May 14, 2004

The Honorable Sam Johnson
Chairman, Subcommittee on Employer-Employee Relations
House Committee on Education and the Workforce
U.S. House of Representatives
Washington, DC 20515

The Honorable Robert Andrews
Ranking Member, Subcommittee on Employer-Employee Relations
House Committee on Education and the Workforce
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Johnson and Ranking Member Andrews:

At the April 29, 2004 hearing on "Examining Long-Term Solutions and Strengthening the DB Pension System," you asked what the parameters should be for setting a maximum threshold for deducting contributions to pensions plans (along with other considerations, such as revenue issues). The American Academy of Actuaries[1] appreciates the opportunity to respond to this very important question. In fact, we have completed a paper on this very subject, which we have attached. In this letter we provide a brief response to your specific questions. More details can be found in the attachment.

First, I want to frame the question within the principles I introduced in my oral testimony. We refer to flexibility, which addresses not only funding flexibility, but also management of the funding obligation under an adverse business cycle. These concepts also touch on the principle of predictability and the opportunity for employers to fund their plans so as to mitigate the financial strains that occur during adverse business cycles. Our suggestions should be coupled with the flexibility for employers to have access to super surpluses if the situation arises, as well as to expand deductible contribution limits.

It is important to balance the value of allowing companies to maintain a well-funded plan over strengthening the funding of all plans. Increased deductions for stronger companies provide a system for greater tax sheltering but do not address the need for better funding of weaker plans sponsors.

At the hearing, I suggested that pension plans could be better funded if laws allowed plan sponsors to deduct more in good years — for example, until plan assets reached 130 percent or 150 percent of current liability (CL). Rep. Andrews asked what parameters Congress should use in setting those limits.

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[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

Possible Margins: In a world where there is no concern about tax revenues, defined benefit plan sponsors could be allowed to deduct up to the total present value of benefits, including benefits that can be earned through future employment with the company. At this point, the employer would not have to contribute any additional funds (except for amounts that might be needed as experience varies from expected or as new employees are hired). Tax revenues are important, however, so current rules limit deductions to 100 percent of CL for accrued benefits (or the ongoing full-funding limit, if greater). Some have proposed increasing this limit to 130 percent or 150 percent of CL. In order to assess how much margin would be appropriate, we have estimated the margin that would have been needed to avoid underfunding in past economic periods.

One approach would be to determine how much margin would have been needed to avoid underfunding in past economic periods. The Academy has created a program that models this approach back to the 1920s, and we would be glad to make it available to you.

The Senate Finance Committee, in its 2003 markup of HR 3108, would have allowed sponsors to deduct contributions until the plan was funded to 130 percent of CL.[2] While a 30 percent margin would have kept plans from falling below 90 percent funded (using current liability, not termination liability (TL)) in most economic periods, it would not have been adequate for the depression years (dramatic decreases in stock prices) or the years 2000-2002 (dramatic decreases in stock prices and interest rates). If policy-makers want the margin to cover an event like this most recent period, then approximately 150 percent of the CL or more might be needed. For example, if policy-makers wanted enough margin to keep assets above 100 percent of CL during this most recent period, 155 percent would have been needed (or 160 percent for a plan covering younger participants).[3]

Contingent Liabilities: All plans have one significant contingent event, which is an involuntary plan termination. The behaviors of plan participants change dramatically under this scenario — they will retire earlier and they tend to elect options that maximize the value of their benefits. In addition, there are other contingent events, such as shutdown benefits. Whether the possibility of these contingent events occurring justifies 150 percent of CL threshold or supports the development of additional deductible contributions needs to be considered.

Revenue Concerns: We recognize the need to balance concerns about pension security with tax revenue impact. To address this concern, a percentage lower than 160 percent could be used, or the use of a larger margin could be restricted (to plans covered under Title IV of ERISA, for example). Another way to reduce revenue losses would be to allow deductions up to 130 percent of CL and eliminate the excise tax on contributions up to 160 percent of CL. This approach would allow employers to reduce future contributions and retain an accrued deduction if and when the funded status fell below 130

[2] For example, see the Senate Finance mark up of IRC §404(a)(1)(D).

[3] What should this margin be? A plan funded to 130 percent of termination liability (TL) on January 1, 2000 with typical assets of 60 percent in equities (50 percent large cap and 10 percent small cap) and 40 percent in bonds similar to the Lehman Aggregate, would be only 83 percent funded on January 1, 2003, assuming the plan's equities fell 30 percent (as they did over the 3-year period from the January 1, 2000 to January 1, 2003, per Ibbotson large and small cap indices) and interest rates fell 150 basis points (as they did during this same period). A plan funded to 155 percent of TL would be 100 percent funded on a TL basis. In addition, larger margins might be needed to handle other situations. For example, the 155 percent margin would need to be higher for plans with higher durations (e.g., 160 percent would have been needed for plans with a duration of 15 reflecting a younger average population). These calculations assume that companies continue to make their annual contributions; the PBGC may be interested in increasing the target percentages to allow for a greater cushion in case weaker companies do not make these contributions. Other factors could increase or decrease the desired margin, including asset allocation and whether smoothing techniques are used. For example, if we kept a plan funded above 100 percent of CL, it still might be funded at 90 percent on a TL basis.

percent. Alternatively, Congress could limit annual contributions (e.g., to 10 percent or 15 percent of CL each year or at least the cost of benefits accruing during the year) when assets exceed 100 percent of CL.

