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Regina T. Jefferson

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DEFINED BENEFIT PLAN FUNDING: HOW MUCH IS TOO MUCH?

Regina T. Jefferson†

INTRODUCTION

THE impetus behind the establishment of current pension law was to provide appropriate incentives for the growth of private pension plans and at the same time improve their basic soundness and equitable character. When Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA),[1] it identified

† Assistant Professor, Catholic University, Columbus School of Law. I wish to thank my mentor, Daniel Halperin, who read and critiqued this work. His support of me, in general, and this project, in particular, has been immeasurable. I cannot thank him enough. I also wish to thank Jessica Schaffer for her extremely helpful research assistance.

1. The Employee Retirement Income Security Act, better known as ERISA, is a massive piece of legislation. ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of I.R.C. and 29 U.S.C. §§ 1001-1381 (1988 & Supp. IV 1992)). Its origin can be traced to President Kennedy's 1962 Economic Report in which he stated that there was a need for review of the rules governing investment policies of pension plans and the effects on equity and efficiency of the tax privileges afforded to pension plans. More than a decade later, President Ford signed ERISA into law on September 2, 1974. The Act completely revised the legal framework of the qualified pension plan as it had previously existed. The most significant innovations of ERISA concerned participation, vesting, and funding standards. Jurisdiction over employee benefits under ERISA was divided among the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation.

adequate funding over the life of a plan and on plan termination as a critical element in accomplishing these goals. Accordingly, ERISA imposed minimum levels of funding under its labor requirements[2] and as a prerequisite to the retention of certain tax benefits afforded to qualified pension plans.[3]

Plans which operationally meet the requirements of Internal Revenue Code section 401(a) are said to be qualified plans. The qualified status of the plan entitles the employer as well as plan participants to substantial tax advantages. The first tax advantage is that employer contributions are deductible by the employer when made, but are not taxed until they are distributed to the employee.[4] This is an exception to the general rule that an employer cannot take a deduction for salary related expenditures as an ordinary and necessary business expense under Internal Revenue Code section 162 prior to the time that the employee includes the payment in income. The exception allows the employer to receive an accelerated deduction. The second tax advantage to qualified plans is that income earned on the accumulated contributions is not taxable until distribution.[5] This allows a tax-free build-up of investment income. The tax-free build-up is the essence of the tax favorable treatment of qualified pension plans.[6]

While sufficient funding was recognized as one of the primary goals of ERISA, Congress continued the maximum funding limitations which capped the deduction for amounts contributed to a qualified plan in a plan year by an employer.[7] Moreover, in an effort to further discourage "overfunding," a ten percent excise tax

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2. Title I of ERISA, commonly referred to as the "labor title," is concerned with the protection of employee benefit rights and is generally enforced by the Department of Labor. ERISA, 29 U.S.C. §§ 1001-1003 (1988 & Supp. IV 1992).

3. Qualified pension plans are plans that comply with I.R.C. § 401(a) and the regulations thereunder in both form and operation. I.R.C. § 401(a) (1988 & Supp. IV 1992). They must, for example, meet minimum participation, vesting, and funding standards. Usually, before placing the plan in operation, employers will request a Determination Letter from the Internal Revenue Service approving their proposed plans and related trusts. However, employers are not required to obtain this determination.

4. I.R.C. §§ 402(a)(1) (1988 & Supp. IV 1992), 404(a)(1)-(a)(3) (1988).

5. *Id.* § 501(a) (1988 & Supp. IV 1992).

6. For an explanation of the time value of money and a description of how the timing of the deduction and the inclusion of income do not necessarily have advantageous effects if the tax rates remain constant, see Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986).

7. I.R.C. § 404(a)(1)(A) (1988).

was imposed, as of January 1, 1987, on all nondeductible contributions.[8]

Legislative history suggests[9] that Congress was driven by two concerns in establishing the maximum funding limitation: (1) Congress did not believe it appropriate to extend tax subsidized benefits to amounts in excess of the funding limitations,[10] and (2) it believed that accelerated funding creates an incentive for employers to terminate their plans in order to recapture surplus assets, a practice referred to as "asset reversion."[11] Asset reversion occurs when a plan terminates, and there are excess assets in the plan which are permitted under law to revert to the employer. Even if the concerns of Congress are legitimate, the recent emphasis on overfunding creates a risk that plans will be insufficiently funded and is, therefore, inconsistent with the established policy of encouraging adequate funding. The goal of this paper is to offer a means of reconciling these competing interests.

