency arises. Another taxpayer that is a member of the same controlled group of corporations as the employer is not liable for a funding deficiency unless the other taxpayer is also responsible for contributing to that plan.

### *Actuarial cost methods*

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

*Normal cost.*—The normal cost of a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

*Past service liability.*—The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective.

*Acceptable methods.*—Normal cost and past service liability are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once every 3 plan years. More frequent valuations may be required by the Internal Revenue Service.

### *Charges and credits to the funding standard account*

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

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

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

*Past service liability.*—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, and employer contribution will be required for the year to avoid and accumulated funding deficiency.

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

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

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

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

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

*Gains and losses from changes in assumptions.*—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from charges in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 plan years, resulting in credits or charges to the funding standard account.

*Experience gains and losses.*—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 15-year period.

*Waived funding deficiencies.*—Within limits, the Internal Revenue Service is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without substantial business hardship. The Internal Revenue Service generally takes the position that a waiver will not be granted unless the hardship is temporary and the employer demonstrates that recovery is likely. No more than 5 waivers may be granted within any period of 15 consecutive plan years. The Internal Revenue Service may require an employer to provide security as a condition of granting a waiver. The waived contribution is a waived funding deficiency.

Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 15 plan years, beginning with the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. Interest on the waived amount is equal to the rate applicable to late payment of taxes (Code sec. 6621(b)).

With respect to applications for waivers submitted after April 7, 1986, SEPPAA provides that the IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $2 million.

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

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

#### *Full funding limit*

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

#### *Time for making contributions*

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

### ***Deductions for employer contributions***

#### *In general*

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (Code sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employer covered by the plan is also covered by another plan of the employer. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contributions and benefits (secs. 404(j) and 415).

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

*Defined benefit pension plans*

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

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[6]

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

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

***Factors contributing to overfunding of defined benefit plans***

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

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

expected to be earned, and the number of employees expected to vest, many years in the future.

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

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

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

*Factors contributing to underfunding of defined benefit plans*

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

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

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

## *Administration Proposal*

### *In general*

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

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

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

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

### *Complement rule*

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

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

### *Funded ratio maintenance requirement*

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

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

*Cash flow requirement*

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

*Controlled group liability*

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

*Contribution due date*

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

*Minimum funding waivers*

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

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

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

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

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

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

*Deduction limits*

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

### *General Accounting Office Report*

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

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

## *Analysis of Issues*

### *Increased funding rate*

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

As a result, supporters of the Administration proposal believe that more rapid funding would more appropriately limit the ability of employers to delay or avoid funding obligations. They argue that an employer should not have the opportunity to make pension promises that exceed its financial capacity. They suggest that the purpose of sound funding is to protect employee benefits by insulating them from business risk of the employer, as well as to protect the PBGC from systematic loss.

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

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

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

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

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

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

*Contribution due date*

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

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

*Funding waivers*

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

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

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

Opponents of further restrictions on funding waivers believe that if employers cannot accept the restrictions they will terminate plans that could have been continued. They argue that the effect of restrictions adopted in SEPPAA, in 1986, should be evaluated before further restrictions are considered.

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

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

### *Deductions*

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

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

## IV. TERMINATION OF UNDERFUNDED PLANS

### A. Conditions for Plan Termination

#### *Present Law and Background*

*Law before 1986*

Prior to 1986, an employer could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC (described below), the employer had no further liability to the PBGC. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

*Guaranteed benefits*

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

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

*Voluntary terminations*

*In general*

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

*Standard terminations*

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

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

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

*Distress terminations*

*In general.*—A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor and each substantial member of the contributing sponsors' controlled groups satisfies at least one of four distress standards described in ERISA. ERISA provides that an entity is a contributing sponsor if it (1) is responsible for funding the plan or (2) is a member of the controlled group of an entity that is responsible for funding or formerly was responsible for funding, and has employed a significant number of participants under the plan while it was so responsible. The term "controlled group" means a group of entities under common control. A "substantial member" of a controlled group is generally any entity whose assets comprise at least 5 percent of the assets of the controlled group.

