PENSION FUNDING REFORM: IT’S TIME TO GET THE RULES RIGHT (PART 1)

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In this two-part article, the author explains how and why ERISA’s historical pension funding rules—although well-intentioned—nevertheless led employers, such as United Airlines’ parent UAL Corp., to have seriously underfunded pension plans, and the Pension Benefit Guaranty Corp. to assume billions of dollars of those unfunded liabilities. Before future pension reform measures should be considered, Kennedy believes that we should learn from the past. Mistakes created through legislative rules should not be repeated, but instead their lessons should help forge effective pension funding reforms.

The second part of the article will discuss various legislative proposals pending before Congress and the policy considerations relevant to those proposals, in light of the historical mistakes that should be avoided in impending legislation.

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I. Introduction

Reforming the current pension funding rules for single-employer defined benefit plans has dominated media coverage for the past few months and forced the American public to examine the current and long-term problems facing those types of plans. Solving the funding problems for retirement plans puts a premium on time—how quickly can solutions be implemented without driving out well-funded plans and leaving behind only the poorly funded plans of sponsors unable to absorb increasingly high funding costs? It also challenges us to examine whether employers are to be encouraged to adopt defined benefit plans. The solution will depend on Congress’s ability to confront the problem today.

In early June 2005, Sen. Chuck Grassley, R-Iowa, chair of the Senate Finance Committee, remarked, “[t]he questions we are asking are simple...[h]ow did this happen, why did this happen, and, most importantly how can we stop it from ever happening again?”1 This two-part article answers those questions. In the first installment of this article, the question as to how and why this happened is answered. Actually it’s no surprise: Congress created the current system and therefore, it shouldn’t be surprised with the results produced by such a system.

As to preventing this from happening in the future, Congress must first learn from its prior mistakes to provide meaningful prospective reform. Congress now has the opportunity to legislate avoiding the next taxpayer bailout for underfunded defined benefit plans while encouraging the development of existing and future defined benefit plans. The second part of this article will discuss the various proposals from a policy perspective. Congress’s challenge will be to decide on a solution that achieves the delicate balance between retaining the defined benefit system and increasing funding for underfunded defined benefit plans. The author does not purport to offer a perfect solution that will satisfy all constituents. However, the historical perspective should be considered as a road-map in shaping?

future legislation so that we avoid prior mistakes — not only to continue our existing defined benefit plans but to encourage the establishment of new defined benefit plans. Unless we learn from the past, we will surely experience the same problems in the future.

In the spring of 2005, United Airlines’ parent UAL Corp. requested that the bankruptcy court terminate four of its underfunded defined benefit plans to bypass its required annual pension contributions. That request, if granted, would relieve United of future pension contributions, helping it toward a possible emergence from bankruptcy as a viable business entity. It would also mark the largest pension default in U.S. corporate history. In May 2005, UAL received that approval and thus transferred those plans and their liabilities (worth $6.6 billion of its $9.8 billion in pension liabilities) to the Pension Benefit Guaranty Corp. (PBGC). That decree resulted in an immediate cumulative deficit of $23.3 billion for the PBGC, a current liability that is disproportionate to its annual level of $1 billion in premiums. Because the PBGC guarantees retirement benefits only up to a maximum of a dollar ceiling (for example, $45,614 in 2005 for a 65-year-old retiree), the settlement resulted in a substantial reduction of benefits for specified United workers and retirees. While such huge UAL underfunded deficiencies might be difficult for certain participants and retirees to understand in light of original legislative intent, compliance with the funding rules never guaranteed that benefits accrued to date would be fully funded.

The bankruptcy courts’ decision will likely have a domino effect on the airline industry — as other financially distressed airlines, such as Delta, Northwest, and perhaps American, have indicated that they may be seeking similar treatment, thereby increasing the potential for PBGC liability. Most observers questioned why such a gross discrepancy between plan assets and liabilities existed for so many years and why steps were not taken to strengthen the funding of defined benefit plans. For those of us immersed in the issues of pension funding, this is simply a déjà vu of the woes that faced the financially depressed steel industry a decade ago. Unfortunately, systemic legislative and regulatory issues regarding the PBGC insurance program and premium structure, the minimum funding requirements for defined benefit plans, and the PBGC’s limited access to a bankrupt company’s assets — all contribute to a repeat of the steel and airline industry woes for other employers. The question is whether Congress will now step up to the plate and — as a matter of sound public policy — provide meaningful reform to the defined benefit system.

Unless history is understood, it will be repeated. Thus, the purpose of this article is to explain the evolution of the minimum funding rules and plan termination rules pre- and post-1974 to assess the various current legislative proposals. The initial part of this article will acquaint the reader with the historical funding rules, so that one may evaluate why and how the rules have evolved, and what rules should not be repeated. In the context of ERISA’s rules, the minimum funding rules are perceived as the most complex and therefore least understood.

The minimum funding rules were amended in 1987, making current contributions dependent on a plan termination liability. Such liabilities were to be determined based on a 30-year Treasury bond rate. Due to the demise of new 30-year Treasury bonds, Congress acted in 2002 with a temporary two-year fix. Thus, Congress will have to intervene in 2005 or early in 2006 for another interim measure if Treasury rates continue to be unavailable. While Congress may decide to focus solely on the issue of the interest rate used in determining plan liabilities, it should use this opportunity to make meaningful changes.

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Id. Note that in 2001 the PBGC stated that there was a surplus of $7.7 billion, despite declines in financial markets and large claims by several major underfunded defined benefit plans. See the press release issued by the Pension Benefit Guaranty Corp., available at http://www.pbgc.gov/news/press_releases/2002/pr02_17.htm (last visited July 1, 2005). It should be noted that the $23.3 billion deficit is based on the PBGC’s one-month lookback for the interest rate, which is more conservative than a four-year composite bond rate, a difference of about 100 basis points. Also according to the PBGC’s 2004 Annual Report, that figure includes $16.9 billion in receivables — claims that had not yet been incurred.


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4 See Carey, supra note 3, stating that the PBGC would guarantee payments to plan participants under the UAL default totaling $6.6 billion, which leaves workers and retirees with a shortfall of $3.2 billion in the form of benefit reductions due to the maximum limitation of benefits paid by the PBGC.

that will bring reforms to underfunded defined benefit plans. This article showcases the rules as they have evolved and the second part discusses the policy reasons behind the current legislative proposals. In fashioning a legislative solution, Congress will need to achieve long-term solvency of the PBGC — by increasing funding obligations for underfunded plans, while preserving the defined benefit system for the future.

The federal law known as the Employee Retirement Income Security Act of 1974 (ERISA) was passed to impose minimum funding levels for defined benefit plans as well as plan termination rules whereby the PBGC would assume some, but not all, of the unfunded liabilities of terminated defined benefit plans. Title I of ERISA is a labor statute that imposes minimum funding rules on covered employee benefit pension plans. Title II of ERISA amends the Internal Revenue Code, imposing minimum funding rules on qualified employee benefit pension plans and maximum deductible limits for qualified employee benefits pension and profit-sharing plans. Due to the overlapping minimum funding rules of Title I and Title II of ERISA, the IRS has been given jurisdiction over the interpretation of those funding rules. While many defined benefit plans enjoyed full funding during the 1990s, the decline in the stock market and decrease in interest rates produced a “perfect storm” at the beginning of the 2000s — turning fully funded plans into underfunded plans. President Bush has proposed an initiative to cure the pension funding problem, while other industry groups offer many alternative proposals.

To appreciate the magnitude of the problem, the PBGC has posted on its Web site a summary of pension plan underfunding (for plans that have at least $50 million or more of underfunding) from 2000 to 2004 — showing that the number of those underfunded plans increased from 221 in 2000 to 1,108 in 2004, while underfunding increased from $19.91 billion in 2001 to $353.73 billion in 2004, and the average plan-funded ratio dropped from 82.8 percent in 2001 to 69 percent in 2004. According to the PBGC, if all underfunded plans covered by the PBGC were to terminate today, the PBGC’s exposure would be $450 billion dollars. While the PBGC focuses on underfunded plans, it is important to look at the single-employer defined benefit plan situation in its entirety. In the 2005 Milliman Pension Study of the 100 largest U.S. corporations that sponsor defined benefit plans, the funding results are not so depressing. For the group in the aggregate, the funded ratio in 2004 was 90.5 percent, up from the prior year’s 88.8 percent (although it remained far below its funded ratio of 130 percent in 1999). Thus, any pension reform should certainly be geared toward keeping sponsors of funded plans in the system. Also it may be important to examine the potential of extending PBGC protection to small employers who may be willing to adopt defined benefit plans and pay PBGC premiums if the code’s coverage rules were revised.