The subject of asset reversion is controversial.[12] A number of highly publicized plan terminations led to reversions and caused a political uproar in the early to mid 1980's.[13] Congress responded by limiting deductible contributions and establishing new excise taxes on nondeductible contributions and reversions. The deduction restrictions and excise tax on nondeductible contributions made surpluses less likely to occur while the excise tax on reversions made the recovery of surplus assets less desirable. Collectively, these changes have succeeded in essentially bringing accelerated funding and the removal of excess plan assets to a halt.[14] How-

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8. *Id.* § 4972(a) (1988).

9. *Overfunded Pension Plans: Joint Hearing before the Select Comm. on Aging and the Subcomm. on Labor-Management Relations of the Comm. on Education and Labor*, 99th Cong., 1st Sess. 2-5 (1985) [hereinafter *Hearings*] (opening statement of Edward R. Roybal, Chairman).

10. The full funding limitation sets a ceiling on the maximum deduction an employer may receive for contributions made to a plan. I.R.C. § 404(a)(1)(A) (1988).

11. *See infra* text accompanying note 44.

12. *See generally Pension Asset Raids, Hearing Before the Select Comm. on Aging*, 98th Cong., 1st Sess. (1983) (discussing pension plan terminations to recover excess assets and in particular, Harper & Row Publisher's termination of their pension plan).

13. *See* Walsh v. Great Atl. & Pac. Tea Co., 726 F.2d 956 (3d Cir. 1983) (class action under ERISA to block employer asset reversion of approximately $250 million); District 65, UAW v. Harpers & Row, Publishers, 576 F. Supp. 1468 (S.D.N.Y. 1983) (action brought by union under ERISA because employer terminated a retirement plan in order to obtain surplus assets of plan).

14. *See* Employee Benefit Research Institute, *Questions and Answers about Employee Benefits*, EBRI ISSUE BRIEF 78, May 1988, at 10 (Table 12) [hereinafter EBRI ISSUE

ever, in addition to deterring tax avoidance schemes, these laws also deter legitimate "overfunding." In some instances, they may ultimately lead to asset shortages. Thus, the recently enacted funding restrictions could prove to be very costly for plan participants in the future.

Ideally, the role of policymakers is to make laws which effectuate change consistent with public interest. However, in order for policy makers to meet this demand, it is necessary for them to identify distinct issues and their respective causes and long term effects. In furtherance of this goal, as it relates to the issue of accelerated funding of qualified defined benefit plans, this Article will address the following questions: (1) whether it is practical to separate the concept of accelerated funding from impending plan termination, (2) whether the removal of excess assets from terminating plans can be deterred in ways which offset tax-subsidized gains attributable to overfunded amounts rather than in ways which discourage accelerated funding, and (3) whether, in the absence of concerns relating to plan termination, accelerated funding is consistent with pension policy.

I. DEFINED BENEFIT PLAN FUNDING

A. *Funding Requirements*

A defined benefit plan pools the plan's assets in an aggregate trust fund and promises a fixed amount to plan participants at retirement, without regard to the plan's investment performance.[15] The defined benefit plan usually provides a monthly payment of the retirement benefit over the life of the employee and a surviving spouse. The benefit amount is determined by a formula which is usually a function of the participant's compensation and service. This distinguishes it from a defined contribution plan where the employer makes annual contributions to individual participant accounts; the accounts are invested, and the employee receives the entire account balance on retirement.[16]

While the retirement benefit itself is definitely determinable in

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BRIEF] (stating that increase in asset reversions in the early 1980s has slowed and reversed by 1988).

15. Defined benefit plan is defined in I.R.C. § 414(i) (1988) and ERISA, 29 U.S.C. § 1002(34) (1988). Defined contribution plan is defined in I.R.C. § 414(j) (1988) and ERISA, 29 U.S.C. § 1002(35) (1988).

16. *See supra* note 15.

a defined benefit plan, the costs of future benefits are based upon actuarial estimates of future salary increases, investment yields, mortality, and turnover. The use of actuarial estimates in conjunction with funding methods enables the employer to systematically allocate plan costs over the life of the plan in order to avoid large plan costs in relatively short periods as plan obligations become due.[17]

Funding methods may be classified in several ways. One criteria of classification is whether costs are determined by using accrued benefits[18] or projected benefits.[19] If plan costs are determined on the basis of accrued benefits, the cost for the current year, referred to as the "normal cost," is the actuarial present value of the benefits accrued in a given year. If the costs are based on projected benefits, the normal cost is generally the level percentage of pay necessary per year to fund the projected benefits for all years of service.[20] Thus, the normal cost allocates future plan costs over the life of the plan and will vary depending on the funding method selected.