The revenue losses generated by this change may not be as great as expected, because:

(1) Most plan sponsors will not take full advantage of the threshold because they would rather invest the funds in the company and hope for a better return through company growth. Also, if they put excess funds into the pension plan, and the assets have excess returns, the plan could become so overfunded that it would never need all the funds. However, employers are loathe to contribute enough to create an overfunded situation because the excise and income taxes give the federal and state governments 95 percent of the reversion (depending on state tax law), while the plan sponsor only gets 5 percent. Certain techniques can be used to reduce this to 65 percent, but they require employers to provide greater benefits that they may have intended, so the employer never actually gets direct use of the funds.[4]

(2) If a plan sponsor takes advantage of this provision now, smaller contributions would be required in future years. In fact, plans funded to 150 percent of CL could have excess returns in future years that can fully exceed the annual contribution. Any additional deductible contributions may not be allowable in the next few years. Thus, a large revenue loss in one year could be followed by more tax revenue in a later year, which could help smooth out revenue income for the US government.

Further Ideas: We appreciate your request for further ideas on this subject. U.S. pension funding rules create volatile contribution patterns and can discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong, and require substantial contributions when the economy declines and plan sponsors can least afford them. Thus, the funding rules create cyclical economic problems for the country. They exacerbate the economic cycle by helping reduce employer cash flows in the good times and hurting them in the bad times. We have seen a number of companies, in a wide variety of industries, whose survival is threatened by the cash contribution requirements of pension plans that were considered to be reasonably well funded (or even overfunded) just a few years ago.

The following are a number of additional approaches that could accomplish this goal of adequate margins. We are not suggesting that all of these approaches should be adopted; but rather that legislators consider a combination of these approaches that would best balance the need for additional security and stability in pension funding with other legislative objectives.

- **Increase the deduction limit to cover key thresholds:**

  — ***Increase year-end unfunded current liability,*** so the plan sponsor can contribute an amount necessary to fully or partially offset asset losses, reductions in the government-mandated current

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[4] Our attached paper suggests remedies to this problem that could satisfy the concerns of employees and the Department of Labor. For example, plan sponsors could be allowed to access plan surpluses (without excise tax) only if the assets exceeded a high threshold, and/or only if they were used to provide other employee benefits, such as active employee health benefits. This ability could be prohibited in union plans (multi- and single-employer) where benefits are bargained, or could be allowed if the union were involved in the decision-making as to where the funds were used. In addition, the prohibitively high 50 percent reversion excise tax used on plan termination could be lowered to something that reflects the tax advantages of the funds in a pension plan in exchange for increasing the income tax rate to the full corporate rate, even where the company tax rate might be lower at the time of the termination or reversion if permitted from a super surplus funded plan.

liability rate, or "significant events" that occur during the plan year. Over the past few years, many companies wanted to contribute large amounts at year-end to avoid having an underfunded plan, but they did not do so because they could not deduct the full contribution (and it would have been subject to an excise tax). This change would address that problem.

— ***Increase the amount necessary to avoid the PBGC variable premium.*** If the actuarial accrued liability is greater than the CL, a plan may have to pay PBGC variable premiums even though it cannot deduct any further contributions because of the full funding limit in section 404. If the vested current liability using PBGC's required interest rate is larger, then employers should be able to deduct contributions to fund up to this amount so that they can avoid the PBGC variable premium. We believe the loss in premium income for the PBGC would be far outweighed by the additional security of a better-funded plan, for not only employers and participants, but for the PBGC as well.

— ***Eliminate the 25 percent of covered payroll restriction on combined defined contribution/ defined benefit deductions*** so that appropriate levels of contributions can be made to secure defined benefit promises without discouraging employers from making contributions to employees' defined contribution accounts. Past proposed legislation that would allow deductions up to 6 percent of payroll to a defined contributions plan in addition to the 25 percent of payroll (or UCL if greater) are a good, partial step in this direction.

- **Expand benefit commitments included in current liability for maximum funding purposes to include:**

— ***Lump sum payments***, which by law reflect a subsidized interest rate. However, under IRS rules, the current liability cannot reflect this subsidized interest rate – so the plan's funding falls further behind with each lump sum payment made.

— ***Automatic increases in benefit limits.*** Under existing laws and regulations, certain benefits cannot be reflected, which can hurt the funding levels of a plan (particularly plans with many participants that have large benefits). This can hurt all the participants upon plan termination (whether they are highly paid or not) if the plan benefits are cut because there is not enough money to cover benefit liabilities. If plans subject to Title IV could fund these benefits, participants in a recently terminated pilot plan would have received more of their accrued benefit from the PBGC.

- **Allow deduction for a contribution equal to the normal cost each year**, representing the growth in benefits attributed to the current year without regard to full funded status. This allows plans to keep up with the expected growth in liability each year. It also avoids contribution "holidays" that may cause employers to get out of the habit of making contributions to the plan, and which may make it that much more difficult to resume funding when necessary. If needed, a cap could be imposed on funding or the deductible contribution could be phased out gradually based on the level of surplus in the plan.

- **Allow smooth "cliffs" inherent in full-funding limits** to avoid unnecessary volatility. The Canadians have developed an approach in which overfunding of pension plans is phased in over five years; funding isn't restricted until the surplus is at least five times the normal cost of the plan.