II. Funding of Retirement Plans Pre-ERISA

Pre-ERISA the predominant fringe benefit offered to employees was a pension benefit, designed to defer the payment of current compensation to provide replacement income for a participant and his or her spouse during retirement. Such plans were formulated as either defined benefit plans or defined contribution plans.

A. Types of Retirement Plans

A defined benefit plan generally embodies a normal retirement formula providing a given level of benefit at a presumed retirement age as a life annuity for the participant or a joint life annuity for the participant and his or her spouse. For those participants who terminate before

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retirement, an accrued benefit formula provides an annual level of accrual, to be paid at the normal retirement age as a life annuity or joint life annuity. When a plan sponsor establishes a defined benefit plan, when the plan was not in existence (that is, "past-service credit"). To do so results in an immediate plan liability, on day one of the plan, for those past-service credits. Congress never limited the dollar amount of past-service credits that could be granted, regardless of the financial health of the employer at the time of the plan’s establishment. Actuarial assumptions are used by actuaries to approximate the cost of the promised level of benefits under the plan. In contrast, actuarial cost methods are used by actuaries to allocate those costs over different periods of time, affording employers with discretion over the incidence of pension expenses.

A defined contribution plan provides for employer or employee contributions that will accumulate over time, credited with investment earnings or capital gains or losses. Once the employer contribution is made to the plan, the employer obligation is fulfilled and the investment risk shifts to the employee. The resulting balance in the employee’s account is the amount available to the employee and his or her spouse for retirement. Traditionally, employer contributions were determined solely as a percentage of an employee’s current pay, which does not permit crediting for past service. Since the 1980s, the IRS has approved of service- and compensation-weighted formulas for allocating employer contributions. Defined contribution plans do not pose long-term funding problems for the employer, as it becomes evident annually whether or not the employer makes the required prescribed employer contribution. (Of course, this defined contribution plan advantage to the employer may, as a matter of public policy, mask undersaving by the employees. Hence, the income-replacement “floor” of defined benefit plans allows workers to know where they will stand at retirement.)

A defined contribution plan may be designed as either a profit-sharing plan or a pension plan. Profit-sharing plans permit discretionary employer contribution levels and are designed as savings vehicles (hence, in-service withdrawals by the employee may be made available). In contrast, pension plans fix the level of employer contributions and are designed as retirement vehicles (hence, in-service withdrawals are not permitted). Also, profit-sharing plans do not have to provide annuities as distribution options, thereby shifting to the participant the mortality risk that he or she may outlive the account balance. Pension plans must offer annuity options to participants.

B. Lack of Funding Pre-ERISA

Before the advent of ERISA, single-employer defined benefit plans were not required to be prefunded (that is, contributions made during the employee’s active lifetime to assure that the full cost of the benefit was funded at retirement). There are a variety of funding approaches that may be taken for the costs of a defined benefit plan. The pay-as-you-go approach simply requires that the employer have funds available as the participant’s monthly pension becomes due. That approach treats pensions as part of current wage costs and is obviously dependent on the employer’s cash flow. As the population of retirees grows relative to current workers, those costs become a significant percentage of current compensation costs. This is the phenomenon that the Social Security program is beginning to experience — moving from the past demographics of 16 workers to support one retiree to current demographics of 3.3 workers to support one retiree. There is a much larger cost assessed on the current worker pool. The terminal funding approach requires that the employer have available at retirement the

normal retirement age, the employee’s accrued benefit shall be the actuarial equivalent of that benefit).


IRC section 412 refers to defined contribution plans as individual account balances.

See Treas. reg. section 1.401(a)(4)-2(b)(3) (providing a plan to allocate amounts on the basis of uniform points, using either age or service, and compensation, if the average of the allocation rates for the highly-compensated employees (as defined by IRC section 414(q)) in the plan must not exceed the average of the allocation rates for the non-highly-compensated employees in the plan).

See Treas. reg. sections 1.401-1(b)(i) and (ii).

See IRC section 412 (minimum funding requirements applicable to pension plans) and Treas. reg. section 1.401-1(b)(1).

See IRC section 401(a)(11), which requires the normal form of distribution to be life only for unmarried participants and joint and survivor annuities for married participants if the plan is subject to the funding rules of IRC section 412 (that is, defined benefit plans and money purchase plans) and any other plan unless that plan provides a death benefit to the surviving spouse and benefits are not payable in the form of a life annuity and that plan is not a transfer plan subject to IRC section 417.

For a further discussion of the various funding models, see Jack VanDerhei, “Funding Public and Private Pensions,” reprinted in Pension Fundng & Taxation: Implications for Tomorrow 59 (Dallas Salisbury and Nora Super Jones eds., 1994).

lump sum amount sufficient to fund annual retirement benefits. While the costs of that approach will increase initially each year until a stable population is reached, subsequent costs should be constant. Alternatively, an advanced funding approach seeks to set aside funds during the participants’ working lifetime to offset the costs of retirement benefits. Once contributions equal or exceed the lump sum amounts needed to provide retirement benefits, the excess provides a cushion of security for participants that amounts will be available to meet ongoing costs.

Before ERISA’s changes, the code regulated the funding of qualified defined benefit plans. For qualified defined benefit plans, the code required a minimum funding of current accruals plus interest on the past service liability (referred to as the “interest-only funding”). Such approach was preferable to the pay-as-you-go approach and the terminal approach. While sound funding may have required the full funding of the past service liability when the plan was created or amended to increase past-service costs, the code (for revenue reasons) never permitted those deductions. Pre-ERISA, the code limited annual deductions to the current accrual of benefits plus 10 percent of the past-service liability. Any excess contributed to the plan was “carried forward and deducted in future years.” The code also prescribed maximum funding limitations to impose a ceiling on the level of annual employer contributions that could be deducted under retirement plans. Employers that had been prefunding pension costs pre-ERISA, the code imposed a full funding limitation — to the extent past service costs had been fully funded, the employer would be unable to make contributions in excess of the plan’s current normal costs. Actuaries computed the maximum limits using actuarial cost methods and actuarial assumptions.

Plan sponsors were also free to terminate the plan at will, even if the plan was not fully funded. The result left participants and beneficiaries particularly vulnerable should a plan sponsor become bankrupt or insolvent. When ERISA was passed in 1974, there were two important issues that Congress wanted to codify:

- minimum funding standards would be imposed to assure that benefits would be prefunded and monies would be available when a participant retired; and
- in the event of plan insolvency, a new organization, the PBGC, would be created and a certain level of pension benefits would be guaranteed by the PBGC. Funding of this guarantee would be through premiums collected from covered plans.

III. Advent of ERISA

A. Minimum Funding Rules

Under the initial funding rules of IRC section 412, a single-employer defined benefit plan was required to hire an enrolled actuary to compute current costs (that is, costs associated with this year’s plan accruals) and the costs of unfunded actuarial liabilities (that is, costs associated with past-service accruals or unfunded prior normal costs), using reasonable actuarial assumptions. Generally, an actuarial cost method produces two cost figures — the annual costs of current accruals (referred to as the plan’s normal cost) and an amortized cost of the plan’s actuarial liabilities (which could be attributable to past-service liabilities or the inability of the plan sponsor to make prior normal cost contributions). Failure to comply with the minimum funding rules subjects the employer to a 10 percent excise tax, plus a second-tier excise tax of 100 percent if the contribution is not made within a given correction period. To understand those concepts, the origination of a fixed-rate (as distinct from a floating-rate) mortgage may be a helpful, although not a perfect, analogy.