Past service liability occurs when an employer gives credit for service prior to the date on which the plan is established.[21] Prospectively viewed, the past service liability, or accrued liability, is the amount that, together with future plan costs, is expected to cover all benefit costs under the plan. The excess of the accrued liability over the plan's assets is the "unfunded accrued liability."[22]

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17. "Funding method" is synonymous with the term "actuarial cost method." A funding method is a recognized technique to determine what portion of a pension's cost should be attributed to the present year, prior years, and future years. There are many different funding methods. ERISA does not mandate that any particular method be used; however, ERISA does specify six acceptable methods. 29 U.S.C. § 1002(31) (1988). Once a method is selected for a plan, it may not be changed without the permission of the Internal Revenue Service. I.R.C. § 412(c)(5) (1988).

18. The accrued benefit in a defined benefit plan is equal to the sum of pension credits earned for the number of years of service to date expressed in terms of annual benefits beginning at normal retirement age. Treas. Reg. § 1.411(a)-7(a)(1) (as amended in 1988).

19. The projected benefit is the benefit the participant expects to receive at normal retirement age provided she does not terminate employment before such time. For a discussion of this subject, see DAN M. MCGILL & DONALD S. GRUBBS, JR., FUNDAMENTALS OF PRIVATE PENSIONS 292-94 (6th ed. 1989).

20. *See id.* at 292.

21. The past service liability is also referred to as the "accrued liability." Despite its name, the accrued liability of a plan is not an accounting or legal liability. *See infra* note 35.

22. I.R.C. § 412(b)(2)(B) (1988). For explanation of actuarial cost methods, see

An employer is required to contribute annually the entire normal cost of the plan. The supplemental costs of the plan are to be amortized over a specified period. In addition to the accrued liability, supplemental costs consist of amounts resulting from plan amendments, experience losses,[23] and losses caused by changes in actuarial assumptions.[24] The amortization period for the initial past service liability, liabilities resulting from plan amendments, and changes in actuarial assumptions is thirty years.[25] Net experience losses are amortized over fifteen years.[26]

While the primary function of an advanced funding method is to apprise the employer of the estimated rate at which the obligations under the plan will accrue, these projections are also used to calculate the funding limitations.[27] Thus, to the extent that advanced funding methods can accurately predict actual plan experience, they provide financial security to plan participants. To the extent that they systematically allocate cost among plan years, they ensure that an equitable apportionment of plan costs, plan deductions, and plan contributions occur over the life of the plan.

1. Pre-ERISA Funding Law

The pension law prior to ERISA was inadequate in providing sufficient financial security for plan participants and equitably apportioning benefit costs over the life of the plan. During this period, there were no specific advanced funding requirements. As a consequence, many of the problems which arose were related to underfunding. Plans which fully complied with the existing statutory requirements terminated with insufficient assets.[28] Benefits were

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MCGILL & GRUBBS, *supra* note 19, at 267-68.

23. Experience losses occur when actual plan costs exceed the actuarial estimates for a given plan year. For example, if the actuary assumes that the plan investments will earn 8% and the investment earned only 5%, the plan will have a deficiency, or an actuarial loss.

24. Supplemental costs also include waived funding deficiencies. These occur when the Secretary of the Treasury, acting through the Internal Revenue Service, waives part or all of a plan's annual contribution upon a showing of substantial financial hardship such that making the plan contribution would adversely affect plan participants. I.R.C. § 412(d) (1988 & Supp. IV 1992).

25. *Id.* § 412(b)(2)(B)(ii)-(iii), (v) (1988). For plans in existence on January 1, 1974, the period of amortization is 40 years. *Id.* § 412(b)(2)(B)(i).

26. *Id.* § 412(b)(2)(B)(iv).

27. *Id.* § 412(c) (1988 & Supp. IV 1992). I.R.C. §§ 412(c)(6) and 404(a)(1)(A) set the minimum funding standard and the maximum deduction an employer may receive for contributions, respectively.