- **Loosen restrictions on access to surplus pension funds.** Under current law, severe restrictions prevent employers from recouping any excess pension funding, so many employers are reluctant to build a funding "cushion" in case the additional funding ultimately proves unnecessary and the money is trapped in the pension plan. Of course, any approach should balance the need for flexibility that will encourage employers to increase their pension funding with concerns about the security of benefits for participants. Some alternatives include:

— ***Allow withdrawals of surplus assets***, but only if the funding level exceeds a relatively high threshold (e.g., 130 percent or 150 percent of current liability or the regular full-funding limit if higher). The ownership of these funds potentially rests with the employees, so if appropriate, Congress could restrict these amounts to be used only for other employee benefit plans. In addition, you could allow the funds to be used for other reasons in bargained plans, if agreed to by a representative employee group.

— ***Define a super surplus*** benchmarked at (for instance) the lesser of 175 percent of current liability, or the present value of all benefits, where withdrawals would not be subject to excise tax but would be subject to the maximum corporate income tax rate regardless of the employers' tax rate at the time of reversion.

— ***Reduce the excise tax*** (currently 50 percent, in addition to regular corporate income tax) at least for reversions up to a specified percentage of the benefit liability.

We have offered the above alternatives for relaxing the restrictions on maximum contributions to pension plans so that employers have more opportunity to shore up the financial security of these plans when they have the resources to do so. This should increase benefit security for plan participants, decrease the demands on the PBGC, and stabilize the financial requirements for the companies that sponsor these plans.

Members of the American Academy of Actuaries are very interested in working with you and your staffs to discuss these ideas and the possible effects on pension plan participants, sponsors, the IRS, and the PBGC. Please feel free to contact Heather Jerbi, Pension Policy Analyst, and Ron Gebhardtsbauer, Senior Pension Fellow, at 202-223-8196 with any questions.

Sincerely,

Kenneth A. Kent, FSA, MAAA
Vice President, Pension Practice Council
American Academy of Actuaries

ATTACHMENT

A M E R I C A N   A C A D E M Y   *of*   A C T U A R I E S

Averting the Next Pension Crisis

In this paper, the American Academy of Actuaries'[1] Pension Committee focuses primarily on the maximum tax-deductible contribution rules for defined benefit plans. We are also studying the minimum funding rules, with the goal of simplifying and fixing them without adversely affecting the objectives behind those rules. We are presenting this draft on the maximum rules before our minimum funding ideas are finalized, in response to requests from policymakers. Ultimately, some of these suggestions may require change to mesh with our recommendations for minimum funding

The current pension funding rules tend to produce volatile contribution patterns and discourage adequate funding margins. Almost by definition, the rules inhibit contributions when the economy is strong, and require substantial contributions when the economy declines and plan sponsors can least afford them. Thus, the funding rules create cyclical economic problems[2] for the country; they exacerbate the economic cycle by helping in the good times and hurting in the bad times. In addition, we have seen in the news a number of companies in a wide variety of industries whose survival is threatened by the cash contribution requirements of pension plans that were considered to be reasonably well-funded (or even overfunded) just a few years ago.

In the 1990s, a number of companies might have contributed voluntarily to their well-funded pension plans, but were discouraged because a contribution
(1) Would not have been deductible;
(2) Would have caused an excise tax assessment; and
(3) Would not have been returned to the employer even if the plan's eventual surplus made the contributions unnecessary.

Not only were employers discouraged from making contributions in past years, but unfortunately, many became accustomed to the contribution holidays. Anecdotally, the budget line item for pension contributions was eliminated at some companies for so long it was forgotten. The subsequent fall in the stock market and very low interest rates made many plans underfunded and triggered the deficit reduction contribution rule. (A chart at the end of this paper shows this graphically.) Now, employers have to contribute unusually large amounts to their newly underfunded pension plans. Some employers responded by freezing and/or terminating their defined benefit (DB) plans. Others find themselves in bankruptcy, unable to support their pension plans and turning to the PBGC for benefit guarantees.

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

[2] Some of our members believe that this is also a function of ERISA's policy of diversification of assets across asset classes. If this ERISA policy were changed to allow the use of bonds only (and if employers could be persuaded to make greater use of immunized bond portfolios), then smaller margins might be acceptable, but that would be a major change in thinking for pension plans, and needs much analysis before legislating such a change. However, other members believe that diversification remains a prudent and more cost-effective way to invest pension assets — so much debate is needed before any change in ERISA's diversification rules are implemented.

In this paper we explore ways of reducing this volatility by raising current contribution limits. Ironically, a number of plan sponsors who would have liked to shore up their pension funding (and eliminate adverse accounting impacts)[3] at the end of 2001 and 2002 were unable to do so in a tax effective manner. Had employers been allowed to make deductible contributions, some would have done so to avoid the difficulties they face today, and pension plans (as well as the PBGC) would be in better shape financially. Going forward, employers are now more keenly aware of the risk of declining funding levels, and many might be interested in taking advantage of any changes in the law that would allow them to build larger funding "cushions" against this risk.

On the other hand, we should not overreact to the "perfect storm," the rare convergence of poor asset returns, unusually low discount rates, and other factors that have affected pension funding levels. Therefore, we would like to see the rules changed so that employers who are financially able to better fund may do so. At the same time, the funding rules should not unduly strain the existing pension system by requiring large increases in pension contributions that may or may not be necessary in the future.

Below are a number of approaches that could accomplish this goal of allowing margins. We are not suggesting that all of these approaches be adopted; but rather that legislators consider what combination of these approaches would best balance the need for added security and stability in pension funding with other legislative objectives.