When someone purchases a home with a mortgage of $250,000, the cost of the transaction is fixed at $250,000, but how that cost should be paid over time depends on many variables, notably the assumed interest rate and the duration of payment. Once an interest rate, duration of payment, and the decision to pay equal monthly installments are determined, the cost method produces a single

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25For a discussion of “interest-only” funding, see Dorrance Bronson, Concepts of Actuarial Soundness in Pension Plans, 97-101 (1957).
26IRC section 404.
28See former IRC section 404(1)(B) (stating that “in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased”).
29IRC sections 2(a) and (c), 29 USC sections 1001(a) and (c), in which Congress declares its policy in adopting ERISA to include “that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered that owing to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits” and “to be the policy of this Act . . . by requiring plan termination insurance.”
30IRC section 412(c)(3).
31Treasury reg. sections 1.412(c)(3)-1(b).
32ERISA section 3(31), 29 USC section 1002(31), lists six acceptable funding cost methods, but allows Treasury to further define acceptable actuarial cost methods (a right reserved in the preamble to Treas. reg. sections 1.412(c)(3)-1 and -2, T.D. 7746). The six approved cost methods are accrued benefits; individual level premium; entry age normal; aggregate; attained age normal; and frozen initial liability. Actuarial cost methods generally fall into two generic categories: those that focus on accrued benefits (that is, methods that allocate to the current year the amount of benefits that actually accrue in that year) and projected benefits (that is, methods that project what the actual pension will be at retirement and then allocate the cost of such benefit uniformly over a given number of years). Cost methods may fund past service liability over a different period of time than current accrual costs; also changes generated by deviations in actuarial assumptions may be amortized or recognized immediately in the annual pension costs.
33See Rev. Proc. 2000-17, 2000-1 C.B. 766, Doc 2000-5479, 2000 TNT 39-5, for situations in which the Service has used its discretion to waive the 100 percent second-tier excise penalty.
Note: The valuation of monthly mortgage payments or a plan's normal costs and amortization of past-service liabilities is extremely sensitive to the interest rate assumed. Our $250,000 mortgage valued at a 7 percent interest rate over a 30-year duration results in a monthly cost of $1,663; whereas the same mortgage valued at a 5 percent interest rate over a 30-year duration results in a savings of $321 per month, for a total savings of $115,633 over the term of the loan. Changes in the interest rate and mortality table used to value plan liabilities will have considerable effect on the current and subsequent costs for the employer.

While the original face value of the home mortgage — and therefore also the required monthly payments — do not vary over the duration of the mortgage, the actual costs of a defined benefit plan will vary over time as participants' years of participation and salary change. Costs of a defined benefit plan will vary over time as the interest rate assumed, for benefit increases, for actuarial gains or losses experienced during the plan year, and so forth. Those changes may be amortized over a period of years so as to smooth their effect, as opposed to having an immediate effect on costs. In determining funding limits, plan assets are not required to be valued at fair market value, but instead may be valued under some smoothing rules. Those smoothing effects on both the liability and asset side were designed to minimize the volatility of the employer's annual pension costs, which was consistent with the premise that pension costs were to be paid over a long period of time. While the smoothing effects assist employers in keeping annual costs predictable, they did not force the employer to make additional contributions due to mark-to-market changes in plan asset values or plan liability values.

Section 412 directed the actuary to use an accounting "T account" in describing the plan's accumulated funding history. On the debit side of the T account, the code listed the required minimum normal costs and prescribed amortization of unfunded actuarial liability and other bases; on the credit side of the T account, the actual employer contributions made and various offsetting amortization of bases were listed. The T account began in 1976 for existing plans and would begin in the first year of establishment for post-ERISA plans. The new minimum funding rules did not require the employer to make the minimum funding contribution until 8½ months after the end of the plan year. Unfortunately, if the employer were unable to make the minimum contribution, this delayed payment date afforded additional time for the employer to mask its financial difficulties, as well as to avoid payment of the excise tax to the Service if the employer petitioned for bankruptcy before the delayed payment period.

In deciding what the required annual funding requirements would be for plan sponsors, there is a tension between funding from a budgetary perspective and providing the ideal funding of the security of employee expectations. In assessing the unfunded actuarial liability for the debit side of the T account, actuaries could use the plan assets' fair market value on the date of the valuation or an actuarial valuation value that incorporated some smoothing if the fair market value of a given plan asset was not readily ascertainable. The initial actuarial value of plan assets ranged between 80 percent and 120 percent of the fair market value of plan assets, affording smoothing for those assets that were not readily valued. For liabilities, the debit side sets forth the plan's normal costs and the 40-year (or 30-year for post-ERISA plans) amortization of unfunded actuarial liabilities, as well as the amortization of other costs over alternate years. The amortization of those unfunded costs provided smoothing for the employer, which resulted in predictable costs.

If the cumulative credit balance exceeded the debit balance, the plan was in compliance with the minimum funding rules; if the cumulative debit balance exceeded the credit balance, the plan was experiencing an accumulated funding deficiency, subjecting it to excise taxes and

34 ERISA section 302(a)(1), 29 USC section 1082(a)(1), and IRC section 412(a)(1).
35 ERISA section 302(b)(2)(A)-(B), 29 USC sections 1082(b)(2)(A)-(B), and IRC sections 412(b)(2)(A)-(B).
36 IRC section 412(b)(2)(B)(iii).
37 IRC sections 302(b)(2)(B)(iv) and (b)(3)(B)(ii), and IRC sections 412(b)(2)(B)(iv) and (b)(3)(B)(ii).
38 ERISA section 302(c)(2)(A), 29 USC section 1082(c)(2)(A), and IRC section 412(c)(2)(A).
notification to plan participants and the PBGC.45 While such disclosure may have comforted participants, it certainly was not an adequate disclosure of the plan’s ability to pay benefits as due if the employer were to become insolvent. In the fixed-rate mortgage context, prefunding of principal amounts may be allowed but it does not alter the required monthly mortgage payment, nor does it prevent foreclosure if future minimum mortgage payments are not made.

Under the T account, if an employer contributed more than was minimally required, such excess would be carried forward cumulatively as a credit balance.46 Whether this is a legitimate policy is questionable. In the mortgage context, one can prepay a mortgage payment, but it does not relieve the individual of subsequent monthly mortgage amounts. Instead, it simply shortens the time until the last of the (still-required) monthly payments is made. In the pension context, to the extent the law wishes to move to a plan solvency basis, use of the credit balances is not accurate in determining whether a current contribution should be made to fund the plan on a plan termination basis. Also the credit balance is carried forward year to year at the interest rate used in the actuarial valuation, not based on the actual interest rate earned by the plan.47

Once a bank has assumed a fixed-rate mortgage, it does not have the right to subsequently increase the monthly mortgage payments due to a change in interest rates or the fair market value of the home. If it did, the imposition of an increased monthly payment could result in foreclosure if the lender could not meet the increased monthly payment (so that floating-rate mortgages typically include liability safeguards, such as rate caps and variable period amortization). Also, the typical mortgage does not compare on a yearly basis the initial mortgage amount with the current market value of the home to evaluate the potential for liability by the bank or financial institution if the mortgage is foreclosed.

Some of the current proposals would mandate substantial increases in funding past-service liabilities; compare current market value of liabilities to assets in determining additional funding; and require substantial increases in PBGC premiums. In the defined benefit context, if Congress were to make too sudden an acceleration of funding obligations, it might force some employers to liquidate, become insolvent or bankrupt (unless that entity is fortunate enough to be within a controlled group of entities that are solvent) leaving the PBGC with even greater liability. Also an annual comparison of liabilities to assets on a mark-to-market basis as an indicator of increased costs does not provide employers with the certainty they need to fund defined benefit plans. Furthermore, any substantial increase in PBGC premium certainly may preclude future adoption of defined benefit plans, especially by a healthy employer who would deem such add-on charges an unnecessary cost of the plan. Too-sudden obligations may also encourage healthy employers with funded defined benefit plans to leave the system due to the additional administrative costs. While use of current market values for asset and liability valuations makes perfect sense from an economic perspective, employers need predictability in determining annual pension costs. When the defined benefit costs become highly volatile depending on the market value of assets and liabilities, healthy employers will leave the defined benefit system and opt for the defined contribution system for which costs are much more predictable. While volatility may be minimized by investing in long-term bonds with similar maturities as plan liabilities, such investment strategy increases the overall cost of the plan to the employer.

B. Initial Full Funding Limitation

Pre-ERISA, the code would not allow a deduction to a plan sponsor if the plan were fully funded (that is, at its full funding limit). ERISA continued that rule in the context of minimum funding requirements.48 With the advent of ERISA, the full funding limit was explicitly determined as the difference between:

- lesser of the fair market value of plan assets or the actuarial value of such assets; and
- the plan’s actuarial liability (or the accrued liability under the entry age normal cost method if the plan’s cost method did not produce a separate accrued liability).49

By not using the fair market value of assets and the plan termination value of liabilities, the full funding limitation permitted some smoothing in determining whether additional employer contributions could be made and deducted. If the full funding limitation was applicable, no minimum funding contribution was required and no deductible contribution could be made.50 That was the result even if the plan was not adequately funded under a plan termination liability analysis.