28. *See infra* note 39 (describing the *Studebaker* case).

occasionally funded under "pay as you go" arrangements. Under these methods, retirement benefits were treated as payroll costs and were paid directly to plan participants by the employer.[29] The employer annually calculated the cost of retirement benefits and funded the benefits in full as each participant reached retirement age.[30] To the extent that the benefits were reasonable in amount, they were deductible from the employer's gross income as an ordinary and necessary business expense and were taxable to the recipient as ordinary income upon receipt.[31] While these plans did not seek the preferential tax treatment afforded to qualified plans,[32] they, nevertheless, created concern about the adequacy of their funding. Accordingly, Title I[33] imposed funding requirements on most employer sponsored plans, qualified as well as non-qualified.[34]

Prior to ERISA, qualified plans had additional funding requirements, although not explicitly set forth in the Internal Revenue Code. As early as 1946, the Internal Revenue Service issued a ruling stating that any time a plan had liabilities greater than those which existed at the time the plan was established, the Service

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29. *See* Donald S. Grubbs, Jr., *Funding*, *in* PENSION AND PROFIT-SHARING PLANS, SERIES D, FOLIO 1, at 1, 7 (David C. Rothman ed., 1978) (discussing pay as you go funding arrangements).

30. The employer's cash outlay under "pay as you go" methods was usually low during the early years of the plan because the number of retired employees was relatively small and no provisions were made to fund the accruing benefits of those employees who were continuing in service. However, as the employee group aged, the number of retirees constantly increased until eventually retirement benefits were a significant percentage of payroll costs. As a result, the annual outlay, expressed as a percentage of payroll, reached a very high level.

31. *See* MCGILL & GRUBBS, *supra* note 19, at 450-51 (discussing how the exemption from federal income tax of investment income from qualified plans influences the management of plan assets).

32. *See* Halperin, *supra* note 6, at 541-42 (discussing methods that nonqualified plan sponsors use to achieve the benefit of exemption despite not being afforded preferential tax treatment under the Internal Revenue Code).

33. *See supra* notes 2 and 3.

34. "Top-hat" plans and other non-qualified plans are generally exempt from most of the ERISA requirements. A "top-hat" plan is "unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 148-49 (1990) (quoting ERISA § 201(2)). While these types of plans are not subject to the Internal Revenue Code limitations on qualified plans, they are ostensibly subject to the requirements of ERISA. They are excepted from the participation, vesting, funding, fiduciary responsibility, and plan termination insurance provisions of ERISA; however, they are not exempt from the reporting and disclosure requirements of Title I of ERISA. 29 U.S.C. §§ 1051(2), 1081(3), 1101(a)(1) (1988 & Supp. IV 1992) and I.R.C. § 501 (1988 & Supp. IV 1992).

might treat the plan as if it had terminated. This meant that all of the accrued benefits of plan participants would immediately vest. Thus, the employer became obligated to pay benefits to employees who had not remained in employment long enough to obtain nonforfeitable benefits under the plan's regular vesting schedule.[35] Therefore, to avoid higher costs, employers were forced to make annual contributions which covered the plan's current cost and interest on the unfunded past service liability.[36] As a consequence, the requirement that a plan be deemed to have terminated in the absence of regular contributions effectively created a minimum funding limitation.[37] Even so, the pre-ERISA funding laws and practices created a climate of uncertainty and instability for pension benefits.[38] Inadequate funding regulations resulted in benefits which often proved to be totally illusory when employers did not comply with existing funding requirements and partially illusory when they did comply.[39]

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35. In 1946, the IRS issued a ruling that stated that, in order to avoid being considered terminated, a plan was required to make contributions large enough and often enough to avoid having liabilities greater than when the plan was first established. As a result, the plan's liabilities would never increase. Contributions large enough to cover the normal cost and the interest on the unfunded past service liability generally met this requirement. A plan has a past service cost when the employer elects to give credit for service before the establishment of the plan. Past service cost is the present value of benefits attributable to past service. In other words, it is the amount needed today to provide the portion of the benefit attributable to past service payable at retirement. The present value of past service cost increases as benefits become closer to payment status. Thus, when a plan is not adequately funded, the plan's assets will not grow at a rate sufficient to prevent the past service liability from increasing. Therefore, to prevent the past service cost from increasing, the employer must contribute a sum equal to the interest that would have been earned if there had been sufficient assets. Prior to ERISA, it was only necessary for the employer to contribute the interest on the unpaid portion of the unfunded past service liability plus the plans current expenses referred to as the "normal cost." Accordingly, the plan's liabilities could not increase unless the plan was amended. *See* PENSION AND PROFIT SHARING 2d, PRE-ERISA REGULATIONS AND RULINGS, ¶69, 556, at 69, 504 (Maxwell MacMillan 1991) (citing P.S. No. 57 which was later modified, and finally declared obsolete by Rev. Rul. 70-278).