The Problem

Contributions are not deductible (and are subject to a 10 percent excise tax) when plan assets exceed maximum tax-deductible limits. In 1987, Congress addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability ("UCL") in IRC Sec. 404(a)(1)(D). But even that has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When interest rates were higher, the full funding limit provided a more generous margin above current liability, at least for pay-related plans, which have the ability to project future compensation increases when calculating the limit.[4] However, when interest rates are low, the deductible limit provides little or no margin[5] for adverse fluctuations in assets or liabilities — and in many cases (as discussed later in this paper) does not even permit recognition of liabilities for benefits the plan is committed to provide. The years 2000 through 2002 saw a significant decline in the funded status of most plans – because the market value of plan investments fell dramatically *at the same time that* liabilities increased due to lower interest rates. Although conditions appear to be improving, we believe structural changes are necessary if a recurrence of this problem is to be avoided.

Suggested Remedies

In a world where there is no concern about tax revenues, defined benefit plan sponsors could be allowed to deduct up to the total present value of benefits, including benefits that can be earned through future

[3] Under FAS87, employers with plans that have any unfunded ABO frequently must record a reduction in net worth equal to the amount of unfunded and unaccrued liability.
[4] For hourly plans (and plans with a large proportion of retirees), the full funding limit can be less than termination liability (because current funding rules preclude anticipating benefit improvements), so these plans have no margin for adverse fluctuations. These are the plans that are now most likely to be underfunded.
[5] Some actuaries suggest that using interest rates below 6 percent for regular ERISA funding today would be most appropriate. However, at one time, the IRS sued certain plans that used a rate below 8 percent.

employment with the company). At that point, the employer would not have to contribute any additional funds (except for amounts that might be needed if experience is worse than expected or as new employees are hired). Tax revenues are important, however, so current rules limit deductions to 100 percent of CL for accrued benefits (or the ongoing full-funding limit, if greater). Some groups have proposed increasing this limit to 130 percent or 150 percent of CL. In order to assess how much margin would be appropriate, we have estimated the margin that would have been needed to avoid underfunding in past economic periods.

The Senate Finance Committee, in its 2003 markup of HR 3108, would have allowed sponsors to deduct contributions until the plan is funded to 130 percent of current liability (CL).[6] While a 30 percent margin would have kept plans from falling below 90 percent funded using CL, not termination liability (TL) in most economic periods, it would not have been adequate for the depression years (dramatic decreases in stock prices) or the years 2000-2002 (dramatic decreases in stock prices and interest rates). If policymakers want the margin to cover an event like this recent period, then 150 percent of the CL or more might be needed. For example, if policymakers wanted enough margin to keep assets above 100 percent of CL during this most recent period, funding levels of 155 percent would have been needed (or 160 percent for a plan covering younger participants).[7] Similarly, we believe that plans with shutdown benefits should be allowed to accumulate additional margin equal to the present value of the additional benefits as if shutdown benefits were triggered on the valuation date.

Revenue concerns: We recognize the need to balance concerns about pension security with concerns about revenue impact. To address this concern, a percentage lower than 160 percent could be used, or the use of a larger margin could be restricted (for example, to plans covered under Title IV of ERISA). Another way to reduce revenue losses would be to allow deductions only up to 130 percent of CL and eliminate the excise tax on contributions up to 160 percent of CL. Alternatively, Congress could limit annual contributions (e.g., to 10 percent or 15 percent of CL each year or at least the cost of benefits accruing during the year) when assets exceed 100 percent of CL.

In addition, we note that revenue losses may not be as great as expected, because:

(1) Most plan sponsors will not take full advantage of the threshold because they would rather invest the funds in the company and hope for a better return through growth in the company. Also, if they put excess funds into the pension plan, and the assets have excess returns, the plan could become so overfunded that it would never need all the funds. However, employers are loathe to

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6 For example, see the Senate Finance mark up of IRC Sec. 404(a)(1)(D). If the change is made to the last sentence of Sec. 404(a)(1)(A), it would only allow deductions of the normal cost (up to the full funding limit or 130 percent of CL if greater), so it would take a long time for a plan with a large retiree liability (and relatively small active normal cost) to build up a margin. In addition, it should not be in Sec.412(c)(7), because that would require the margin for plans that were immunized with bonds or plans that were planning on terminating. Requiring a large margin for these plans makes no sense, because they would never need it and would be subject to a large excise tax on any future reversion of excess assets.

7 What should this margin be? A plan funded to 130 percent of termination liability (TL) on Jan. 1, 2000 with typical assets of 60 percent in equities (50 percent large cap and 10 percent small cap) and 40 percent in bonds similar to the Lehman Aggregate, would be only 83 percent funded on Jan. 1, 2003, assuming the plan's equities fell 30 percent (as they did over the 3-year period from the Jan. 1, 2000 to Jan. 1, 2003, per Ibbotson large and small cap indices) and interest rates fell 150 basis points (as they did during this same period). A plan funded to 155 percent of TL in 2000 would be 100 percent funded in 2003. In addition, larger margins might be needed to handle other situations. For example, the 155 percent margin would need to be higher for plans with higher durations (e.g., 160 percent would have been needed for plans with a duration of 15). These calculations assume that companies continue to make their annual contributions; the PBGC may be interested in increasing the target percentages to allow for a greater cushion in case weaker companies do not make these contributions. Other factors could increase or decrease the desired margin, including asset allocation and whether smoothing techniques are used. For example, if we kept a plan funded above 100 percent of CL, it might be funded at only 90 percent on a TL basis.

contribute enough to create an overfunded situation because the excise and income taxes give the federal and state governments 5 percent of the reversion (depending on state tax law), while the plan sponsor only gets 5 percent. Certain techniques can be used to reduce this to 65 percent, but they require employers to provide greater benefits that they may have intended, so the employer never actually gets direct use of the funds.[8]

(2) If a plan sponsor takes advantage of this provision now, smaller contributions would be required in future years. In fact, since investment returns can exceed bond rates, plans funded to 150 percent of CL could have excess returns that fully exceed the annual contribution. Any additional deductible contributions may not be allowable in the next few years. Thus, a large revenue loss in one year could be followed by more tax revenue in a later year, which could help smooth out revenue income for the U.S. government.