The value of the plan’s actuarial liability was based on the actuary’s assumptions regarding interest and mortality,51 not a present value determination as if the plan were to terminate today. Because the plan may not be distributing benefits for 40 years (for a 25-year-old participant), the interest rate used in valuing that benefit would reflect a long-term investment. To the extent that interest rate had to be changed prospectively, any increase in liability could be smoothed over a period of years. The code

45ERISA section 302(a)(2), 29 USC section 1082(a)(2), and IRC section 412(a). See also IRC section 4971 for the excise tax assessed on an accumulated funding deficiency and ERISA section 101(d)(1), 29 USC section 1021(d)(1), requiring disclosure to participants if the employer fails to make the required contribution under ERISA section 302, 29 USC section 1082, within 59 days of its due date.

46ERISA section 302(b)(3), 29 USC section 1082(b)(3), and IRC section 412(b)(3).

47ERISA section 302(b)(5)(A), 29 USC section 1082(b)(5)(A), and IRC section 412(5)(A).

48ERISA section 302(c)(7), 29 USC section 1802(c)(7), and IRC section 412(c)(7).

49ERISA section 302(c)(7)(A), 29 USC section 1802(c)(7)(A), and IRC section 412(c)(7)(A).

50ERISA section 302(c)(6), 29 USC section 1802(c)(6), and IRC sections 412(c)(6) and 404(a)(1)(A).

implicitly assumed that the employer would always continue in business and thus funding over a longer period of time was acceptable.

The full funding limitation applies to the minimum funding rules of section 412 and the maximum deductible rules of section 404. With the passage of ERISA, using the minimum funding rules of section 412 and the maximum deductibility limits of section 404, plan sponsors were afforded a corridor within which to make contributions that will satisfy both requirements.

The minimum funding rules of ERISA and the code encouraged employers to grant past-service liabilities (regardless of the financial health of the sponsor), and permitted post-service liabilities to be funded over a 40-year amortization schedule (for employers with liabilities at ERISA’s effective date) or even the remaining active lifetime of current participants was shorter than 40 years. Perhaps 40 years was selected as the most palatable duration of time, as there had been no prefunding of past- or current-service liabilities pre-ERISA. Congress may have believed that employers would not embrace the new funding rules if a sufficient period of amortization of past-service liabilities was not granted.

In retrospect, ERISA’s funding rules were initially too liberal and should have been based on the participants’ expected future service with the employer, so as to guarantee full funding of the participant’s benefits on retirement. Also financially weak employers should not have been able to create large amounts of past-service liabilities.

C. Maximum Deductible Limits

The code established a maximum deduction ceiling for employers sponsoring both a qualified defined benefit and a qualified defined contribution plans for the same group of employees. In that situation, the overall deduction ceiling for the employer is 25 percent of the covered employee’s payroll for the current year.52 In the second part of this article, there are many legislative proposals that would increase the maximum funding limits for defined benefits plans. Should one of those proposals become law, it may be important to increase this overall deduction ceiling so that employers can continue to fund defined benefit plans and maintain contributory code section 401(k) plans for their employees.

D. ERISA’s Termination Structure

ERISA was initially drafted to permit employers to freely opt in and out of the defined benefit system,53 even though the employers were in full control of the amount of unfunded plan liabilities created and the PBGC had no control over the level of liability it would assume. In fact, the minimum funding rules created the potential for employers to fund at the actual minimum funding levels but nevertheless decide to terminate the plan at will and thereby transfer unfunded liabilities to the PBGC. While ERISA decided to insure past and future service, the premiums charged to employers of defined benefit plans had no relationship to the level of unfunded liabilities — the premiums were initially set by Congress as a per-capita flat dollar amount of $1 per participant per year.54 The PBGC receives no appropriated funds, only its premiums. The result was to insure weak employers at the cost of healthy employers with funded plans.

While the design of such a system seems to have inherent flaws, discussion of those problems was circulated pre-ERISA. While most agreed that some type of public insurance of private pension plans should be adopted, Congress knew that risks such as “moral hazard” and “adverse selection” existed with such a system. Moral hazard referred to the risk that conduct would change so as to increase the likelihood of receiving the benefits from the insurer, whereas adverse selection referred to the non-random selection that those who had the greater likelihood of current liabilities would opt into the insurance arena. Unfortunately, a voluntary insurance schedule destabilizes the insurance pool as the low-risk employers opted out of the system (that is, cost of premium coverage is not necessary) and high-risk entities opted into the system (that is, cost of the premium coverage is less than expected current liabilities receipt).55

ERISA’s flawed insurance system led to the voluntary termination of underfunded pension plans to shift liabilities to the PBGC. Since premium costs, despite increases, were still relatively low ($8.50 per participant in 1985), low-risk entities may have been neutral as to whether opt in or opt out of the arena. By 1986, Congress substantially revised ERISA’s Title IV single-employer plan termination rules.56 Employers could voluntarily terminate a defined benefit plan only if plan assets were sufficient to cover all plan liabilities. That is now referred to as a standard plan termination.57 The plan is permitted to terminate by making distributions to all eligible participants, beneficiaries, and alternate payees. The PBGC oversees the process, but incurs no liability. In contrast, employers maintaining underfunded defined benefit plans may terminate such plans only if the employer satisfies the distress plan termination rules.58 Those new rules require the plan sponsor and each member of the

54See Pub. L. 93-406, section 4006(a)(1)-(5) (1974) (enacting ERISA section 4006(a), 29 USC section 1306(a)).
55See the Society of Actuaries Committee on Actuarial Principles, Fundamental Principles Exposure Draft (June 1991) in which an insurance system is defined as a financial security system that (1) finances actuarial risks that arise from insurable events; (2) groups risk subjects according to a risk classification system; (3) pays benefits that are related to an insurable interest; (4) the actuarial value of benefits payable is finite; and (5) considerations are consistent with the actuarial value of the related benefits. Those features were not present in the initial design of Title IV’s insurance program for single-employer sponsors of covered defined benefit plans. See also, Holman W. Jenkins Jr., “Send United to the Great Hangar in the Sky” Wall Street Journal, May 25, 2005 (noting that overpromising benefits was too good a bargain for some employers to pass up, as the PBGC was liable for a portion of the underfunding).
56Pub. L. No. 99-272, section 11077(a) (1986), altering ERISA sections 4041(a), (b), and (c), 29 USC sections 1341(a), (b), and (c).
57ERISA section 4041(b), 29 USC section 1341(b).
58ERISA section 4041(c), 29 USC section 1341(c).
sponsors’ controlled group to satisfy one of the following criteria: a petition in bankruptcy or insolvency had been filed seeking liquidation of the sponsor; the sponsor demonstrates that it will be unable to pay its debts when due and will be unable to continue in business if a termination is not approved; or the cost of providing the pension coverage has become unreasonably burdensome as a result of a decline in the work force.59

As a result of the new rules, it became much more difficult to voluntarily terminate a defined benefit plan. Such legislative efforts demanded more of weak employers and more of healthy employers with underfunded plans. Employers had to continue to fund those plans. Many decided to “freeze” future benefit accruals under the plan (that is, discontinue future benefit accruals) to reduce future costs.

Alternatively, some single-employer plans experienced dramatic increases in plan surpluses during the 1980s. This led to the termination of several plans to access the plan surplus. To prevent that access, Congress introduced a draconian 50 percent excise tax on any surplus received by the plan sponsor from an overfunded single-employer defined benefit plan.60 Afterwards, many employers with surplus plans decided not to terminate the defined benefit plan but instead decided to convert the plan into a hybrid defined benefit plan (such as a cash balance plan) to use the surplus for future contributions.61 Those plans (if conversions) are now in limbo as the IRS will not issue favorable determination letters for converted cash balance plans (as opposed to new ones) and Congress has imposed a moratorium on the IRS’s ability to issue determination letters on converted cash balance plans in the future.62

Under the rules of ERISA, the PBGC does not insure all pension benefits promised under the terms of the employer’s defined benefit plan. Instead, the PBGC guarantees specific pension benefits, namely (1) pension benefits, (2) nonforfeitable according to the terms of the plan before the plan termination, and (3) limited by a maximum dollar amount (with plan amendment increases phased in over 5 years).63 For example, benefits such as disability benefits are not covered by the PBGC and thus if an underfunded plan terminates, the recipient of any plan disability income cannot look to the PBGC for relief. Similarly, when a qualified plan terminates, it is required under the code to fully vest participants in their accrued benefits; hence an employee 50 percent vested in his benefit of $1,000 per month at 65 for life only would become 100 percent vested in his or her benefit of $1,000 per month at 65 for life only. The PBGC will only guarantee the benefit that was vested prior to the termination — the $500 per month at 65 for life only. There is also a maximum dollar limit applicable to the PBGC guarantee, which varies year to year (for example, for 2005, the maximum dollar amount is $45,614 per year at 65).64

E. ERISA’s Premium Structure

For the sake of simplicity, the initial 1976 PBGC single-employer premium was set at $1 per participant for single-employer plans.65 The premium was raised to $2.60 in 1977; to $8.50 in 1985; $16 in 1987; and $19 in 1991,66 an increase of 1,800 percent in 15 years. Such a flat premium rate would be analogous to charging everyone the same flat premium for car insurance. Just as the cost of car insurance affects how one drives, the level of the PBGC premium motivated behavior by plan sponsors. The flat premium rate did not take into account the plan’s unfunded liability, or the likelihood that the plan would terminate due to the financial health of the employer (moral hazard and adverse selection features that an insurer would never undertake).