36. Current cost is synonymous with normal cost. *See supra* text accompanying notes 20-21.

37. The regulations also addressed certain funding concepts as a means of determining whether a complete discontinuance of contributions occurred for purposes of requiring vesting. Treas. Reg. § 1.401-6(c) (1963). For an explanation of vesting under ERISA, see BARBARA J. COLEMAN, PRIMER ON ERISA 31-34 (3d ed. 1989) (describing the earning of nonforfeitable rights to pension benefits as the "heart of ERISA").

38. MCGILL & GRUBBS, *supra* note 19, at 48-51.

39. PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 50 (Jan. 1965).

Prior to ERISA, employers could not take unlimited deductions for contributions to the plan, which suggests a concern for overfunding. During periods when the economy rose and tax rates were high, employers could accelerate funding by making excess contributions to their pension plans in order to obtain larger tax deductions.[40] These contributions were often attributed to amounts paid in connection with past service liabilities as opposed to current ones.[41] As a result, pre-ERISA maximum deduction rules limited annual deductions for contributions on account of past service liability to ten percent of total past service liability.

ERISA liberalized this rule to allow the past service liability to be amortized over ten years.[42] The ten year amortization payment represents twelve to fifteen percent of the past service liability, depending on the interest rate. Thus, using ten year amortization, as permitted by ERISA, allows a larger deductible contribution than was allowed under pre-ERISA law.[43]

Another regulatory deficiency which existed prior to ERISA, although not addressed until 1986, was the absence of legislation sufficiently deterring plan revocation. With the exception of the statutory requirement that all plan assets be held for the exclusive benefit of plan participants and their beneficiaries, plan terminations were generally not discouraged. Therefore, provided that all plan

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One such case is the Studebaker case. The closing of the Studebaker automobile plant in South Bend, Indiana, in December of 1963 is regarded as an important event leading to the enactment of ERISA. *See* LANGBEIN & WOLK, *supra* note 34, at 53-57. As a result of the plant closing, 5,000 workers were dismissed and 1,800 more eventually lost their jobs. *Id.* at 53. When the plant closed, the company entered into an agreement with the United Automobile Workers (UAW) for the termination of its pension plan. *Id.* at 54. The termination agreement implemented the default priorities contained in the plan. *Id.* It divided the plan participants into three groups and paid their benefits accordingly: (1) 3,600 retirees and active workers who had already reached the plan's normal retirement age of 60 received their full benefits in the form of life annuities, (2) 4,000 employees age 40 to 59 who had at least 10 years of service with the employer received lump sum payments representing about 15 percent of the actuarial value of their accrued benefits, and (3) 2,900 workers who had no vested rights received nothing. *Id.* The Studebaker closing was not litigated. However, the plant closing did give rise to a lawsuit about the continuation of a collectively bargained health program. UAW, Local 5 v. Studebaker Corp., 50 Lab. Cas. (CCH) ¶ 19,307 (N.D. Ind. 1964). This case made policy makers more aware of the inadequacy of existing funding requirements and, as a result, caused them to focus on plan funding and related matters.

40. *See* Treas. Reg. § 1.404(a)-1(b) (1963) (discussing tax deduction for employers who make contributions to pension plans).

41. *See, e.g., supra* note 39 (describing the Studebaker case).

42. I.R.C. § 404(a)(1)(A)(iii) (1988).

43. Grubbs, *supra* note 29, at 21.

liabilities could be satisfied, an employer was free to revoke a trust at any time and recapture the plan's excess assets without penalty.[44]

2. Current Funding Law

In 1974, ERISA brought the issue of funding to the foreground by establishing new minimum standards for pension funding.[45] Congress wanted to encourage the establishment of qualified plans. It also wanted to encourage the advanced funding of these plans in order to better assure that benefits could be provided to plan participants as promised.[46] As a result of these goals, ERISA expanded the scope of requirements for qualified plan deductions and required employers to contribute annually at least the normal cost and the amount necessary to amortize any unfunded liability over periods usually ranging from 15 to 40 years.[47] Prior to

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44. Asset reversions were deterred only to the extent that plans were subject to the exclusive benefit rule. LANGBEIN & WOLK, *supra* note 34, at 517-18 (discussing the exclusive benefit rule and its history). This rule operated to disqualify any plan if it engaged in transactions that benefitted the employer rather than the plan participants. I.R.C. § 404(a)(1)(A)(i) & (c)(1) (1988). Accordingly, an employer could not terminate a plan and recover the assets without first paying for the benefits that participants had accrued to the date of termination. The absence of an excise or penalty tax in the event of a plan termination or reversion suggests that no attempt was made to recover the tax gain attributable to the excess amounts recovered by the employer after the accrued benefit liability had been satisfied. The 10% excise tax (increased to 15% in 1988) enacted in 1986 on asset reversions is one method of recapturing some of the tax benefits for such amounts.

