A Few New Rules for Pensions in the US
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In late December 1987 a massive Budget Reconciliation Act was passed and signed by the President. This bill changes more than 7,000 provisions of the Internal Revenue Code including many affecting pensions. Of particular interest to actuaries are some of the new rules such as those relating to minimum and maximum funding requirements, plan termination insurance premiums, employer liabilities at plan termination, interest assumptions, etc. A brief description of these provisions follows.

FULL FUNDING LIMIT

The limit for deductible plan contributions has been lowered for most plans, though the prior law maximum will still hold if it is lower than the new one. Because this provision raises significant revenue, Congress put it into effect immediately--it takes effect for years beginning after December 31, 1987.

The new full funding limit is defined as the excess, if any, of

- o the lesser of
  - accrued liability, including normal cost, under the plan, or
  - 150 percent of "current liability" (including all preparticipation service and presumably including current year accruals),
- o over the lesser of
  - the fair market value of the plan's assets, or
  - the actuarial value of the plan's assets.

Treasury is authorized to adjust this limit to take account of the demographic characteristics of the plan participants (age and service) or to permit factors other than current liability to be used. The Federal revenue effects of an alternative must be substantially the same as the 150 percent limit, however. Because of considerable controversy over possible ramifications of this new lower limit, Treasury is to study its effects and report to Congress by August 15, 1988, the same date regulations are to be issued on this topic.

CURRENT LIABILITY

In general, current liability is all liabilities to participants and beneficiaries under the plan. This liability is to be determined as if the plan terminated (with the implication that employment continues). Plan assumptions are to be used, including reasonable turnover and mortality rates. Thus, this calculation parallels the ABO calculations under FAS 87. The interest rate used to determine the current liability is to reflect the current annuity buyout rate, net of expenses and profit, and must fall within a "permissible range" of 10 percent above or below the weighted average rate for the 30-year Treasury bonds for the 4-year period ending on the last day before the beginning of the plan year of the valuation. Currently this range would be from about 8-1/4 percent to 10 percent.

A survey of the actuarial assumptions used by some 800 large plans indicates that 80 percent use an interest assumption outside the permissible range to value plan benefits. The rates now in use are generally lower than the lower limit of the range. Therefore, "current liability" for most plans will be lower than the FAS 35 disclosure liabilities. Plans do not necessarily need to change the interest rate used for funding purposes.

MINIMUM FUNDING STANDARD

Because ERISA's minimum funding standards have not protected the PBGC from huge claims, Congress has tightened the funding rules for plans that are not fully funded. For those plans, contributions are subject to additional requirements, beginning in 1989. The minimum contribution requirements can take account of credits in the funding standard account.

Affected Plans. The new requirements apply to defined benefit plans with funded ratios of less than 100 percent, but not to those exempt from current funding rules and not to multiemployer plans. The new rules do not affect plans with 100 participants or less, but all defined benefit participants in the controlled group count for that purpose, including those in multiemployer plans. The standards apply partially to plans (controlled groups) with 101 to 150 participants and in that range the otherwise-required increase is multiplied by 2 percent for each participant in excess of 100. Plans need not make contributions in excess of old-law funding rules if they have assets (the actuarial value of assets reduced by the credit balance) equal to or in excess of current liability.

Minimum Contribution. Plans less than 100 percent funded must contribute an amount equal to:

- the old-law minimum (based on the interest rate used to determine the liability under the old rules); plus

- the excess of 18-year amortization of "Old Unfunded Liability" over Old Amortization Payment for Plan Liability, plus 3 to 7 year amortization of new unfunded liability plus a special amount for benefits contingent on unpredictable

events. The amortization of Old Unfunded Liability and New Unfunded Liability is called the Deficit Reduction Contribution, and is based on Current Liability.

Unfunded Old Liability Amount. This component is the contribution necessary to amortize the unfunded old liability in equal annual installments over 18 years, beginning with the first plan year beginning after 1988. Unfunded old liability is the amount of current liability that is not funded at the beginning of the 1988 plan year, determined without regard to plan improvements adopted after October 16, 1987.