Bethlehem Steel unloaded a claim of $3.7 billion to the PBGC after paying only $60 million in premiums over a 10-year period 1994 to 2003.67 Likewise United Airlines has paid $75 million in premiums over a 10-year period 1995 to 2004, yet its pensions are underfunded on a plan termination basis by more than $5 billion.68 Obviously


64 See the table of Maximum Benefit Limitations by Year, available at http://www.pbgc.gov/services/descriptions/guarantee_table.htm (last visited July 1, 2005).

65 For more information on cash balance plans, see GAO, Private Pensions: Implications of Conversions to Cash Balance Plans, HEHS-00-185 (2000), and GAO, Cash Balance Plans: Implications for Retirement Income, HEHS-00-207 (2000).


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the level of the premium was set too low and did not require the plans with the greatest underfunding to contribute more.

The premium also did not vary depending on the level of past-service liability granted by a plan sponsor. The Pension Protection Act of 1987 added a second-tier premium for plans with unfunded vested benefits. The second-tier premium was initially $6 for each $1,000 of unfunded vested benefits, divided by the number of participants, subject to an overall cap of $50 ($16 basic + $34 variable) per participant. In 1994, the cap on the variable rate portion of the premium was phased out. Hence, the annual PBGC premium is a flat $19 per participant and a variable rate premium of 0.9 percent of the amount of the plan’s unfunded vested benefits. In determining the unfunded vested benefits for the variable rate premium, the interest rate is 85 percent of the annual rate determined by the Secretary of Treasury on amounts invested in long-term investment-grade corporate bonds. While this variable rate portion of the premium shifts more of the cost of the insurance protection to the poorly funded plans, it does not take into account that the employer could become insolvent or bankrupt.

The 1987 legislation also imposed a requirement on certain underfunded plans that quarterly premiums be paid, 15 days after the end of each quarter. Thus, for a calendar plan year, installments were due on April 15, July 15, and October 15 of the current year, and January 15 of the following year.

As a result of the current premium structure, as plans became fully funded, there was the temptation to terminate, leaving poorly funded plans as the sole constituents of the insurance system. By 1985 there were about 22 million active participants in single-employer defined benefit plans at a time when the premium rate was $8.50 per participant per year. By 2002 the number dropped to 17 million when the premium rate was $19 per participant per year. Thus, any future premium increases to offset PBGC liability will be applied to a declining pool of participants. During the last week of April 2005, the House and Senate passed a $2.6 trillion budget mandating reforms be made to PBGC, generating $6.6 billion in savings over five years. The administration’s recommended PBGC premium increase of $30 per employee per year (a substantial increase from the current $19 rate) would raise $18 billion over five years (based on the assumption that the risk-based premium is assessed against all underfunding, that the flat-rate reforms are enacted and the total premium revenue would cover expected future current liability and amortize the PBGC’s $23 billion deficit over 10 years). As of September 30, 2004, the PBGC insured approximately 44.4 million participants in more than 31,200 defined benefit plans — of those, 34.6 million were participants in 29,600 covered single-employer pension plans, and the rest under multiemployer plans.

F. PBGC’s Investment Structure

ERISA was designed to be a closed system, such that the U.S. government was not intended to fund the guarantee of benefits for terminated plans. Hence, the PBGC is not backed by the full faith and credit of the federal government. It does have a $100 million line of credit from the Treasury for liquidity purposes should annual premium and investment receipts become inadequate to meet operating costs.

The PBGC’s assets consist of premium revenues (accounted for in revolving funds) and assets from terminated plans and their sponsors (accounted for in the trust funds). By law the assets in the revolving fund are required to be invested in fixed-income securities. In its 2004 financial report, the PBGC noted that its policy was to invest these funds only in Treasury securities.

Footnote continued on next page.
contrast the PBGC has discretion in the investment of its trust funds. Before 2004, the PBGC had a significant portion of its total invested trust fund assets in equities.\textsuperscript{80} Thus, as trust assets in employer-sponsored defined benefit plans were negatively affected by the turn in the market in 2000, the PBGC’s trust assets were similarly affected. As such, the PBGC adopted a new investment policy in 2004 to reduce the volatility arising from a mismatch between assets and liabilities. The percentage of trust assets invested in equities will be decreased to somewhere in the range of 15 percent to 25 percent of total invested assets.\textsuperscript{81} The intent is to reduce the PBGC’s investment risk.

As part of any pension funding reform proposal, investment strategies for the PBGC’s investment of premiums and plan assets should be scrutinized due to the effect of investments on the PBGC’s overall financial health. If the PBGC’s assets are down at the same time as the private system’s assets are down, then the PBGC will be most needed when it is the weakest. PBGC assets should either be noncorrelated, or even negatively-correlated, with volatile private-sector assets.

G. ERISA’s Disclosure Requirements

The results of a plan’s funding standard account are disclosed on Schedule B of Form 5500, which is filed with the Department of Labor seven months after the end of the plan year (with an additional 2½ month extension). Schedule B discloses the plan’s assets, current and accrued liabilities, employer contributions, expected payments to retirees and beneficiaries, the actuarial cost method and actuarial assumptions, and the amortization bases. Due to the delayed filing date, it does not provide timely disclosure to participants as to whether required contributions have been made and as to the plan’s funded status. A summary annual report (SAR) is required to be sent by the plan administrator to participants and beneficiaries regarding the financial health of the plan. Disclosure as to whether sufficient contributions to satisfy the minimum funding standards and any amount of deficit must be made. If the plan is less than 70 percent funded, the funded status must be explicitly disclosed. The SAR must be provided within nine months after the end of the plan year or within two months after the extended due date for Form 5500.

The evolving fund’s value was $16.2 billion and the trust fund’s value was $21.3 billion. Cash and fixed-income securities represented 70 percent of the total assets invested at the end of the year, compared to 63 percent at the end of 2003. Equity securities represented 30 percent of total assets invested, compared to 37 percent at the end of 2003. A very small portion of the invested portfolio remains in real estate and other financial instruments.\textsuperscript{80} \textsuperscript{81}Id. According to the PBGC, 41 percent of its investments were in equities (as of Sept. 30, 2000) and equity returns were $237 million less than in 1999, available at http://www.pbgc.gov/publications/anrpt/00anmrpt.pdf?xml=http://pbgc.gov.mater.com/texis/master/search/mysite.txt?q=investment+of+premiums&order=r&cid=38016828581d3c24&cmd=xml (last visited July 1, 2005).

ERISA section 4010 requires specific disclosure by employers with plans that (1) have aggregate unfunded vested benefits in excess of $50 million (determined on a variable-rate premium basis), (2) have missed required contributions in excess of $1 million, or (3) have outstanding minimum funding waivers in excess of $1 million. That disclosure must be made to the PBGC; however, ERISA section 4010(c) prohibits the PBGC from disclosing this information, except for the information that is otherwise public. Thus, participants of underfunded pension plans sponsored by financially weak employers may be unaware of the extent of the problem until the employer goes into bankruptcy or the plan is assumed by the PBGC.