45. I.R.C. § 412 (1988 & Supp. IV 1992).

46. *See* LANGBEIN & WOLK, *supra* note 34, at 226-27 (discussing the change resulting from ERISA which imposed minimum funding requirements where none existed prior to its enactment). Congress also wanted to protect the Pension Benefit Guarantee Corporation (PBGC), the agency established under Title IV of ERISA to function as the insurer of a minimum guaranteed benefit for defined benefit pension plans. As insurer, the PBGC assumes responsibility for the payment of benefits when a plan terminates with insufficient assets. Thus, underfunding puts the PBGC at risk even though the plan sponsor is liable to the PBGC for the amount necessary to pay guaranteed benefits up to the statutory maximum. Originally, the PBGC was even more at risk because employers had an unconditional right to terminate their plans, provided they gave proper notice to the PBGC. Moreover, the employer was not liable to the PBGC for unfunded insured benefits which exceeded 30% of the net worth of the employer at the time of termination. With the enactment of the Single-Employer Pension Plan Amendments Act of 1986 (SEPPA), the employer's ability to terminate plans with unfunded accrued benefits was restricted to distress situations. Furthermore, the Omnibus Budget Reconciliation Act of 1987 eliminated the 30% limit on the employer's liability. As a result of these laws, the minimum funding requirements have less importance today for PBGC protection than they did prior to 1986. For a detailed explanation of PBGC liability, see MCGILL & GRUBBS, *supra* note 19, at 583-85.

47. Amortization periods have been liberalized, allowing for contributions up to the

ERISA, employers had been required to make contributions sufficient to cover the plan's normal cost and the interest on the plan's initial actuarial liability.[48] There had been no requirement to amortize the unfunded liability.[49]

Section 412 of the Internal Revenue Code provides the statutory guidelines for pension funding.[50] Plan costs under section 412 are determined through an actuarial valuation.[51] The valuation process uses an actuarial cost method to estimate plan cost and to assign those costs to appropriate plan years.[52] In order to produce such estimates, the actuary must make assumptions about the future experience of the plan including the rate of investment return on plan assets, the mortality of plan participants and their beneficiaries, turnovers resulting in forfeitures of nonvested benefits, salary increases, the retirement ages of plan participants, and the selection of optional forms of benefit offered by the plan.[53]

In an effort to minimize the disparity between projected cost estimates and actual plan experience, Congress imposed the requirement that plan assumptions be reasonable.[54] In other words, it is necessary for the assumptions to reasonably reflect the plan's historical performance or, if the plan is newly established, reasonably predict its future experience.[55] Therefore, the actuarial estimates upon which a plan's funding is based must achieve a certain level of accuracy when compared with actual plan experience.[56] Notwithstanding this requirement, actuarial assumptions can produce only cost estimates, not actual costs. The actual cost of a plan is the sum of benefit payments made to participants and their beneficiaries, plus plan expenses, minus investment income on plan as-

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sum of the normal cost plus a level payment of unfunded liability amortized over shorter periods of time, but not less than 10 years in any event. *See* I.R.C. § 404(a)(1)(A)(iii) (1988).

48. *See supra* notes 35-37 and accompanying text.

49. *See supra* note 35.

50. *See* I.R.C. § 412 (1988 & Supp. IV 1992).

51. *See id.* § 412(b).

52. *See id.*

53. LANGBEIN & WOLK, *supra* note 34, at 228.

54. I.R.C. § 412(c)(3) (1988).

55. *See* I.R.C. § 412(c)(3)(B) (1988) (requiring that the assumptions offer the actuary's best estimate of anticipated experience under the plan).