Unfunded New Liability Amount. This component is a percentage of the "unfunded new liability" which is the plan's unfunded current liability less the unamortized portion of (i) the unfunded old liability and (ii) unpredictable contingent event benefits. If the current liability is less than 35 percent funded, then the applicable percentage is 30 percent, so that a benefit improvement would have to be fully paid for in about 4 years. Clearly this will sharply curtail the benefit improvements that can be granted in collective bargaining in some major industries. The 30 percent factor is decreased by .25 times the excess of the funded current liability percentage over 35. Thus, if a plan were 75 percent funded the applicable percentage is 20 percent; if 95 percent funded the percentage is 15 percent. These percentage amortization factors are set out in the law itself and are independent of interest rates.

Unpredictable Contingent Event Benefits. There are special rules for funding benefits arising out of unpredictable events. Benefits triggered by age, service, disability, death, or early retirement are not considered unpredictable. If an unpredictable event occurs (such as a plant shut-down) then an additional funding charge is required,

over and above the other minimum amounts. The additional charge is the greater of:

(1) the total amount of unpredictable contingent event benefits paid in the year (regardless of the form of benefit), multiplied by a percentage equal to the unfunded percent of current liability. This item phases in over time--only 5 percent of the resulting amount would be charged in 1989, rising to 100 percent by the year 2001 as follows:

5 percent	for 1989 and 1990
10 percent	for 1991
15 percent	for 1992
20 percent	for 1993
30 percent	for 1994
40 percent	for 1995
50 percent	for 1996
60 percent	for 1997
70 percent	for 1998
80 percent	for 1999
90 percent	for 2000
100 percent	for 2001 and thereafter.

(2) the amount needed to amortize the liability for the unpredictable contingent event benefit in equal annual installments over 7 years.

For the year the event occurs, an amount equal to 150 percent of the first item above will satisfy the UCEB requirement. Thus, for a few years, this alternative allows the Plan sponsor to defer charges for UCEBs, especially if the first-year payout is large. Ironically, greater deferrals are permitted for plans in the steel industry (which was largely responsible for the huge PBGC deficit).

AMORTIZATION PERIODS

The amortization period for the net experience gain or loss occurring in 1988, or the waived funding deficiency is 5-years (15 years for multiemployer plans).

The amortization period for net gains or losses from changes in actuarial assumptions is 10 years. These had been 15 years.

ACTUARIAL ASSUMPTIONS

Each actuarial assumption must be reasonable taking into account the plan experience and reasonable expectations, or must in the aggregate result in a contribution equivalent to that computed as if each assumption were reasonable.

ADJUSTMENT FOR MAXIMUM CONTRIBUTION

For plans with more than 100 participants, the maximum amount deductible cannot be less than the current unfunded liability without regard to any reduction by the credit balance in the funding standard account. All defined benefit plans of an employer are aggregated for this provision. Thus, an employer can fully fund his current liability in a single year on a deductible basis.

ANNUAL REPORTS

For a plan year at the end of which a plan is funded below 60 percent of current liability, a statement must be included in the annual actuarial report (Schedule B) setting out the percentage by which the plan is funded. DOL can assess a civil penalty of up to $1,000 per day from the date of a plan administrator's failure or refusal to file an annual report. An annual report that has been rejected by the DOL for failure to provide material information may be treated as not having been filed for purposes of this penalty.

INTEREST RATES ON ACCUMULATED CONTRIBUTIONS

Mandatory employee contributions to a defined benefit pension plan will have to be credited with interest at an annual rate equal to 120 percent of the mid-term applicable federal rate (AFR), as in effect for the first month of the plan year. Previously, the interest rate for determining accumulated employee contributions was 5 percent per annum, with the authority given to Treasury to adjust that rate. Treasury will no longer have authority to alter this rate.