IV. Evolution of Funding/Termination Rules

A. Changes to ERISA’s Initial Funding Rules

Under the 1987 legislation, funding for defined benefit plans became subject to two calculations: the normal FSA calculations and a new calculation that may require a greater employer contribution, determined by the plan’s current liability — an attempt to capture the plan’s solvency, not simply long-term pension liability.\textsuperscript{82} The intent was to protect the PBGC from incurring liability in the event of a premature plan termination. The current liability captured plan liabilities accrued to date,\textsuperscript{83} whereas the actuarial liability (used for amortization purposes) could be based on projected future benefits (including future salary increases).\textsuperscript{84} The new funding rules were referred to as the deficit reduction contribution (DRC) rules.\textsuperscript{85} Thus, plans were portioned into two camps: those that were funded and limited by the full funding limitation to increase funding, and those that were unfunded.

Because the value of plan liabilities on a current plan termination basis or on an ongoing plan basis is sensitive to actuarial assumptions, Congress decided to impose an interest rate determined by statute for determination of a plan’s current liability.\textsuperscript{86} The plan actuary could use a

\textsuperscript{82}Pub. L. No. 100-203, IRC section 9303(a)(10) (The Pension Protection Act of 1987, Part II of Title IX of the Omnibus Budget Reconciliation Act of 1987).

\textsuperscript{83}ERISA section 302(c)(7)(B), 29 USC section 1802(c)(7)(B), and IRC section 412(a)(7)(B).

\textsuperscript{84}TThe actuarial liability (including the normal cost) is the liability for projected benefits under the plan (that is, cost of items reasonably expected to be incurred if the plan continues in operation even though not incurred if the plan were to be terminated currently). The interest rate assumption used in determining the actuarial liability does not have to fall within the interest rate corridor used in valuing the plan’s current liability.

\textsuperscript{85}IRC section 412(i)(2).

\textsuperscript{86}See GAO, Pension Benefit Guaranty Corp. Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform, GAO-04-150T (October 14, 2003), available at http://www.gao.gov/new.items/d05294.pdf (last visited July 1, 2005) (stating that the PBGC analysis notes that a drop in interest rates of 1 percentage point, from 6 percent to 5 percent, increased termination liabilities of the Bethlehem Steel pension plan by about 9 percent). See also VanDerheij, supra note 23.

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reasonable interest rate in determining current liability, which was at least 110 percent of a four-year weighted average using the Treasury 30-year bond rate; but no fixed mortality rates were prescribed. The intent of a four-year weighted average was to smooth fluctuations in liabilities that could occur if there were sharp swings in interest rates. The result would reduce volatility in the minimum funding requirements and make funding more predictable. At that time, the fixed interest rate was about 9 percent. The 110 percent and the four-year weighted average served as a cushion against volatility in the employer’s determination of costs. The code now permitted the prefunding of any unfunded current liability. The plan actuary now had two different sets of actuarial assumptions in valuing the actuarial liability and the current liability.

The point of the current liability rules was to check plan funding not only from a long-term (valuing actuarial liability) approach, but also from a plan solvency (using current liability) approach. The result of the current liability rules was to produce a series of funding targets — failure to meet such targets subjected the employer to new hurdles. Unfortunately, the end result was to focus on the various funding targets to avoid the new rules, instead of focusing on funding the plan from a solvency perspective.

Under the 1987 rules, if a defined benefit plan was funded at a level of 90 percent of the current liability, the plan was subject to prior funding rules. There was a transitional rule if the plan dropped below 90 percent of current liability but was funded at 80 percent of current liability and had been at the 90 percent threshold for two consecutive years (out of the preceding three years). Most actuaries were determining the normal funding costs at an interest rate of about 7 percent, which triggered the full funding limitation and eliminated the need to make any current contributions. To the extent the plan fell below the 90 percent current liability level, the amortization periods were shortened to increase funding. As a result, employers of underfunded plans set their funding target to achieve the 90 percent current liability threshold, thus avoiding the new increased funding requirements. Funding at the 90 percent current liability also avoided the participant notice requirement regarding the funded status of the plan and the level of benefit guarantees provided by the PBGC.

For poorly funded plans, amortization periods were increased to 18 years for unfunded past-service liabilities and any increases in future plan benefits were amortized over a period of years subject to a sliding scale (25 percent to 15 percent depending on the level of the plan’s current liability). The same interest rate used to determine current liability would be used in determining the deficit reduction contribution rate. The 1987 legislation also shortened the amortization periods for some bases (for example, gains, losses, and assumption changes) and limited the availability of funding waivers. Such funding efforts forced underfunded plans to fund toward, but not at, a solvency criterion. Because of the 90 percent current liability threshold, many underfunded plans were careful to meet the 90 percent level so as to avoid increased funding contributions and participant notification. Plans also were being funded up to the full funding limitation so as to avoid a variable PBGC premium. The 1987 legislation resulted in plan sponsors of fully funded plans contributing only for minimum funding contributions, to avoid a surplus situation that would trigger the punitive 50 percent excise tax. Congress had imposed the 50 percent excise tax penalty in response to the raiding of pension plans in takeover situations to gain access to the surplus. Such approach prevented the raiding of pension plans, but it also prevented employers from contributing “too much” (to protect the plan participants) as that excess would be lost in taxes if the plan terminated.

For fully funded plan sponsors, the new rules posed new funding targets that employers would have to meet to avoid certain problems:

- While the law permitted 110 percent of the 4-year weighted average of the Treasury 30-year bond rate to be used in determining current liability and the deficit contribution rate, quarterly employer contributions would not be required if using a 100 percent
rate satisfied the rules. Hence, plans moved to 100 percent of the 4-year weighted average of the Treasury 30-year bond rate to avoid the requirement of quarterly contributions.

- If the plan sponsor funded up to the full funding limitation, there would be no variable portion of the PBGC premium that is due. In determining vested liabilities for that purpose, the interest rate was fixed at 85 percent of the previous month’s composite corporate bond rate — another determination of liabilities at a different interest.

- Under the new funding rules, lump sum distributions available under a plan were to be valued at the same interest rate used in determining current liability, not the interest rate used under the plan (which could have provided a subsidized benefit for lump sum distributions). While not apparent from the legislation, one explanation as to why that rule prevailed is that the PBGC never guarantees lump sum distributions as a form of payment; hence, why build into the cost of the current liability any lump sum subsidy that the PBGC will not incur.

The PBGC was also instrumental in having Congress adopt the standard and distress termination rules discussed earlier. Another funding issue that developed under poorly funded plans focused on the ability of retirees to elect lump sum distributions in lieu of the life only, or joint and survivor annuity. Although the plan was underfunded, lump sum distributions permitted retirees to receive the full value of their benefit (even the portion in excess of the PBGC dollar maximum) to the detriment of retirees that elected annuities.

B. Funding Rules From 1987 to 1994

During those years, the employer’s contributions became dependent on many funding targets that the employer may or may not decide to attain. As a result, the minimum funding rules were not instrumental in determining that an adequate level of plan contributions was made. The PBGC continued to lobby for more stringent funding rules that would reduce the potential for PBGC liability. By 1994 the PBGC was instrumental in having Congress make the following changes:

- introduce a current mortality table for the calculation of current liability (that is, the 1983 GAM Table);
- lower the 110 percent number applied to the 4-year weighted average Treasury 30-year bond rate to 105 percent over a 5-year period, to reduce smoothing of the interest rate; and
- restrict the amount in retroactive plan benefit increases for poorly funded plans.

For fully funded plans, the 1994 legislation provided no change in the minimum level of contributions. As such, those plans had no incentive to increase plan contributions if the cushion provided in the funding rules would later disappear. Since any plan surplus would be subject to a punitive tax of 50 percent, there was a disincentive to make additional contributions to cushion those plans in lean years. With 20/20 hindsight, the imposition of the 50 percent excise tax on distributed surplus proved disastorous as it reduced the potential for surplus contributions in good years and increased contributions during lean years. The new message was clear: stay at the minimum level of contribution due to the punitive excise tax.

For employers with surplus defined benefit assets who wished to react to younger employees’ desire for defined contribution plans, some employers reacted with cash balance plans — plans that were defined benefit plans but allocated the surplus to future allocations for all eligible participants. Since defined benefit plans were required to have “definitely determinable benefits,” fixed interest rates were guaranteed on the participants’ allocations — making such arrangements more valuable to younger participants than traditional defined contribution arrangements had been.