56. Prior to the Pension Protection Act of 1987 (PPA), individual actuarial assumptions were required to be reasonable in the aggregate. LANGBEIN & WOLK, *supra* note 34, at 228. PPA amended ERISA to require that each actuarial assumption be individually reasonable. Pension Protection Act of 1987, Pub. L. No. 100-203, § 9307(b)(1), 101 Stat. 1330 (1987) (codified as I.R.C. § 412(c)(3) (1988)).

sets. Therefore, it is unlikely that a plan will ever have assets equal to the amount needed to provide the benefits actually accrued under the plan.[57] Consequently, a plan at any given time will probably have too many or too few assets.

Congress furthered the adequate funding of pensions with sanctions for any unsatisfied funding requirements. The sanctions under ERISA[58] reflect the perceived importance of deterring underfunding as compared to overfunding: an underfunded plan is subject to the imposition of a very high excise tax[59] while, generally, an overfunded plan faces only the loss of a deduction for the excess amount.[60] Under Title II of ERISA, the excise tax on a funding deficiency is initially 5% of the deficiency.[61] If it is not corrected within 90 days after the employer receives notice of the deficiency, there is an additional 100% tax.[62] These taxes, which effectively mandate adequate funding, are imposed as excise taxes and, as a result, the employer is not permitted to deduct such amounts for income tax purposes.[63]

Notwithstanding the fact that ensuring adequate contributions was the primary focus of ERISA, it retained the pre-ERISA policy of limiting excess contributions.[64] Accordingly, Congress continued

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57. *See* EDWARD T. VEAL & EDWARD R. MACKIEWICZ, PENSION PLAN TERMINATIONS § 12.1 (1989) (asserting that incorrect actuarial assumptions and the permissible actuarial methods cause this result).

58. I.R.C. §§ 4971(b) (applying an additional tax to underfunded programs), 4961 (providing an abatement of additional taxes after a correction is made), & 4963(e) (defining the correction period) (1988).

59. I.R.C. § 4971(b) (1988). The qualified status of a plan is generally not affected by a failure to meet the funding requirements. LANGBEIN & WOLK, *supra* note 34, at 138. However, if the plan's failure to meet the funding requirement constitutes a discontinuance of contributions then the plan will be considered terminated. In addition, the Department of Labor, the plan participants, and its fiduciaries may initiate a civil action to compel the employer to comply with the funding requirements. ERISA § 502(a)(3), 29 U.S.C. § 1132(a)(3) (1988).

60. *See* I.R.C. § 404(a)(1)(A) (1988) (providing for a limitation on deductions); Tax Reform Act of 1986, § 1131(c), 100 Stat. 2085, 2477-78 (adding § 4972 with its increased penalties). Under current law, effective January 1, 1987, if annual contributions exceed deductible amounts, an employer not only faces the loss of a deduction but the imposition of a 10% excise tax as well. I.R.C. § 4972(a) (1988). Some provision is made for carry-overs which allow for subsequent deductions. I.R.C. § 404(a)(1)(E) (1988). However, because the recently imposed excise tax on nondeductible contributions remains effective for as long as the plan is overfunded, the excise tax would seem to render carry-overs impractical. *See infra* part III.(B).

61. ERISA, § 1013(b), I.R.C. § 4971(a) (1988).

62. I.R.C. § 4971(b) (1988). The 100% tax can be waived by the IRS "in appropriate cases." *See* ERISA § 3002(b), 29 U.S.C. § 1202(b) (1988).

63. I.R.C. § 275(a)(6) (1988).

64. *See* ERISA, Pub. L. No. 93-406, § 1013(c), 88 Stat. 829, 921-24 (1974) (codified

to limit how much an employer could contribute to a plan as a deductible contribution in a given year. The rationale for the limitation was that excess contributions did not constitute ordinary and necessary business expenses and were more likely prepayments for future years rather than present accruals.[65] Additionally, the regulations expressed concern that excess contributions could revert to the employer on termination.[66] Therefore, only amounts which fell within the permissible limits were deductible. The rule which overrides other rules of deductibility, provides that the tax deduction for a particular year cannot exceed the amount needed to bring the plan to a fully funded status. That is, no deduction can be taken for contributions that would raise the plan assets to a level above the actuarial value of the plan's liabilities.[67]

The Omnibus Budget Reconciliation Act (OBRA), enacted in 1987, placed even greater restrictions on accelerated or overfunding.[68] OBRA made significant changes to the existing full funding limitation, which was based on the excess of a plan's assets over its accrued liability, taking expected benefits into account.[69] It introduced the concept of "current liability" in order to further reduce the extent to which an employer is permitted to fund a defined benefit plan.[70] Under the current liability concept, contribution levels are limited by treating the plan as if it terminated.[71] In other words, the plan's obligations at a given time are determined without regard to projections of future salary increases. The current liability concept limits contributions to amounts necessary to increase plan assets to equal the lesser of accrued liability or 150% of current liability, regardless of the funding method

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as amended I.R.C. § 404).

