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H.R. 2830: The Pension Protection Act of 2005

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Summary

On June 30, 2005, the House Committee on Education and the Workforce favorably reported H.R. 2830 (Boehner), *The Pension Protection Act of 2005*. As amended by the Committee, the bill would:

- Reform the funding rules for both single-employer and multiemployer defined benefit pensions,
- Require sponsors to disclose more information about pension finances,
- Restrict benefit payments and benefit accruals in underfunded plans,
- Increase the premiums that plan sponsors pay to the Pension Benefit Guaranty Corporation (PBGC), which insures defined benefit plans, and
- Clarify, prospectively, that cash balance pension plans do not ordinarily violate the legal prohibition on age discrimination in employee benefits.

This report will be updated as further legislative developments warrant.

Funding Requirements for Single-Employer Pension Plans. The *Pension Protection Act* would increase funding requirements for defined benefit pension plans and shorten the period over which funding shortfalls must be eliminated.¹ In general, plans would be required to fund 100% of their “funding target” which under current law is referred to as the plan’s “current liability.” The funding target would be the present value of all benefits — including early retirement benefits — that plan participants have earned as of the beginning of the plan year. The plan would have to amortize (pay off with interest) any funding shortfalls over seven years. Under current law, a plan’s unfunded liability can be amortized over periods of up to 30 years in some circumstances. Under the bill, a plan’s funding requirement in any year would be the present value of the benefits expected to be earned during the year by all active participants (called the “normal cost” of the plan) plus payments to amortize over seven years any pre-existing

¹ *Defined benefit* pension plans usually pay benefits based on an employee’s salary and years of service. With each year of service a worker earns a benefit equal to either a fixed dollar amount or a percentage of his or her final pay or average pay. Employers must pre-fund these benefits.

unfunded liability, less any permissible credit balance for prior contributions. The 100 percent funding target would be phased in over five years, as follows:

Year	Funding target (Percent of liabilities)
2006	92%
2007	94%
2008	96%
2009	98%
2010	100%

Plans with assets equal to less than 60% of the plan’s liabilities (less than “60% funded”) would be considered “at-risk” of default, and would be required to use more conservative actuarial assumptions in determining plan liability. Under the required actuarial assumptions, the plan sponsor would have to calculate the plan’s current liability as if all participants would choose the retirement date and form of distribution that would be most costly to the plan. In addition, a “loading factor” of 4% of the plan’s liabilities plus \$700 per participant would be added to their required contribution. A plan’s “at-risk” status would be based on the plan’s ratio of assets to liabilities. In determining the ratio of assets to liabilities and calculating the loading factor, plans would use “regular” liabilities (calculated without assuming that everyone would take the most expensive benefit and without the load charges). The additional funding requirements for at-risk plans would be phased in at 20% per year after a plan enters at-risk status.

Valuation of Assets and Liabilities. Under current law, a plan sponsor can determine the value of a plan’s assets using “actuarial valuations.” Actuarial valuations of plan assets can differ from the current market value of those assets. For example, in an actuarial valuation, the plan’s investment returns may be averaged — or “smoothed” — over a five-year period, and the average asset value may range from 80% to 120% of the assets’ fair market value. This “smoothing” is permitted because pension plans are considered long-term commitments, and smoothing reduces volatility in the measurement of plan liabilities and assets that can be caused by year-to-year fluctuations in interest rates and the rate of return on investments. Smoothing of interest rates and asset values therefore reduces the year-to-year volatility in the plan sponsor’s required minimum contributions to a defined benefit pension plan. H.R. 2830 would narrow the range for actuarial valuations to 90% to 110% of the fair market value of assets and reduce the maximum smoothing period from five years to three years.

Pension plan liabilities — the pensions owed to participants and survivors — extend many years into the future. Determining whether the plan is adequately funded requires converting this long-term stream of pension payments into an equivalent lump sum, which is essentially the amount that would be needed today to pay off those liabilities all at once. This lump sum — representing the “present value” of the plan’s liabilities — is then compared to the value of the plan’s assets. An underfunded plan is one in which the value of the plan’s assets falls short of the present value of its liabilities by more than the percentage allowed under law. Converting a future stream of payments (or income) into a present value requires the future payments (or income) to be “discounted” using an appropriate interest rate. Other things being equal, the *higher* the interest rate, the *smaller* the present value of the future payments (or income), and vice versa.

