

**PRESENT LAW AND BACKGROUND RELATING TO VALUING
ASSETS IN DEFINED BENEFIT PENSION PLANS**

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on October 29, 2008

Prepared by the Staff
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I. INTRODUCTION AND OVERVIEW

The Committee on Ways and Means of the House of Representatives has scheduled a public hearing on economic recovery, job creation, and investment in America. Among the issues the Committee will consider is the recent loss in value of assets in retirement accounts. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present law and background relating to permissible methods of valuing the assets of single-employer² defined benefit pension plans for purposes of complying with the minimum funding rules that apply to such plans under the Internal Revenue Code (the “Code”) and the Employee Retirement Income Security Act of 1974 (“ERISA”).³

A defined benefit pension plan is one of two basic types of retirement plans that an employer may provide for its employees. The other type of plan is a defined contribution plan. In the case of a defined contribution plan, a specific contribution is made to the plan for each participant, and the participant’s sole retirement benefit under the plan is the amount of such contributions together with the participant’s share of the plan’s earnings or losses on such contributions. No promise is made by the employer as to the amount of money that will be available to the participant upon retirement, and thus the participant bears the risk of loss, and benefits from any gains, with respect to investment of plan contributions. In contrast, a defined benefit pension plan generally provides a participant with a specified benefit at a specified age (e.g., the plan might provide for annual payments commencing at age 65 equal to one percent of a participant’s final average compensation for each year of service with the sponsoring employer). Unlike a defined contribution plan, the sponsor of a defined benefit pension plan is responsible for ensuring that adequate contributions are made to the plan so that benefits earned under the plan can be paid, and the sponsor bears the risk of loss with respect to investment of plan contributions.

Defined benefit pension plans generally are subject to minimum funding rules that require the sponsoring employer to periodically make contributions to fund plan benefits.⁴ The

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Valuing Assets in Defined Benefit Pension Plans* (JCX-82-08), October 24, 2008. This document is available at www.jct.gov.

² A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.

³ Except as otherwise noted, all references to sections in this document are to sections of the Code.

⁴ Code sec. 412. Parallel minimum funding rules are also set forth in ERISA. A number of exceptions to the minimum funding rules apply. For example, governmental and church plans are not subject to the minimum funding rules. A governmental plan is a plan established and maintained for its employees by the Federal government, a State government or political subdivision, or an agency or instrumentality of the foregoing. A governmental plan includes a plan established and maintained by an Indian tribal government or political subdivision (or agency or instrumentality) thereof as long as all participants are employees of such entity, all of whose services are in the performance of essential

minimum funding rules for single-employer defined benefit pension plans were substantially revised by the Pension Protection Act of 2006 (“PPA”).⁵ Among the changes made by PPA were revisions to the rules governing the measurement of the value of a plan’s assets for purposes of complying with the funding rules. The revised measurement rules have been criticized by plan sponsors and others on the grounds that the rules require an employer to either accept a significant degree of volatility and uncertainty with respect to the employer’s annual minimum funding obligation or base the minimum funding obligation on a methodology that tends to overstate the funding obligation. The PPA’s minimum funding rules are generally effective for plan years beginning after December 31, 2007.

governmental functions (but not in the performance of commercial activities). A church plan is a plan established and maintained for its employee by a church or by a convention or association of churches which is exempt from tax under section 501 of the Code. A church plan may elect to be subject to the minimum funding rules.

⁵ Pub. L. No. 109-280. PPA also revised the funding rules that apply to multiemployer defined benefit pension plans. However, the revisions did not preclude such plans from using a valuation methodology that takes into account expected earnings on plan assets.

II. PRESENT LAW AND BACKGROUND

A. Minimum Funding Rules

The purpose of the minimum funding rules is to ensure that the sponsoring employer of a defined benefit pension plan makes periodic minimum contributions that will adequately fund benefits promised under the plan. The rules permit an employer to fund the plan over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan.

The due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year. The Secretary of the Treasury is authorized to waive a minimum required contribution in the case of a temporary substantial business hardship.

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the sponsoring employer.⁶ The initial tax is ten percent of aggregate unpaid contributions for single-employer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the Internal Revenue Service (or the date of assessment of the initial tax). The additional tax is equal to 100 percent of the unpaid contributions. Before issuing a notice of deficiency with respect to the excise tax, the Secretary of the Treasury must notify the Secretary of Labor to provide the Secretary of Labor with a reasonable opportunity to require the employer to correct the deficiency or comment on the imposition of the tax.

The Pension Benefit Guaranty Corporation (“PBGC”) was established for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified annual limits) if the sponsoring employer is not able to fulfill its obligation to adequately fund the plan and the plan is terminated when it is underfunded.⁷ The benefit protection function of the PBGC is carried out through an insurance program that applies to defined benefit pension plans. Sponsors of plans that are subject to the insurance program are liable to the PBGC for premium payments. PBGC termination insurance serves as a backstop to the minimum funding rules.