Allow deduction to reflect increases in unfunded liability at year-end

Many companies would have liked to contribute an amount to fully fund their liabilities at year-end to improve the plan's funded position and avoid adverse accounting impacts. Such contributions would help participants and the PBGC, and we believe they should be encouraged. However, such contributions may not be deductible under current law. There are several situations in which the plan's unfunded liability at year-end can exceed the unfunded CL used to determine maximum tax-deductible contributions, because the latter does not reflect several items that may increase a plan's unfunded liability during the year, including:

(1) Asset losses that occur during the year, or reductions in the interest rates, (which increase liabilities);
(2) Benefit improvements that are not included in the current valuation because they are adopted or effective after the valuation date;
(3) Increases in liability due to the payment of lump sums with the government-required subsidy. These subsidies cannot be prefunded under IRS rules.

We suggest that employers should be permitted (but not required) to determine the maximum tax-deductible contributions for a year based on estimated year-end unfunded current liability. This could be done using actual year-end market values and current liability adjusted to reflect the approximate effects of changes in the current liability interest rate and other changes -- perhaps using the same principles as currently applied to adjust liabilities for PBGC variable rate premiums to reflect "significant events."

[8] This paper suggests remedies to this problem that could satisfy the concerns of employees and the Department of Labor. For example, plan sponsors could be allowed to access plan surpluses (without excise tax) only if the assets exceeded a high threshold, and/or only if they were used to provide other employee benefits such as active employee health benefits. This ability could be prohibited in union plans (multi- and single-employer) where benefits are bargained, or could be allowed if the union was involved in the decision-making on where the funds were used. In addition, the prohibitively high 50 percent reversion excise tax used on plan termination could be lowered to something that reflects the tax advantages of the funds in a pension plan in exchange for increasing the income tax rate to the full corporate income tax rate, even where the company's tax rate might be lower at the time of the termination.

Allow deduction up to the amount that will eliminate the PBGC variable rate premium

Similarly, employers may wish to fund the amount necessary to eliminate the PBGC variable rate premium for the following year.

One way an employer can do so under current rules is by contributing an amount up to the full-funding limit for the prior year. However, under certain circumstances (i.e., if the actuarial accrued liability under the plan's funding method determines the plan's full-funding limit), current rules may not permit the deduction of the amount necessary to eliminate the variable rate premium. We believe it would be helpful if plan sponsors were allowed to deduct any contributions made up to the amount on which PBGC premiums are based (i.e., the plan's liability for vested benefits using the required interest rate specified in ERISA Sec. 4006).

Although implementing this proposal would decrease premium income to the PBGC for plans that receive this additional funding, we believe that the additional security created by making these plans better funded is more valuable to the PBGC — and to plan participants — than the premium income.

Contribute up to the present value of benefits

Another suggestion is to allow employers to contribute additional amounts up to the total present value of benefits on a non-deductible basis but with no excise tax, with the ability to carry their deduction forward to a year in which their contribution is less than the maximum deductible amount permitted by law.

Eliminate 25 percent of covered payroll restriction on combined defined contribution/defined benefit deductions

Current law restricts the deductible contribution to defined contribution plans if the combined contribution for defined benefit and defined contribution plans covering the same individuals exceeds 25 percent of covered payroll. This is yet another impediment for employers who would like to strengthen the funding of their defined benefit plans, although Congress has partially addressed this by limiting the situations in which the 10 percent excise tax applies. If the 25 percent restriction were eliminated for Title IV plans with respect to tax deductions or at least with respect to the 10 percent excise tax, employers could contribute additional amounts to the defined benefit plan without jeopardizing contributions for defined contributions plans. Past legislative proposals that allow deductions up to 6 percent of payroll to a defined contribution plan in addition to the 25 percent of payroll (or UCL if greater) are a good, partial step in this direction.

Allow funding for future benefit increases in hourly plans

Hourly plans are typically not as well funded as salary-related plans because contributions for anticipated benefit increases may not be deducted under current IRS regulations. Predicting these benefit increases is impossible, but projections of future benefit levels, using an objective rate such as the CPI should be permitted for purposes of determining deductible contribution limits. It would not make sense to require these projections for minimum contributions, since the plans may or may not ever have any more benefit increases. Requiring these projections could also complicate the bargaining process, so it is important that these projections be allowed, but not required. Note that under current law even those benefit increases already negotiated but with effective dates in future years, are not included in CL and so are not reflected in maximum contribution limits that reflect CL.

Multiemployer plans

Proposals to allow deductions up to 130 percent of accrued liabilities are also important for multiemployer plans because their contributions are generally fixed for the length of the bargaining period. If investment returns are unusually good (as in the 1990s), plan assets could easily exceed the plan's full funding limit (which, as discussed earlier, may not include future amendments increasing benefits). This will cause the fixed contributions to be non-deductible (and subject them to an excise tax). To alleviate this problem, multiemployer plans increased benefits (sometimes to surprisingly high amounts) in order to make the contributions deductible. With the recent fall in asset values, they now are faced with the opposite problem. The fixed contribution is now less than the minimum required contribution, which will subject these plans to a 5 percent excise tax, and eventually a 100 percent excise tax. However, since accrued benefits generally cannot be cut, it can be difficult, if not impossible, to fix this problem. The best solution is to not force unneeded benefit increases when assets do well. The best way to do this would be to exempt multiemployer plans from the 404 maximum deductible limits, as suggested at the April 29, 2004 House hearing on pension funding. Experts on the panel noted that plan sponsors would not take undue advantage of this exemption because contributions made to multiemployer plans can never be used for other purposes. If Congress is unable to exempt these plans, then other ideas in this paper, such as allowing deductions up to 150 percent of CL for multiemployer plans could help to resolve this concern.