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

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

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

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

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

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

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

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

*PBGC claims in bankruptcy*

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

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

*Termination by PBGC*

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

### *Administration Proposal*

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

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

The Administration proposal provides that if a plan terminates with assets less than the plan's termination liability, a transfer of assets would be required. The proposal would require a transfer of assets from other plans of the controlled group to the terminating plan. Under allocation rules to be developed, the value of assets required to be transferred would be equal to the amount necessary to cover the termination liability of the terminating plan. Under the proposal, however, a transfer of assets from an ongoing plan would not be required to the extent the transfer would reduce the assets in that plan to less than the plan's termination liability. A transfer of a plan with assets less than its termination liability to a sponsor outside of the controlled group would be treated as a termination of the transferred plan for purposes of this rule requiring asset transfers. (Special provisions would be developed to take into account the relative benefit levels of the underfunded and overfunded plans and to protect against manipulation of the asset transfer requirement through benefit increases.)

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

### *General Accounting Office Report*

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

### *Analysis of Issues*

#### *Employer liability upon termination*

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

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

Similar arguments apply with respect to the proposal to make employers liable for termination liabilities without limitations. Those who favor the termination liability standard question the propriety of allowing financially distressed but solvent employers to escape liability to the PBGC or to participants. Those who oppose the termination liability standard believe that the standard would make recovery of distressed employers less likely.

*PBGC status in bankruptcy*

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

Certain experts question whether plan participants should receive nonguaranteed benefits, either under the plan or under a plan providing substantially similar benefits, before the PBGC has been made whole. They believe that giving priority to the PBGC would protect its financial condition and make it better able to provide a higher level of guaranteed benefits for more participants. They also believe that giving PBGC priority would be consistent with the result under present law that occurs when a plan is terminated with assets at a level that is sufficient to provide guaranteed benefits.

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

*Controlled group rules*

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

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

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

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

## B. Plan Investment in Employer Securities

### *Present Law and Background*

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

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

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

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

### *Administration Proposal*

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

In addition, the Administration proposal would extend the 10-percent limitation on holding employer securities to the defined contribution portion of a floor-offset arrangement.[7] Thus, the defined benefit pension plan and the defined contribution plan would be considered as a single plan for purposes of the limitation on

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

qualifying employer securities. Under the proposal, therefore, neither component plan under a floor offset arrangement could hold more than 10 percent of its assests in qualifying employer securities. Transition rules similar to the rules provided by ERISA when the 10-percent limit was introduced would apply to plans which currently do not meet the 10-percent limit.

### *Analysis of Issues*

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

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

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

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

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

Some commentators question why any employer securities should be held under a retirement plan. They contend that a prohibition against an investment in employer securities by a retirement plan would prevent an employee's retirement security from being linked to the same entity on which the employee relies for current income.

It is argued that the Administration proposal inappropriately prohibits investments in employer securities on the theory that such investments increase the risks to plan participants and the PBGC. Those who oppose the Administration proposal contend that the actual risk of an investment in employer securities should be measured and should not be subject to a mechanical rule which presumes that employers securities are high-risk investments. They believe that the proposed rule would reduce the status of employer securities relative to other investments without regard to the financial stability and earnings record of the employer.

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

## V. EMPLOYER ACCESS TO ASSETS OF OVERFUNDED PLANS

### *Present Law and Background*

#### *Exclusive benefit rule*

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

Similarly, under ERISA, the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan (ERISA sec. 403(c)). However, as under the Code, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution (ERISA sec. 4044(d)).[8]

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

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

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

the amendment, the plan provided that any excess was to be distributed to employees.[9]

Under present law, the determination of whether there are excess assets is made on a plan-by-plan basis. Thus, if an employer maintains more than one defined benefit pension plan, the employer is permitted to recover excess assets in an overfunded plan, regardless of whether the other plans have sufficient assets to satisfy their liabilities. The present-law rules provide an incentive to employers to maintain multiple plans funded at varying levels in order to maximize their access to tax-favored plan assets at the expense of benefit security. Some employers have received assets reversions from their overfunded plans and then terminated their underfunded plans. Under these circumstances plan participants and their beneficiaries are deprived of their full benefits and, in some cases, unfunded liabilities are shifted to the PBGC.

*Access to plan assets prior to termination*

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

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

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

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

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

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

method (with the approval of the IRS), and (4) appropriate notice is provided to employees.