Under the bill, plan sponsors would determine the funding target (the present value of the plan's liabilities) using three interest rates, which would be based on when the benefits are projected to be paid: in less than five years, in 5 to 20 years, or in more than 20 years. The Secretary of the Treasury would determine the three rates, which would be derived from a "yield curve" of investment-grade corporate bonds.² Interest rates would be averaged over a three-year period under a weighting formula using 50% of the rate from the most recent plan year, 35% of the rate from the previous plan year and 15% from the plan year before that. The yield curve would be phased in during the 2006 and 2007 plan years, and become fully effective for the 2008 plan year. This methodology would permanently replace the four-year average of corporate bond rates established under P.L. 108-218, which expires with plan years ending after 2005.

Contribution Limits and Credit Balances. H.R. 2830 would allow plan sponsors to contribute more to their pension plans than they can under current law. It would set the maximum tax-deductible contribution at 150% of the plan's funding target (150% of the plan's current liability).³ Within certain limits, sponsors would be able to offset required current contributions with previous contributions. However, using these so-called "credit balances" to offset required contributions would be permitted only in plans that are at least 80% funded and only after subtracting pre-enactment credit balances from plan assets. Credit balances also would have to be adjusted for investment gains and losses since the date of the original contribution that created the credit balance.

Lump-Sum Distributions. By law, defined benefit pensions must offer participants the option to receive their accrued benefits in the form of an annuity — a series of monthly payments guaranteed for life. Increasingly, however, defined benefit plans also have offered participants the option to take their accrued benefits as a single lump sum at the time they separate from the employer. The amount of a lump-sum distribution from a defined benefit pension is inversely related to the interest used to calculate the present value of the benefit that has been accrued under the plan: the higher the interest rate, the smaller the lump-sum and vice versa. Under current law, lump-sum distributions are calculated using the average interest rate on 30-year Treasury bonds. The interest rate on long-term Treasury securities has historically been lower than the average interest rate on long-term investment-grade corporate bonds because bond markets generally consider U.S. Treasury securities to be free of the risk of default. The Treasury Department stopped issuing the 30-year bond in 2001, and the interest rate on bonds that have not yet been redeemed has fallen as the supply of bonds has shrunk. (Bond prices and interest rates are inversely related. As bond prices rise, their yields fall.)

H.R. 2830 would require plan sponsors to calculate lump-sum distributions using three interest rates based on investment-grade corporate bonds. As a result, participants of different ages would have their lump sum distributions calculated using different

² A yield curve is a graph that shows interest rates on fixed income securities (bonds) plotted against the maturity date of the security. Normally, long-term bonds have higher yields than short-term bonds because both credit risk and inflation risk rise as the maturity dates extend further into the future. Consequently, the yield curve usually slopes upward from left to right.

³ The bill would allow a plan sponsor to deduct for tax purposes a contribution equal to the greater of (1) 150% of current liability or (2) if the plan is not "at-risk," 100% of liability determined as if the plan were at-risk, plus the plan's normal cost, minus the value of plan assets.

interest rates. Other things being equal, lump-sum distributions paid to workers nearer to retirement would be calculated using a lower interest rate than would be used for younger workers. As a result, all else being equal, an older worker would receive a larger lump-sum than a similarly situated younger worker. The interest rates used to calculate lump sums would be based on *current* bond rates rather than the three-year *weighted average* rate used to calculate the plan's funding target (current liability). The new rules for calculating lump sums would be phased-in over five years.

