PRESENT LAW AND BACKGROUND

RELATING TO

FUNDING AND DEDUCTIONS FOR DEFINED BENEFIT PENSION PLANS

Scheduled for a Joint Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

and the

SUBCOMMITTEE ON SOCIAL SECURITY

of the

COMMITTEE ON WAYS AND MEANS

on June 24, 1986

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of present law and background relating to funding and deductions for defined benefit pension plans.

The Subcommittees on Oversight and Social Security of the House Committee on Ways and Means have scheduled a joint hearing on June 24, 1986, which will focus on underfunding of some single-employer pension plans and the effect termination of such plans has on the Federal single-employer plan termination insurance program.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Background Relating to Funding and Deductions for Defined Benefit Pension Plans (JCX-6-86), June 23, 1986.

Present Law and Background Relating to Funding and Deductions for Defined Benefit Pension Plans

A. Overview

Under a defined benefit pension plan, benefit levels are specified under a plan formula and are not solely dependent on the balance of an account for an employee. 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.

Prior to ERISA, few requirements applied to the manner in which an employer funded a defined benefit pension plan. ERISA added to the Code certain minimum funding requirements for defined benefit plans, designed to ensure that the plans are adequately funded to provide promised benefits.

In addition, ERISA established within the Department of Labor, a tax-exempt corporation known as the Pension Benefit Guaranty Corporation ("PBGC"). The corporation's function is to insure participants (and their beneficiaries) of plans covered by the termination insurance program against the loss of benefits (up to certain guaranteed levels) arising from the termination of a plan with less than sufficient assets. Unless exempted by ERISA, all qualified 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. ERISA also provides that, upon the termination of an underfunded plan, an employer may be liable to the PBGC for at least a portion of the insufficiency.

The PBGC administers separate termination insurance programs for multiemployer and single-employer pension plans. A multiemployer plan is a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement. The term "single-employer plan" refers to all other types of pension plans. The Multiemployer Pension Plan Amendments Act of 1980 revised the circumstances under which an employer withdrawing from, or terminating, a multiemployer plan is liable for unfunded benefits, reduced the level of benefits guaranteed by the PBGC under multiemployer plans, and increased the premiums payable to the PBGC with respect to participants in multiemployer plans.

The Consolidated Omnibus Budget Reconciliation Act of 1985 altered the circumstances under which a single employer defined benefit pension plan may be terminated, increased an employer's liability to the PBGC and plan participants upon the termination of an underfunded single-employer plan, and generally increased the premiums payable to the PBGC with respect to participants in single-employer plans.

B. Minimum Funding Standard

In general

Under the Code and the non-tax provisions of ERISA, 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 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 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." An accumulated funding deficiency is subject to a 5-percent nondeductible excise tax (sec. 4971). If the deficiency is not corrected within a period specified in the Code, then it is also subject to a 100-percent nondeductible excise tax. The excise taxes are imposed on the employers who are responsible for contributing to plans with accumulated funding deficiencies.

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 contribution is not made, the employer (or employers) who is responsible for contributing to the plan would be subject to a 5-percent excise tax for the year. If the deficiency were not corrected within the specified period, then the 100-percent tax would be imposed.

Actuarial cost methods

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

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

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

Acceptable methods.--Normal cost and past service liability are key elements in computations under the minimum funding standard. While 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.

Contributions

Employer and employee contributions are recorded as credits to the funding standard account. Under the funding standard, employer contributions made on account of a year are credited for the year if they are made within a specified period after the close of the year.

Normal cost

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

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

Past service liability

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

Plans in existence on January 1, 1974.--In the case of a plan that was in existence on January 1, 1974, the funding standard account is charged annually with a portion of the past service liability under the plan determined as of the first day of the plan year to which the funding standard applied to the plan (generally 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 amortization period unless the plan becomes fully funded.

Plan not in existence on January 1, 1974.--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 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 years to offset charges for this past service liability.

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

For example, assume that a plan uses the calendar year as the plan year. Assume that, during 1986 the plan is amended to increase benefits and that the net result of plan amendments for 1986 is that the past service liability under the plan is increased by $500,000. Assume that the plan's actuary uses an interest rate of eight percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.

Accordingly, for each year in the 30-year period beginning with 1976, the plan's funding standard account is charged with the amount of $44,414. Assuming that there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid an accumulated funding deficiency unless the plan becomes fully funded.

Gains and losses from changes in assumptions

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the old assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 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. 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 contribution requirements of the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) could not make the required contribution without substantial business hardship. 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 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.

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 it takes a smaller contribution to balance charges and credits in the alternative account than it would take 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 five plan years.

Certain excess contributions

The minimum funding standard includes provisions (the full funding limitation) 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.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

A pension plan does not meet the requirements of the Code for qualified status unless it is for the exclusive benefit of employees and their beneficiaries. Under some circumstances, employer contributions in excess of the level for which a deduction is allowed may indicate that the plan is not being maintained for the exclusive benefit of employees.