Anticipate automatic increases in maximum benefit limits

IRC Sec. 404(j) and Sec. 415(b)(2)(E)(iv) provide maximum compensation and benefit limits for qualified pension plans, which are subject to annual inflation adjustments. These limits were established to curb excessive benefit levels. (For example, the current maximum pension benefit at age 65 is $165,000 per year, and the compensation on which benefits are based today is $205,000). IRS funding rules, however, do not allow employers to anticipate future increases in these limits when determining minimum or maximum funding requirements for defined benefit pension plans. This clearly works at cross-purposes with the concept of advance funding for pension obligations.

This is particularly true for defined benefit plans with large benefits for everyone (e.g., plans covering airline pilots and in inflationary periods (during which particularly rapid increases in the benefit limits will occur). We believe it would be desirable to permit (if not require) pension funding rules to make reasonable provision for future increases in benefit limits.

Many large plans automatically incorporate the increase in these limits for future retirees each year. But since they cannot anticipate them when calculating funding obligations, the funding for these increases is delayed even though the employer is committed to provide them. We recommend inclusion of these automatic benefit increases for defined benefit plans, at the very least for maximum deductible purposes, and preferably for minimum funding purposes as well. This also would help participants' benefit security. For example, workers and retirees would have received more of their accrued benefits from PBGC in a recently terminated pilot plan had funding of these benefits been mandated.

Reflect lump-sum payments in current liability

Plans that offer voluntary lump-sum payments must provide them using the subsidized interest rates required under IRC Sec. 417(e). These low interest rates can dramatically increase the liability associated with these pension benefits (over the cost of the pension required by the DRC rules in Sec.

412(l)). Employers cannot avoid this liability (at least for already-accrued benefits) by amending lump-sum benefits out of the plan without violating anti-cutback rules.

However, even though plan sponsors are committed to providing these benefits once they are in the plan, IRS guidance in Notice 90-11 does not permit them to reflect the additional cost in current liability.[9] This restricts their ability to contribute amounts needed to support the plan. We recommend inclusion of the full lump sum amount in current liability, at the very least for maximum deductible purposes, and preferably for all purposes.

Allow deduction for normal cost in all years

One useful approach is to allow employers to make a deductible contribution to the pension plan every year while a plan continues to provide additional benefit accruals even if the plan is currently fully funded. That would avoid the recent problem of employers not budgeting for contributions to their pension plan (because they hadn't been deductible). What should this contribution be? Some actuaries have suggested the normal cost under the plan's funding method (or if not applicable, the entry-age normal cost or projected unit-credit normal cost) or the present value of current accruals (in the DRC calculation). Others have suggested that the aggregate-method normal cost (or open-group normal cost) [10] be deductible in all years. We note that one reason assets exceed actuarial liabilities at certain times is because asset returns have been better than expected. If assumptions are correct on average, then asset returns could be worse than expected at some point in the future. Given this dispersion of asset returns, the normal cost using an average interest rate may be appropriate every year. If necessary, a cap could be imposed on funding. For example, the rules could specify that no contribution is deductible to the extent it results in assets greater than the total present value of accrued and projected benefits for all current plan participants.

Normal cost phase-out

A more modest alternative to the above suggestion would be to phase out the deductible contribution gradually based on the level of surplus in the plan, instead of it being a cliff as under current funding rules. For example, a plan sponsor could deduct the normal cost, minus the surplus divided by 5. Thus, when the surplus is zero, normal cost is deductible. When the surplus is five times the normal cost, it would be zero. The deduction rule would phase out between those two surplus amounts.

If this general approach is acceptable, policymakers in the United States could adjust the actual mechanics, if desired. For example, the threshold for determining surplus could be 130 percent of current liability (or the FFL if greater) and/or the phase-out period could be extended to 10 years or some other period.

Allow, provide incentives, or mandate?

To minimize controversy regarding these ideas, we suggest that the rules *allow* the normal cost contribution, not *require* it. On the other hand, some policymakers may suggest that underfunded plans (or even plans funded below 120 percent of CL) should be required to contribute more. Because of the importance of this issue, we suggest that changes in both the minimum and maximum funding rules be

[9] This is particularly true when the lump-sum rate is below the range for the current liability rate — and that has happened many times over the past 10 years.
[10] The IRS could be instructed to grant automatic approval for plan sponsors to use the aggregate or open group method for their maximum contribution in any year.

considered carefully to make sure we have a logical and cohesive structure for addressing the funding of DB plans.

We also note that strong incentives exist for companies to contribute more. For example, if assets fall below the accumulated benefit obligation, there can be adverse implications for the employer's corporate balance sheet. If assets fall below the liability for vested benefits, companies must pay an additional premium to the Pension Benefit Guaranty Corporation (PBGC). If assets fall below 90 percent of current liability, contributions can increase dramatically due to the DRC. Recent drops in the market have provided a good reason for employers to increase their funding margins and build a "cushion" to protect against adverse experience.