PBGC Premiums for Single-Employer Plans. The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to insure pension benefits under defined benefit pension plans. The PBGC is funded by premiums paid by plan sponsors and investment returns on the assets held in its trust fund. It receives no appropriations from Congress. The PBGC does not have the legal authority to set its own premiums, which are set in law by Congress. The PBGC has had to take over a number of large underfunded plans in recent years, and it reported a deficit of \$23.3 billion at the end of 2004, raising concerns that the agency may require a taxpayer-financed "bailout" at some point in the future. The PBGC receives two types of premiums from plans sponsored by individual employers: a per-capita premium of \$19 per year that is charged to all single-employer defined benefit plans, and a variable premium equal to \$9 per \$1,000 of underfunding (0.9%) charged to underfunded plans.

H.R. 2830 would raise the base annual PBGC premium from \$19 to \$30 per participant. The \$30 premium would be phased in beginning in 2007, on a schedule based on the plan's funded status. For plans that are at least 80% funded, the higher premium would be phased in over five years. In plans that are less than 80% funded, the higher premium would be phased in over three years. The premium then would be indexed to average national wage growth. The act would also increase the variable-rate premium (to be renamed the "risk-based premium") of \$9 per \$1,000 of underfunding by indexing it to the rate of growth of average wages beginning in 2008. Unlike current law, a plan would not be exempted from the risk-based premium if it was not underfunded in any two consecutive years out of the previous three years. The risk-based premium would be assessed on all underfunded plans, regardless of the plan's funding status in earlier years.

Limits on Benefits in Underfunded Plans. H.R. 2830 would limit certain forms of benefit payments and the accrual of new benefits in underfunded plans. Plans funded at less than 80% could not pay lump-sum distributions and could not increase benefits without first fully funding the new benefits. In plans less than 60% funded, benefits would be "frozen" and no new benefits could be earned under the plan. Participants would have to be notified of these restrictions on benefits. An actuary would have to certify that the plan had re-attained funded status before new benefit accruals could begin. As introduced, these restrictions would have applied to plans that were under-funded after credit balances had been deducted from plan assets. As amended by the Committee, the benefit restrictions would not apply if the plan's assets were at least 100% of plan liabilities *before* subtracting credit balances. In pension plans considered to be at risk of default, assets set aside in trust funds to pre-fund deferred compensation for highly compensated employees would be taxable as employee income.

Prohibition on "Shut-Down" Benefits. "Shutdown benefits" are pension payments made to long-service employees when a plant is shut down. These benefits typically are negotiated between employers and labor unions. Shutdown benefits usually

are not pre-funded because the probability of future plant shutdowns is unpredictable. Because they are unfunded, shutdown benefits weaken the financial status of the PBGC when it takes over an under-funded pension plan of a company that has promised its workers these benefits. H.R. 2830 would prohibit shut-down benefits and similar “contingent-event” benefits. This change generally would be effective in 2007.⁴

Disclosure Requirements. The bill would plan administrators to provide an annual “funding notice” within 90 days of the close of the plan year to each participant and beneficiary and to any labor organization representing participants. The notice must include (1) identifying information; (2) the ratio of active to inactive participants; (3) the plan’s assets and liabilities and the ratio of assets to liabilities; and (4) the plan’s funding and asset allocation policies. Plan sponsors also would have to include more information on the Form 5500 that they file annually with the Internal Revenue Service, including an explanation of the actuarial assumptions used to project future retirements and asset allocations. Plans would have to provide participants a copy of the summary annual report (SAR) within 15 days of the deadline for filing the Form 5500.

Section 4010 of ERISA provides that plans underfunded by \$50 million or more must file a report with the PBGC, but it prohibits the PBGC from releasing this information to the plan participants or the public. H.R. 2830 would require the plan sponsor to provide participants with a notice of their filing with the PBGC. The notice would include (1) the number of the sponsor’s at-risk plans in which the ratio of assets to liabilities in the preceding plan year was less than 60%; (2) the value of the assets, the funding target, and the asset/liability ratio for each plan; and (3) the aggregate value of plan assets, plan funding targets (taking into account only vested benefits) and asset/liability ratios for all plans. The notice would have to be sent to participants no later than 90 days after the related notice is sent to PBGC. The PBGC notice is due 105 days after the close of the year. The disclosure requirements would be triggered if the plan were underfunded by \$50 million or more; if the plan were less than 60% funded; or if the plan were less than 75% funded and sponsored by an employer in a financially troubled industry. Congress would also have to be given the same information sent to the PBGC.