⁶ Code sec. 4971.

⁷ ERISA sec. 4002(a).

B. Pre-PPA Minimum Funding Rules

Prior to the enactment of PPA, a single-employer defined benefit pension plan was required to maintain a special account called a “funding standard account” to which charges and credits (such as credits for plan contributions) were made for each plan year. If, as of the close of a plan year, the account reflected credits equal to or in excess of charges to the account, the plan generally was treated as meeting the minimum funding rules for the plan year. Thus, as a general rule, the minimum contribution that an employer was required to make for a plan year was determined as the amount by which the total charges to the funding standard account exceeded total credits to the account.

A plan was required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represented the cost of future benefits allocated to the plan year under the funding method used by the plan for current employees. The supplemental cost for a plan year was the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a “net experience loss” (described below).

In determining plan funding under an acceptable actuarial cost method, a plan’s actuary generally made certain assumptions regarding the future experience of a plan. These assumptions typically involved rates of interest, mortality, disability, salary increases, and other factors affecting the value of plan assets and liabilities. The actuarial assumptions were required to be reasonable. If the actual unfunded liabilities of the plan were greater than those anticipated (i.e., the plan’s assets were not sufficient to fund plan liabilities), then the difference was a net experience loss. If the plan’s actual unfunded liabilities were less than those anticipated by the actuary on the basis of these assumptions, then the excess was a net experience gain. Prior to enactment of PPA, net experience gains and losses for a year generally were amortized over a five-year period, resulting in credits (where there were gains) or charges (where there were losses) to the plan’s funding standard account.

In determining the charges and credits to be made to the plan’s funding standard account, the actuarial value of a plan’s assets could be used instead of fair market value. The actuarial value of plan assets was the value determined on the basis of a reasonable actuarial valuation method that took into account fair market value, provided that the method was permitted under Treasury regulations. However, any actuarial valuation method used by the plan was required to result in a value of plan assets that was not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value. In addition, if the valuation method used average values of the plan assets, the averaging period could not exceed the five most recent plan years, including the current plan year.

The plan was permitted to use certain actuarial valuation methods that allowed for appreciation or depreciation in the market value of plan assets to be recognized more gradually or smoothly than would be the case if the actual fair market value of plan assets was used. Thus, these methods are sometimes referred to as “asset smoothing” valuation methods.

The smoothing effect could be achieved under a variety of permissible actuarial valuation methods. For example, the value of plan assets might be determined on the basis of an average of plan assets over a period of time, with adjustment of the valuations used in calculating the average for subsequent plan contributions, distributions, and certain plan earnings.⁸ Another methodology would compare the actual value of plan assets on the valuation date to the expected value of plan assets for such date (which resulted in a loss or gain), and determined the actuarial value of the plan's assets by adding a specified portion of the loss (or subtracting a specified portion of the gain) to the market value for the current year and succeeding years.⁹ The specified portion of loss or gain was a decreasing fraction based on the number of years in the smoothing period. For example, if the smoothing period was five years and there was a loss, 4/5 of the loss would be added to the market value for the current year to determine the actuarial asset value, 3/5 would be added in the next year, 2/5 would be added in the third year, 1/5 would be added in the fourth year, and the loss would be fully recognized in the fifth year.

⁸ Treas. Reg. 1.412(c)(2)-1(b)(7).

⁹ Rev. Proc. 2000-40, 2000-2 C.B. 357.

C. PPA Minimum Funding Rules

Under the PPA's new minimum funding rules for single-employer defined benefit pension plans, the minimum required contribution for a plan year generally depends on a comparison of the value of the plan's assets as of the beginning of the plan year with the plan's funding target and the plan's target normal cost.¹⁰ The plan's funding target for a plan year is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. In such a case, the minimum required contribution for the plan year generally is equal to the sum of the plan's target normal cost for the year and a portion of the funding shortfall for that year and prior plan years.¹¹

Under the PPA's minimum funding rules, the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date; and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets at that time. The PPA rules also provide that any averaging must be adjusted for contributions to the plan and distributions to participants as provided by the Secretary of the Treasury.

Proposed regulations have been issued under the PPA rules that permit the value of plan assets to be determined on the basis of averaging.¹² Under the proposed regulations, the average value of plan assets generally is increased for contributions that are included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period. Similarly, the average value generally is decreased for distributions included in the last valuation date during the averaging period but that were not included in the prior valuation dates during the averaging period.