A list of the penalties and restrictions follows. If policymakers want to increase the incentives for funding, then a threshold for one or more of the penalties could be increased (e.g., the threshold for security) or restrictions on lump sums and benefit accruals could be added.

If the funding ratio falls below*	Then
125%	No Sec. 420 transfer to the company post-retirement health plan Company can not use the prior year valuation.
110%	Restrictions on the size of lump sums to the top 25 and possibly other HCEs.
100%	Accounting rules may force a hit to net worth (uses 100 percent of ABO). PBGC variable premiums are payable (lower interest rate on vested CL). Companies must pay quarterly contributions. PBGC files lien on company if missed contributions > $1 M. PBGC financial filings required if underfunded over $ 50 M. Certain corporate transactions must be reported to the PBGC if the plan is underfunded. Bankrupt firms may not increase benefits.
80%/90%	Additional deficit reduction contributions required. Notice to employees with funding ratio and PBGC guarantees required.
60%	Security required for plan amendments.

*Note that the above ratios are based on varying measures of liability.

Withdrawals and transfers

Incentives for employers to increase their funding margins may not work unless we also address the one-sided nature of the funding equation – employers who try to protect the plan by making additional contributions have very little opportunity to use those contributions if it later turns out that they weren't needed. For example, if an employer contributes enough to increase a plan's funding ratio to 150 percent, and then the investments do very well, the plan may become extremely overfunded.

If the employer needs some of the surplus pension money, its only viable option may be to terminate the pension plan. Not only is this a difficult, complex process that hurts employees by freezing their accruals, but also 85 percent of the margin would have to go to the federal government and even more would be paid in the form of state and local taxes, leaving very little for the plan sponsor who funded the contributions.

One approach would be to allow a withdrawal only if:
- assets exceed some high threshold (e.g., 130 percent or 150 percent of current liability, present value of all benefits on a termination liability basis or the ongoing actuarial accrued liability if greater);
- the uses of the withdrawal could be restricted to employee benefit plans.

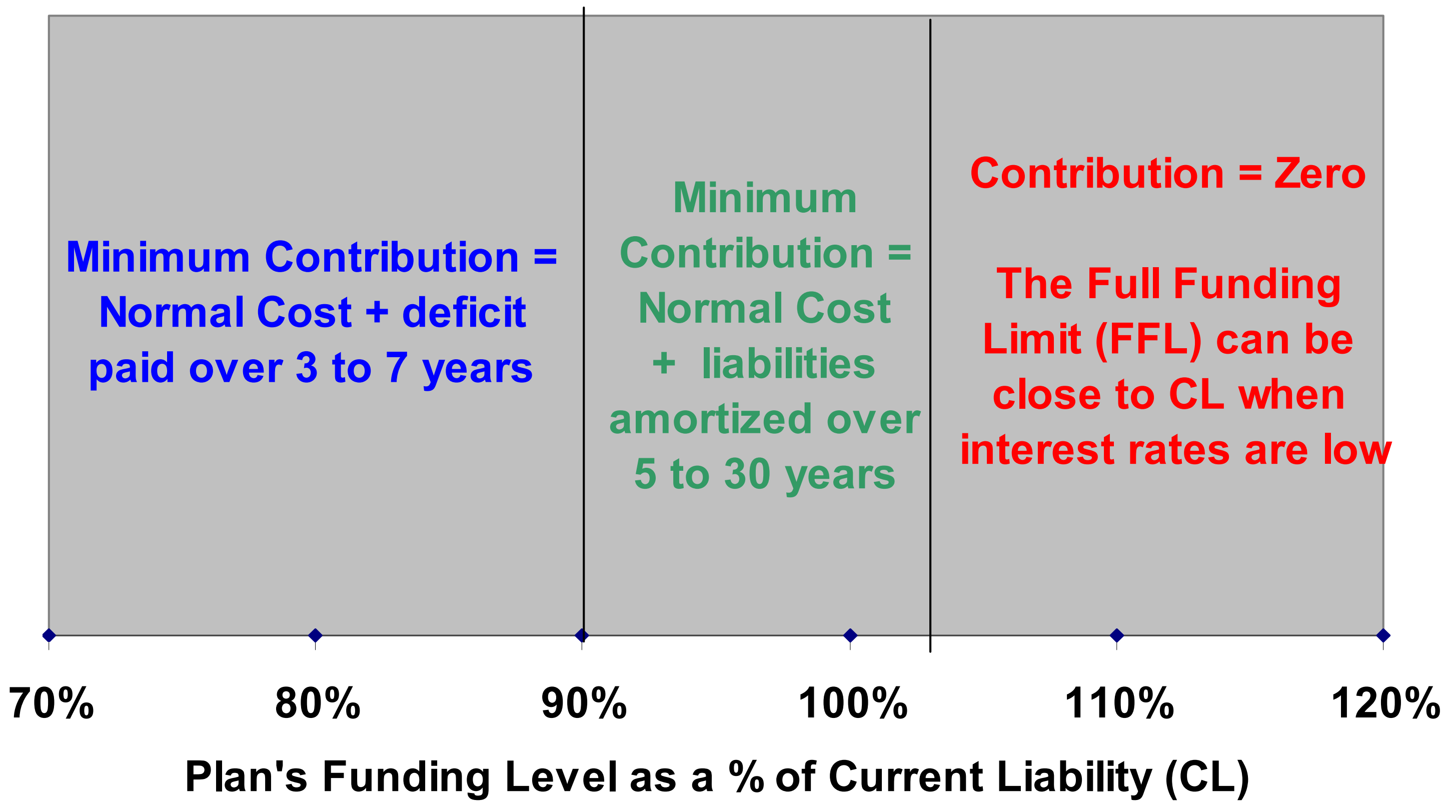
If the plan is subject to bargaining, then the union could be involved in determining where the super surplus is transferred, and how much surplus is transferred.