Rules for Multiemployer Plans.⁵ H.R. 2830 would establish new funding standards for multiemployer plans, with special rules for plans that are less than 80% funded. Multiemployer plan sponsors would have to amortize unfunded prior service liability over 15 years, rather than over 30 years as under current law. “Endangered” plans - those that are less than 80% funded - generally would be required to develop a plan to increase contributions, reduce or cease new benefit accruals, and adopt other plan amendments that can reasonably be expected to meet prescribed improvements in the plan’s funded status within 10 years. Alternative schedules for improving solvency would apply to endangered plans that are less than 70% funded and to plans more than 70% funded but less than 80% funded. Employers currently contributing to severely

⁴ In 2004, the 6th U.S. Circuit Court of Appeals ruled that in order to protect its insurance program from the financial burden of unfunded benefits, the PBGC could set a plan termination date that would prevent the agency from being liable for shutdown benefits. In March 2005, the U.S. Supreme Court declined to hear the case, leaving the Circuit Court’s decision in place.

⁵ Multiemployer plans are common among workers covered by collective bargaining agreements.

underfunded plans would be required to make 5% to 10% surcharge contributions until the next collective bargaining agreement is adopted.

Multiemployer plans would be required to furnish actuarial and financial reports within 30 days of a request from a contributing employer or labor organization, and they would have to report the amount of an employer's withdrawal liability within 180 days of receiving a written request from a contributing employer. They also would have to identify the number of contributing employers and the number of workers for whom there is no contributing employer. The bill would increase the maximum tax-deductible contribution for multiemployer plans to 140% of current liability.

Investment Advice. H.R. 2830 would allow advisors or affiliates of investment funds offered in a §401(k) plan to offer investment advice to plan participants. Eligible plans would be exempted from certain rules governing prohibited transactions under ERISA and the Internal Revenue Code. To qualify for this exemption, the adviser would have to meet disclosure and qualification requirements. The adviser would have to provide notice of fees, material affiliations, any limitation on the scope of advice, and services provided with respect to the advice. The notice would have to state that the adviser is acting as a fiduciary and that the participant or beneficiary could arrange for outside "third-party" advice. By providing investment advice, the adviser would be acting as a fiduciary subject to the terms of ERISA that apply to plan fiduciaries. In addition, the advisor would have to be either a registered investment adviser under the Investment Advisers Act; a bank or similar financial institution; an insurance company; a registered broker or dealer; or an affiliate, agent, or employee of one of these institutions. Fees paid to the adviser would have to be reasonable and at least as favorable as an arm's length transaction, and the participant would have to make the actual investment and asset allocation decisions. The bill defines the scope of a plan sponsor's fiduciary obligations as limited to "the prudent selection and periodic review" of the adviser, and provides that the sponsor has no duty to monitor specific investment advice given by the adviser, and therefore would not be liable for the specific advice given.

Cash Balance Plans and other Hybrid Pensions. The Committee adopted an amendment that would establish principles for testing defined benefit plans for age discrimination and would clarify that "cash balance plans" do not ordinarily discriminate against older employees under federal law. It describes how cash balance plans and other "hybrid" pensions that have characteristics of both defined benefit and defined contribution plans would be tested for age discrimination, and clarifies that a defined benefit plan does not discriminate on the basis of age if a participant's entire accrued benefit, as defined under the plan's benefit formula, is no less than the accrued benefit of any worker similarly situated in every respect except for age. Pre-retirement indexing (for example, periodic adjustments that protect the economic value of the benefit against inflation prior to distribution) could be disregarded in making this determination. The amendment also provides that in the case of cash balance plans, paying a lump sum equal to the participant's account balance would be sufficient to prevent a prohibited forfeiture of an accrued benefit, provided that the plan credits interest at a rate no greater than a market rate of interest. The amendment would apply prospectively, i.e., after enactment.