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

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

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

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

### *Tax treatment of reversions*

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

## *Administration Proposal*

### *In general*

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

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

*Asset withdrawals from ongoing plans*

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

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

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

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

*Asset reversions on plan termination*

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

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

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

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

### *Transactions having the effect of a reversion*

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

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

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

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

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

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

### *Frequency limits*

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

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

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

*Taxation of withdrawals and reversions*

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

### General Accounting Office Report

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

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

### Analysis of Issues

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

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

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

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

One of the main arguments advanced by critics of the proposal for entitling employees to the excess relates to the nature of the defined benefit promise, particularly in the context of plan terminations. Employees who participate in a defined benefit pension plan may expect that they will be able to continue working and to increase their service and compensation credit under the plan. If the plan is terminated before employees have earned the maximum benefit available under the plan, then they will not have received all that they expected; the ability to increase service and compensation credit would be eliminated. Accordingly, in such cases it may be appropriate to provide that a portion of excess assets must be applied to benefit increases. This argument has less application where a withdrawal is made and the plan is ongoing.

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

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

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

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

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

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

## VI. POST-RETIREMENT MEDICAL BENEFITS

### *Present Law and Background*

#### *Comparison with retirement plans*

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

Other rules apply to post-retirement medical benefits. As discussed in more detail below, there are two tax-favored funding arrangements to accumulate assets to provide post-retirement medical benefits separately from other retirement benefits. First, separate accounts in certain qualified retirement plans may be used to provide post-retirement medical benefits (Code sec. 401(h)).

Although assets allocated to a medical post-retirement medical benefit account are accorded tax treatment similar to that provided for other assets held by a qualified retirement plan, the benefits provided under post-retirement medical accounts are required to be incidental to the retirement benefits provided by the plan. The incidental benefit requirement may preclude funding the entire post-retirement medical benefit through a separate account in a qualified plan.

Post-retirement medical benefits may be excludible from the gross income of a plan participant or beneficiary when paid. Other benefits provided by a qualified plan are generally includible in gross income except to the extent they are attributable to nondeductible employee contributions.

The second funding medium that can be used to prefund post-retirement medical benefits is a welfare benefit fund (Code secs. 419 and 419A). Welfare benefit funds generally are not subject to the contribution limits applicable to the separate accounts under a qualified plan. In addition, medical benefits provided through a welfare benefit fund generally are excluded from the employee's gross income, which differs from the general rule applicable to distributions from a qualified retirement plan. However, income set aside in a welfare benefit fund to provide post-retirement medical benefits generally is subject to income tax.

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

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

*Right to post-retirement medical benefits*

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

### *Funding media*

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

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

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

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

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

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

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

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

Certain special rules apply to the deductibility of employer contributions to a welfare benefit fund without regard to whether the fund is a VEBA. Under these rules, contributions by an employer to such a fund are not deductible under the usual income tax rules, but if they otherwise would be deductible under the usual rules, the contributions will be deductible within limits for the taxable year in which such contributions are made to the fund.

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

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

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

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

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

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

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

### *Administration Proposal*

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

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

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

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

### *Analysis of Issues*

The rationale for the Administration proposal is that it would increase the likelihood that retirees will receive medical benefits. Those who support the proposal argue that the availability of a tax-exempt funding arrangement for post-retirement medical benefits will reduce the cost to employers of establishing post-retirement medical benefit plans and will reduce their cost of improving benefits under existing plans. Further, supporters of the proposal believe that the reduced employer cost would permit some employers to avoid reduction or elimination of those benefits. In addition, to the extent that liabilities for post-retirement medical benefits are funded, proponents of the Administration proposal argue that it would increase the likelihood that employees will receive their promised benefits. Further, the availability of a tax-exempt funding arrangement for post-retirement medical benefits permits an employer to reduce its cost of such benefits by the amount of the tax benefits provided.

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

Critics of the Administration proposal maintain that, to some extent, the proposal would grant significant tax-favored prefunding without imposing minimum standards. They argue that the Administration proposal would not prevent an employer from creating a surplus in a defined benefit pension plan through excessive contributions. The flexibility that employers have with respect to their funding methods and their actuarial assumptions enables them to create a surplus. Critics are concerned that the Administration proposal would encourage tax-favored prefunding of post-retirement medical benefits through excessive contributions to a defined benefit pension plan.

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

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

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

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

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

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

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