How could this result happen? Pre- and post-1974, federal legislation and the tax code’s tax rules did not mandate that defined benefit plans had to be fully funded in the event of a plan termination. Between 1987 and 1994, the minimum funding rules were strengthened but did not result in full funding of current plan liabilities. The current cost of plan liabilities (current liability) was determined by the code in reference to the 30-year Treasury bond rates. In October 2001, the U.S. Treasury no longer issued those bonds, causing turmoil for

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defined benefit plans in determining their current liability figure. Faced with the potential for billions of dollars of liabilities, the Bush administration is supporting legislation that would dramatically increase the required funding of underfunded plans and raise the level of premiums paid to the PBGC to offset those costs for the sponsors of funded and underfunded plans.\textsuperscript{105}

C. Funding Rules From 1994 to 2000

The poster children for the current reform measures are the steel industry claims during the 1980s and the airline industry claims in the late 1990s and early 2000s. These plans maintained large credit balances which resulted in no minimum contributions under section 412.\textsuperscript{106} As interest rates fell after 1994, the level of plan liabilities increased and the current liability portion of the funding requirement led to an increase in plan contributions for underfunded plans. For fully funded plans, the increase in interest rate elevated current liability and actuarial liabilities, but the bull market in equities produced such high plan asset values that minimum and current liability funding obligations were not required.

Due to the increase in asset values and the increase in the interest rate for the current liability — not embraced by actuaries in determining the interest rate for actuarial liabilities — the new contribution level for employers became driven by the current liability (not the actuarial liability). That impact left plan actuaries to focus on the value of plan assets and current liability, ignoring the plan’s long-term actuarial liability. An entire generation of pension actuaries failed to see the value of the plan’s actuarial liability due to the level of current liabilities and plan assets. If an employer was unable to meet the minimum funding standard account, a waiver could be requested — liabilities in that context were to be based on 120 percent of the federal midrate interest, another interest rate to be considered.

By the end of the 1990s, the funding of defined benefit plans was defined in terms of the following funding targets, instead of targets that focused on adequately providing for employees’ expectations:

- attain 110 percent of current liability for funding to avoid the top 25 lump sum restrictions (this is certainly relevant in the small employer context when one of the highly compensated individuals wishes to procure a lump sum distribution from the plan);\textsuperscript{107}
- attain 100 percent of current liability to avoid quarterly employer contribution requirements;\textsuperscript{108}
- attain 90 percent of current liability to avoid additional funding charges (subject to volatility test) and participant notification;\textsuperscript{109}

- attain 80 percent of current liability to avoid required additional funding charges and alternative participant notification;\textsuperscript{110} and

- attain 60 percent of current liability to avoid restrictions on plan amendment improvements.\textsuperscript{111}

Thus, instead of deciding the best level of funding given the employer’s current financial condition and the participants’ comfort level, employers focused on attaining those funding targets. The determination of what constitutes the plan’s accrued liabilities varied depending on the purpose for which those figures were used. Using the plan’s actuarial assumptions, the accrued liabilities represented the past-service costs not yet funded (as well as the plan’s actuarial cost method’s normal cost amount not yet funded).

The results issued by the GAO to congressional committees affirmed what actuaries and plan sponsors had experienced from 1994 to 2000 — 62.5 percent of sponsors of the largest plans made no cash contributions due to the changes in the funding rules and the use of T account credits.\textsuperscript{112} By 2002, almost 25 percent of the 100 largest plans were less than 90 percent funded.\textsuperscript{113} By 2004 the PBGC estimated that plans of financially weak companies with a reasonable chance of termination had an estimated underfunding in the neighborhood of $96 billion.\textsuperscript{114} The report’s concurrent liability conclusion was that the code’s funding rules were not adequate, thereby subjecting the PBGC to potential billions of dollars in liability. Effective reform recommended incurred liability concluded:

- improve accuracy of plan assets and liability measurement values;
- develop a PBGC premium structure that charged sponsors based on risk;
- address the issue of permitting severely underfunded plans from making lump sum distributions in lieu of annuity distributions;
- resolve the outstanding controversy concerning cash balance and other hybrid plans; and
- improve disclosure information to provide greater transparency for the PBGC, plan participants, unions, and investors, without adding considerable burden to plan sponsors.

With the decline in the stock market in the early 2000s, plan asset values declined and plans that had been fully funded in the 1990s now were reported as underfunded. According to the IRS, requests for waivers of the minimum funding contributions increased exponentially. For employers that couldn’t meet the higher minimum funding requirements and were not able to secure a waiver,


\textsuperscript{106}See Treas. reg. sections 1.401(a)-5(b)(3)(iv)(A)-(C).

\textsuperscript{107}IRC section 412(m)(1).

\textsuperscript{108}See ERISA section 101(d)(1), 29 USC section 1021(d)(1).

\textsuperscript{109}See IRC section 412(l)(9)(B) and ERISA section 101(d)(1), 29 USC section 1021(d)(1).

\textsuperscript{110}See IRC section 412(l)(9)(B) and ERISA section 101(d)(1), 29 USC section 1021(d)(1).

\textsuperscript{111}See IRC section 412(l)(11).


\textsuperscript{113}See supra note 13.

those employers were assessed an excise tax of 10 percent on the amount of the accumulated funding deficiency and given a time frame to meet the minimum funding level to avoid a second-tier excise tax of 10 percent on the amount of the accumulated funding deficiency.

D. Funding Rules From 2000 to 2002

Treasury decided in October 2001 to discontinue issuing 30-year Treasury bonds, and as a result the yields on previously issued 30-year Treasury bonds became artificially low.\textsuperscript{115} As a result, legislative changes had to be made to determine a plan’s current liability under the minimum funding rules. Between 2000 and 2002, the bull market had burst and interest rates were declining, which depressed plan assets and increased plan liabilities — funded ratios were now at an all-time low. Congress responded with a two-year measure, permitting employers to use a 30-year corporate bond rate (which approximated 120 percent of the 30-year Treasury bond rate) as the interest rate for current liability valuation.\textsuperscript{116} The higher interest rate resulted in lower liability values and decreased minimum funding contributions. Unfortunately, the measure provided relief only for two years. While the Bush administration has announced that it will bring back the 30-year Treasury bond in early 2006, Congress should not lose this opportunity to pass some real pension reform.

E. Evolution of the Disclosure Rules

ERISA was initially drafted to provide financial information about defined benefit plans through Form 5500, and particularly Schedule B, which provides actuarial information about the plan’s T account. Unfortunately, disclosure of Form 5500 is not due until seven months after the end of the plan year, with an available 2½ month extension. Participants and beneficiaries may request copies of the plan’s Form 5500. That lag in disclosure makes it exceedingly difficult for participants and beneficiaries to ascertain the funding status of the plan. Pension plans are also required to furnish a summary of Form 5500 to participants and beneficiaries through an actuarial SAR. That statement simply states whether the minimum funding standards have been attained. Only if the value of the plan assets is less than 70 percent of the plan’s current liability must the SAR disclose the percentage of underfunding. The SAR is to be furnished within 9 months after the end of the plan year (plus a 2-month extension if requested).

Section 4010 was added to ERISA to require the reporting of plan actuarial and employer financial information in the event (1) the aggregate unfunded vested benefits exceeded $50 million, (2) missed required contributions exceeded $1 million, or (3) outstanding minimum funding waivers exceeded $1 million.\textsuperscript{117} Such filing was on a controlled group basis. Unfortunately, ERISA requires the PBGC to maintain confidentiality of that information.\textsuperscript{118} Plan administrators were required under ERISA section 4011 to notify participants and beneficiaries of the plan’s funding status and the limits of the PBGC’s guarantee. That disclosure on the plan’s funding status is not at the same termination liability level reported to the PBGC. The notice was to be furnished no later than 2 months after the filing deadline for Form 5500 for the previous plan year (and could be distributed with the plan’s SAR). Hence, participants are not being given an accurate picture of the plan’s funded status on a plan termination basis in a timely fashion.\textsuperscript{119}

For plans that were less than 90 percent funded on a current liability basis and thus required to pay a variable