This interest rate is used to accumulate employee contributions for purposes of computing benefits derived from such contributions (i.e., the employee-provided portion of the accrued benefits). The Act amends the rules for allocating excess benefits upon plan termination according to the ratio that the present value of accrued benefit attributable to employee contributions bears to the present value of total benefits.

PBGC PREMIUM RATE INCREASE

Starting with the 1988 plan year, flat rate premiums for single employer defined benefit plans will be $16 per participant. The previous charge was $8.50. Underfunded plans will pay an additional variable rate premium of as much as $34 per participant.

The variable rate premium is based on the amount by which the plan's "current liability" for vested benefits exceeds the actuarial value of the plan's assets (reduced by any credit balance in the funding standard account). The interest rate that must be used in this valuation is 80 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

The variable rate premium is determined by multiplying each $1,000 of underfunding by $6, then dividing the product by the number of plan participants at the end of the previous plan year. The variable rate premium may not exceed $34.

For example, if a plan had $1 million of unfunded vested benefits and 500 participants as of December 31, 1987, the variable rate premium would be 1000 x 6 ÷ 500 or $12 per participant. This would be payable in addition to the $16.00 regular premium. A special rule reduces the $34 cap on the variable rate premium by $3 for each year in the five plan years before the 1988 plan year (i.e., plan years 1983-1987) that the employer contributed the maximum deductible contribution to the plan. This reduction applies only to premiums due for plan years 1988 through 1992.

DISTRESS TERMINATION RULES

In order to terminate in a distress termination, the contributing sponsor and each member of its controlled group each must satisfy one of the distress criteria (e.g., bankruptcy, business hardship). In addition, in order to meet the bankruptcy criterion, the bankruptcy court must determine that the debtor will be unable to emerge from Chapter 11 reorganization proceedings unless the termination is approved. Also, the debtor must notify the PBGC of any request for bankruptcy court approval. This will end the practice of reorganizing, dumping pension liability on the PBGC and then reentering the same business and adopting the same pension plan.

OBSERVATIONS

This legislation illustrates the preference of Congress to rely on mechanical limitations rather than on the judgement of professionals. Only a few actuaries were adopting unreasonably low interest assumptions in order to maximize tax deductions. Their activities were apparently sufficient to bring about the complex and precise requirements imposed by the new law. Legal requirements are now so complex as to make pension plans almost non-administrable. In the future, pension plans will become more and more a large company phenomena. Small companies will either forego pension plans or adopt defined contribution programs.

Two powerful forces have influenced legislation in the U.S. for the last decade. One is a broad social concern for the welfare of the poor and the old which has resulted in mandated vesting, widows benefits, benefits for divorced spouses, etc. These requirements complicate plan administration immensely. The second force is the need for revenue which has led to a sharp reduction in the maximum deductible contribution. On this occasions, however, the PBGC's deficit and need for revenue served as an additional force because the PBGC's operating results are also included in the Federal Budget. This led to a sharp increase in the minimum contribution requirements for many plans. Pensions were thus at the confluence of the most important societal forces. The defined benefit variety may not survive long if this should persist.

APPENDIX - SUMMARY OF INTEREST RATES

Employee Contributions

120 percent of mid-term AFR for first month of plan year.
January, 1988 mid-term AFR: 8.47%
120 percent: 10.16%

Current liability

90 to 110 percent of the weighted average rate of interest on 30-year Treasury securities during the 4 year period ending on the last day before the beginning of the plan year. Weights 4 in last year, 3 in year before, 2 in year before that and 1 in fourth year back.

Average for 4 year period ending December 31, 1987: 9.17%
90 percent: 8.25%
110 percent: 10.09%

PBGC Premium Calculation

80 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

December, 1987 monthly average: 9.12%
80 percent: 7.30%

Waived Contributions

150 percent of mid-term AFR for first month of plan year.
January, 1988 mid-term AFR: 8.47%
150 percent: 12.71%

Missed Quarterly Installments

175 percent of mid-term AFR for first month of plan year.
January, 1988 mid-term AFR: 8.47%
175 percent: 14.82%