If the above requirements are met, the excise tax could be waived just as in Sec. 420 transfers to retiree health plans. In addition, the excise tax for reversions (and other withdrawals when assets exceed the above threshold) could be defined as that amount that eliminates the tax shelter on the withdrawal (based on some assumption as to how long the surplus was in the plan). This percentage could be lower than the current 20 percent and clearly lower than the 50 percent excise tax rate.

Summary

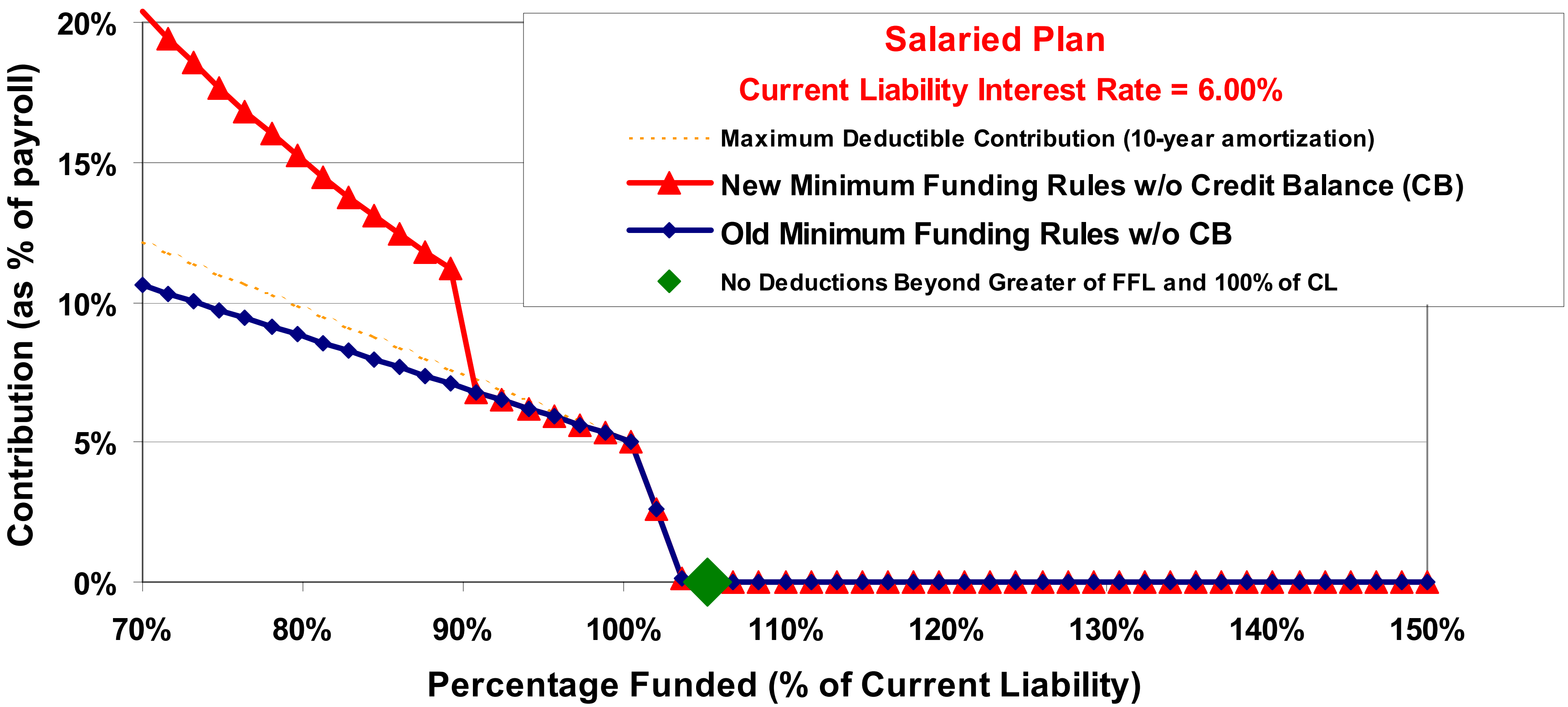
Pension plan funding levels dropped dramatically over the past few years causing financial distress to plan sponsors and concerns to plan participants and the PBGC. In light of this experience, plan sponsors may be more willing in the future to make contributions in all years, even if plans are modestly overfunded under current measures. That, in turn, would positively impact funding levels and thereby reduce the chance of a future pension funding crisis. To further this policy goal, Congress could make the contributions deductible (or at least not subject to the Sec. 4972 excise tax), expand IRC Sec. 420 provisions for transfers to other benefit plans, and reduce the prohibitive 50 percent excise tax in Sec. 4980(d) on reversions. Various proposals have been provided in this paper. We at the American Academy of Actuaries are very interested in working with policymakers to discuss such rules. Please feel free to contact Heather Jerbi, Pension Policy Analyst, and Ron Gebhardtsbauer, Senior Pension Fellow, at 202-223-8196 if you would like to discuss these issues further.

Current Contribution Rules



For many plans, the original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels around 90% to 100%). The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

Funding Rules



When pension contributions are not deductible, they are also subject to excise tax. When interest rates are low, extra deductible contributions can not be made to build up a margin.