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\item \textsuperscript{115}See IRS Notice 2002-26, 2002-1 C.B. 743, Doc 2002-7544, 2002 TNT 60-20.
\item \textsuperscript{116}Pub. L. No. 108-218 (Pension Funding Equity Act of 2004), effective for plan years beginning in 2004 and 2005. On April 8, 2004, the Senate passed the conference agreement to H.R. 3108 by a vote of 78-19. The House passed the conference agreement on April 2 by a vote of 336 to 39. The bill had to be signed into law before April 15, the crucial deadline for quarterly employer pension contributions. The indices used in the composite corporate bond rate include Citigroup High Grade Credit Index, Merrill Lynch US Corporate, and Lehman Brothers US A Long Credit. See Notice 2004-34, 2004-18 IRB 848, Doc 2004-8021, 2004 TNT 71-9. The IRS publishes by notice each month the composite corporate bond rate, the corporate weighted average interest rate, and the permissible range of rates.
\item \textsuperscript{117}Pub. L. No. 103-465, section 772 (1994), adding ERISA section 4010, 29 USC section 1310.
\item \textsuperscript{118}See Reuter Report, available at http://today.reuters.com/news/newsArticleSearch.aspx?storyID=238079+13-Jun-2005+RTRS&src=Grassley+and+PBGC (last visited June 13, 2005) (stating that Sens. Chuck Grassley, R-Iowa, and Max Baucus, D-Mont., chair and ranking member of the Senate Finance Committee, respectively, have requested information from the PBGC about hundreds of underfunded pension plans who reported information during 2003 and 2004 and a similar request had been made in April 2005 by Rep. John Boehner, R-Ohio, of the House Education and Workforce Committee and the panel’s ranking Democrat, Rep. George Miller, D-Calif., to the PBGC for information about defined benefit plans that were 75 percent-or-less funded). See also a press release by Sens. Grassley and Baucus, available at http://www.finance.senate.gov/press/Gpress/2005/prg062305.pdf (last visited June 23, 2005), notifying the public that they sent letters to 36 unidentified companies requesting detailed information regarding funding of their defined benefit plans, as far back as 1999, to ascertain the effect of interest rates and market declines on the funding of those plans.
\item \textsuperscript{119}See Labor reg. section 2520.104b-4(a). Also note that the Financial Accounting Standards Board changed its rules regarding the reporting of plan expenses and plan liabilities for purposes of the employer’s balance sheets in 1980. Unrestricted by the code’s determination of liabilities, FASB required employers to post a new liability figure known as the accumulated benefit obligations (ABO), determined using actuarial methods and interest and mortality assumptions that could have nothing to do with the valuation of costs and liabilities under the code’s funding rules. Such actuarial assumptions could vary year to year and did not have to correspond with the funding rates reported by the plan under Form 5500 filings. The liability figure made it difficult for investors to ascertain plan termination liability should the employer become bankrupt.
\end{itemize}
\end{footnotesize}
rate premium, notices to participants and beneficiaries were required. However, plans that were at the full funding limitation were exempt from paying the variable rate premiums.

F. Focus for Single-Employer Sponsors

Instead of focusing on the funding initiatives that would move employers to a fully funded system, the mandates of ERISA and the code resulted in the following:

- The current funding system focuses on a myriad of funding targets that employers seek to achieve to resist consequences under the minimum funding rules, in lieu of funding rules that make sense for amortization of past-service liability.
- Employee disclosure rules are erratic depending on the type of employer violation.
- An employer contribution 8½ months after the end of the plan year to satisfy the minimum funding obligation discourages permitted transparency of the employer’s ability to make that minimum contribution and delays notification to participants of the plans’ funding ratio. As participants’ benefits under a defined benefit and a defined contribution plan from the same employer have been decoupled, the employer’s deductible ceiling should be likewise decoupled.
- There are four different determinations of the plan liabilities figure, one used for valuation of plan liabilities that must be determined: the actuarial cost method’s actuarial liability; the plan’s current liability (determined by statute); the plan’s termination liability used in computing the variable portion of the PBGC premiums; and the plan’s liability used in the section 414(l) merger, spinoff, etc. context. The interest rates and mortality tables for each of those calculations are not the same, resulting in four different calculations for a plan’s liability.

- The many smoothing methods available for asset values and amortizations of past-service liabilities, gains and losses, changes in actuarial assumptions, and the use of prior credit balances permit underfunded plans to avoid or delay payment of contributions, even if the plan is underfunded.
- The excise tax of 50 percent discourages employers from overfunding a defined benefit plan, thereby providing a cushion in the event plan asset values decline or liabilities increase; that excise tax discourages employers from making additional contributions.
- The current PBGC premium structure is not actuarially sound, and the PBGC’s lack of standing in bankruptcy proceedings is a substantial problem for securing participants’ rights to benefits.
- Employers of severely underfunded plans are not required to freeze accruals, limit benefit increases, nor restrict the use of lump sum distributions.
- PBGC’s investment policy regarding its assets should be revised, so that the PBGC is not down at the same time as the industry is down.

V. Conclusion

We need to recognize that post-ERISA legislation was formulated through a series of well-intentioned compromises to afford employers extended periods for prefunding pension liabilities. Those rules were liberal because they presumed the employer would continue in existence over extended periods and would not take advantage of the system by minimizing contributions during financially lean years and shifting liabilities to the PBGC in the event of employer insolvency. As a parent of three young adults (ages 21, 19, and 18), the author likens this system to having my children decide their own curfew (within extreme limits, such as 6 a.m.) and then being amazed that they took advantage of the system.

Unless Treasury reissues a 30-year bond, Congress must legislate by the time the first quarterly employer contribution is due for the 2006 plan year, prescribing the interest rate to be used in ascertaining the plan’s current liability amount. The second part of this article examines the various legislative solutions — explaining them from an actuarial perspective and then discussing them from a public policy standpoint. Hopefully the unfolding of the results of the prior legislative initiatives will have an effect on the development of effective pension funding reform.

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120 See ERISA section 204(h), 29 USC section 1504(h), notice for prospective changes in future benefit accruals; whereas there is no mandate requiring employers to continue benefit accruals in the future.

121 See Treas. reg. section 1.414(l)-(3) (requiring that, in a merger, consolidation, or transfer context, benefits are to be valued on a termination basis based on reasonable actuarial assumptions and deeming that PBGC assumptions as of the date of the merger or spinoff are deemed reasonable for this purpose).
Appendix A
Pension Funding Terminology

**Actuarial cost method** is the process of assigning the cost of the promised benefits (and expenses) to individual plan years as an annual cost. The cost method determines a normal cost component and an accrued liability component.

**Actuarial assumptions** are the assumptions used by the actuary to estimate the costs of the promised benefits under the cost method. The true cost of the plan is not known until the last participant or retiree dies; in the interim, actuaries use assumptions such as interest, mortality rates, turnovers, disability rates, and so forth to estimate the cost of the plan.

**Normal cost** is the cost of the actuarial liability that is attributable to the current year’s service according to the cost method chosen. The actuarial liability is the total present value of all pension benefits. Some cost methods permit the normal cost to be separately determined from past-service liability, such that the past-service portion can be amortized over a different period than the normal cost.

**Actuarial value of plan assets** permits smoothing in the value of the plan assets, as long as the total value is between 80 percent and 120 percent of the fair market value of the plan assets. The actuarial value of plan assets is used in determining the minimum funding contribution levels and the maximum deductible limits.

**Funding standard account** is an accounting T account included in Schedule B of Form 5500, used to monitor whether the employer contributes the minimum required amounts. Charges to the funding standard account include the normal cost and amortization of the unfunded liabilities and plan contributions are credits to the funding standard account.

**Credit balance** occurs when the employer contributes more than is required according to the charges made to the funding standard account. Those amounts are carried over to the next year at an interest rate used in the funding calculation (not the actual interest rate earned) and may be used to offset future required employer contributions.

**Averaging and smoothing** are methods by which the actuary adjusts the annual valuation of assets and liabilities to reflect a long-term commitment as opposed to current and immediate changes to asset and liability values. Such averaging and smoothing is done to provide predictability in annual employer costs.

**Credit ratings** refer to a plan sponsor’s credit rating by an outside organization which assesses the risk of the company to attain their liability commitments, including the minimum funding contributions for any covered defined benefit plans.

**Yield curve** is an interest rate curve valued over time, to reflect the fact that plan liabilities vary in value according to their specific durations.

**Deductible employer contributions** refers to the code’s limitation on the amount an employer sponsor may deduct for contributions to a qualified defined benefit and/or defined contribution plans. Coverage of the same employees under a qualified defined benefit and defined contribution plans limits the employer sponsor to a maximum of 25 percent of covered payroll (or the minimum required under the code’s minimum funding standards).

**Lump Sum Calculations** refers to the computation of a participant’s or beneficiary’s benefit as a single lump sum amount, using a specified interest and mortality rate. To the extent the interest rate for lump sum values is more favorable than the rate used to determine annuity values under the plan, participants and beneficiaries will elect lump-sum values and increase the overall cost of benefits under the plan.

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