The PPA asset valuation rules do not permit adjustments to average value on account of the difference between the actual value and the expected value of plan assets (such as an

¹⁰ A plan with 100 or fewer participants is permitted to designate any day during the plan year as its valuation date for purposes of the minimum funding rules.

¹¹ A shortfall amortization base is generally established for each year for which a plan has a funding shortfall, and each base is amortized over a seven-year period. The base is generally comprised of the funding shortfall for that year, less the present value of shortfall amortization installments that apply to the current year and succeeding years on account of prior-year shortfall amortization bases. The aggregate of the shortfall amortization installments for the current plan year is referred to as the shortfall amortization charge, and this charge is added to the plan's target normal cost in determining the minimum required contribution.

¹² 72 F.R. 74215 (December 31, 2007).

adjustment for expected earnings) and, thus, do not permit asset smoothing valuation methods that took into account such adjustments prior to PPA.

D. Policy Considerations

The valuation of plan assets is a critical determination under the minimum funding rules for a single-employer defined benefit pension plan. The minimum contribution rules are designed to ensure that a plan is fully funded over time and, under the rules, a valuation method that results in a higher plan asset value also results in a lower minimum required contribution on the part of the sponsoring employer. Thus, one perspective on acceptable valuation methods is that such methods should only take into account actual plan asset values at a measurement date that is close in proximity to the measurement of the plan's liabilities. Under the narrowest formulation of this perspective, the valuation of plan assets would simply be the fair market value of the assets as of the plan liabilities valuation date (which is one option for valuing plan assets under PPA).

A valuation method that is based on a single measurement date, however, introduces a considerable degree of volatility and uncertainty on the part of a sponsoring employer with respect to its plan funding obligations. This is because, under such an approach, the employer's funding obligation for a given year is entirely dependent on the value of plan assets on a single day, which may not be reasonably representative of average asset values over a longer period. A minimum funding rule that mandates this type of uncertainty may discourage some employers from sponsoring defined benefit pension plans. Because employers sponsor retirement plans in the United States on a voluntary basis, the degree to which a particular rule discourages employer behavior is an important policy consideration. An asset valuation method that permits the use of an averaging period, such as the 25-month period permissible under the PPA's funding rules, addresses the volatility and uncertainty concerns inherent in a single date valuation rule.

Some argue that an asset valuation method that uses an averaging period has the potential effect of systematically understating a plan's assets, and they criticize the PPA's averaging valuation method because the methodology does not remedy this distortion. Such persons observe that plan assets, when measured over the life of a plan and adjusted to take into account subsequent plan contributions and benefit distributions, gradually tend to increase in value over time on account of earnings. However, an average value of plan assets based on two or more valuation dates within the life of the plan will only capture a portion of the earnings that are attributable to the averaging period since earlier valuation dates within the averaging period do not include earnings attributable to later portions of the averaging period. The degree to which earnings are potentially disregarded is magnified by the length of the averaging period. To remedy the potential distortion, some have argued that the PPA's averaging method should allow for adjustment of the average value of plan assets to include expected plan earnings during the averaging period. Such persons argue that, without such an adjustment, the PPA's averaging method systematically requires a sponsoring employer to contribute more to a plan under the minimum funding rules than is actually necessary to properly fund the plan.

Section 201 of H.R. 6382, the Pension Protection Technical Corrections Act of 2008, contains a provision that addresses this criticism by permitting a limited form of asset smoothing

in the valuation of plan assets under PPA.¹³ Under the provision, the averaging method under PPA is amended so that plan asset values are adjusted in the manner specified by the Secretary of the Treasury for a plan's expected earnings. Such an adjustment would be in addition to the present law adjustments for contributions and distributions. The provision requires that the expected earnings rate must be specified by the plan's actuary (and thus the specified rate must represent a reasonable actuarial assumption). In addition, the rate specified by the actuary cannot exceed the applicable third segment rate¹⁴ for the plan. Thus, the assumed earnings that may be taken into account in valuing a plan's assets cannot exceed the interest rate that is payable with respect to investment grade long-term corporate bonds.

¹³ H.R. 6382 passed the House of Representatives on July 9, 2008. Section 14(a) of the Pension Protection Technical Corrections Act of 2007, S. 1974, which passed the Senate on December 19, 2007, contains a similar provision as section 201 of H.R. 6382.

¹⁴ The PPA's minimum funding rules specify the interest rates that must be used in determining a plan's target normal cost and funding target. Under the rules, present value generally is determined using three interest rates, each of which applies to benefit payments expected to be made from the plan during a certain period. The third segment rate applies to benefits reasonably determined to be payable after the end of the 20-year period that applies to the first and second segment rates. Each segment rate is a single interest rate determined by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The yield curve used by the Secretary is based on yields on investment grade corporate bonds that are in the top three quality levels available.