C. Deductions for Employer Contributions

In general

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

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. Deductions are not allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Defined benefit pension plans

As outlined above, employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. 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.[2]

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

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[2] 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.

(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. Generally, this rule permits deductions for contributions in excess of the level required by the minimum funding standard.

D. Factors Contributing to Overfunding

The funding standard provided by present law requires 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 all events have not occurred that have fixed the 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, benefits expected to be earned, and the number of employees expected to vest, many years in the future.

In funding a plan, assumptions are made regarding the anticipated rate of investment earnings. Because actual experience often differs from anticipated 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 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 after the date of termination are not taken into account in determining benefits. Actuarial error results because the anticipated expense of benefits expected to be earned, including benefits based on expected pay raises, will not be 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 buying annuity contracts providing a significantly higher rate of return than was assumed by the plan.

E. Factors Contributing to Underfunding

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

For example, if at the time a plan was adopted it provided benefits measured by service performed before the plan was adopted, if the liability for those benefits is amortized over a period of 30 years, and if the plan terminates before the end of the 30-year period, then the plan will be underfunded unless unanticipated gains offset the unfunded liability arising from the past service benefit.

Similarly, 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. (The Consolidated Omnibus Budget Reconciliation Act of 1985 clarifies, with respect to applications for waivers submitted after the date of enactment, 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.)

F. Restrictions on Plan Termination

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 (described below), 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.

Law after 1985

Under ERISA, as amended by the Consolidated Omnibus Budget Reconciliation Act of 1985, effective January 1, 1986, an employer may 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.

Benefit commitments include all guaranteed benefits (including qualified preretirement survivor annuities) and all benefits that would be guaranteed but for the insurance limits on the amount or value of the benefit, 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.

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 (as defined in ERISA) and each substantial member (as defined in ERISA) of the contributing sponsors' controlled groups satisfy at least one of four distress standards described in ERISA.

Upon the termination of a plan, pursuant to a standard termination in which all benefit commitments are fully funded, the employer has no further liability to the PBGC or to plan participants.

Distress termination

Liability to the PBGC.--Under ERISA, upon the termination of a plan pursuant to a distress termination, with assets insufficient to fund benefits guaranteed by the PBGC, each contributing sponsor and each member of their controlled groups 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, 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 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. For purposes of computing the total amount of unfunded guaranteed benefits, any accumulated funding deficiency and the balance of any waived funding deficiency are treated as receivables of the plan and, thus, as plan assets.

Under ERISA, the full amount of the liability to the PBGC for unfunded guaranteed benefits is generally due and payable as of the date of plan termination. However, ERISA provides that if the liability to the PBGC for unfunded guaranteed benefits exceeds 30 percent of the collective net worth of the parties that are liable to the PBGC, then the payment of that excess amount is to be made under commercially reasonable terms prescribed by the PBGC. The parties are to make a reasonable effort to reach agreement on such terms. Any terms prescribed by the PBGC are to provide for the deferral of 50 percent of any amount of liability otherwise payable for any year if the PBGC determines that no person subject to such liability has individual pretax profits for the fiscal year ending during such year.

Liability to participants.--ERISA provides that if the PBGC determines that there is an "outstanding amount of benefit commitments," the PBGC is required to appoint a fiduciary with respect to a special termination trust. The fiduciary must be independent of the contributing sponsors (and members of a controlled group including sponsors) and generally is subject to the fiduciary requirements of ERISA (other than the prohibited transaction rules of ERISA section 406(a)). 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 of 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 total amount of outstanding benefit commitments under the plan, or (2) 15 percent of the total amount of benefit commitments under the plan. Under ERISA, the termination trust generally will be administered by the PBGC except in cases in which PBGC determines that delegation of this responsibility is cost effective.

Under ERISA, payment of liability for outstanding benefit commitments is to be made under commercially reasonable terms prescribed by the fiduciary of the termination trust. The parties are required to make a reasonable effort to reach agreement on terms. In addition, ERISA describes special safe-harbor terms in those cases in which liability to the termination trust is less than $100,000.

ERISA also provides that any payment schedule is to provide for the deferral of 75 percent of the liability otherwise payable to the termination trust for any year if no person subject to liability to the termination trust has any individual pre-tax profits for that person's fiscal year ending during such year.

ERISA provides rules governing the allocation and distribution of assets of the termination trust to participants and beneficiaries.

<u>Guaranteed benefits</u>

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 ($1789.77 for 1986).

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.

G. GAO Report on Termination of Plans with Excess Assets

In response to a request from the Chairman of the House Select Committee on Aging, the General Accounting Office (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 recent Administration actions (i.e., termination 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.