65. *See* Rev. Rul. 64-159, 1964-1 C.B. 163 (ruling that excess payments are not deductible because they are not for services actually rendered); *see also supra* text accompanying notes 18-19 (discussing the difference between using accrued benefits or projected benefits to estimate costs); *infra* text accompanying note 86 (discussing the use of a benefit plan as a savings account).

66. *See* Treas. Reg. § 1.401-2(b) (as amended in 1981) (defining when excess contributions may revert to the employer).

67. *See* I.R.C. § 404(a)(1)(A) (1988).

68. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-57 (1987) (codified as amended in scattered sections of the U.S.C.).

69. *See* ERISA, Pub. L. No. 93-409, § 1013(c), 88 Stat. 921-24 (1974) (codified as amended at 26 U.S.C. § 404(a)(1) (1988)) (defining overfunding limitation).

70. *See* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9303, 101 Stat. at 1330-33 to 1330-34 (codified as amended at 26 U.S.C. § 412(*l*) (1988) (defining current liability and limiting deductible contributions to that amount).

71. *See* I.R.C. § 412(*l*) (1988 & Supp. IV 1992) (describing current liability rules).

used.[72] Until the enactment of OBRA, it was believed that some employers were able to make excessively large contributions by projecting enormous benefit costs.

Current liability also prohibits funding particular benefits and events.[73] OBRA specifically provides that an employer may not consider benefits conditioned upon unpredictable events as benefits promised under the plan for deduction purposes.[74] Thus, for purposes of calculating current liability, all contingent unpredictable liability, such as the likelihood of a plant shutting down or of employing a large number of new hires in the future, is excluded from funding allowances while more reliable and predictable events such as normal retirement and early retirement, are permitted.[75] The concept of current liability operates as a termination liability assessment and is in fact referred to in the Act's legislative history as "termination liability."[76]

OBRA also imposed additional restrictions on the interest rate assumptions that an actuary may use in computing a plan's current liability.[77] This was done in response to increasing concern over the use of very low interest rate assumptions in conjunction with tax avoidance schemes. Designed to maximize the tax deductibility of employer contributions, reliance on low interest rates allowed some employers to abuse the tax advantages afforded qualified plans. Therefore, as of December 31, 1987, all costs, liabilities, rates of interest, and other factors under the plan must be determined on the basis of actuarial assumptions which are *individually* reasonable.[78] Prior to this legislation, as noted earlier, actuarial assumptions were required to be reasonable in the aggregate.[79] The individually reasonable requirement gives the actuary less flexibility in choosing plan assumptions. For example, the legislative history suggests that the individually reasonable interest rate requirement effectively creates an "unsafe harbor" for those interest rate assumptions which are not related to the current rates for 30-

72. I.R.C. § 412(c)(7)(A) (1988).
73. *See infra* notes 77-79 and accompanying text.
74. I.R.C. §§ 412(c)(7)(B), (*l*)(7)(B) (1988).
75. I.R.C. § 412(*l*)(7)(B) (1988).
76. H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 843 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1245, 2313-1589-90.
77. *See* I.R.C. § 412(c)(3) (1988).
78. *See supra* note 56 (discussing the requirement of reasonableness).
79. *See supra* note 56.

year government securities.[80] Thus, once again, policy makers reacted to remedy a situation that they believed permitted deductions for amounts not attributable to the plan year, thereby creating large surpluses which could eventually revert to employers on plan termination.

B. The Occurrence of Overfunding

Some policy makers apparently fail to recognize that despite efforts to minimize the difference between actuarial estimates and actual plan experience, plan surpluses are frequently an unavoidable consequence of actuarial science rather than a deliberate scheme for tax avoidance. As a result, pension law, as it relates to accelerated funding, reflects the suspicion that all excesses are inherently sinister and inseparable from the controversy over asset reversion.[81]

However, all accelerated funding is not necessarily motivated by an employer's desire to temporarily take advantage of a tax exemption with an eye toward future recovery. Conservative interest rate assumptions are often used in an attempt to ensure that adequate funds are available in the event of an early distribution on account of death or disability.[82] The sponsor of a smaller plan is more likely to be concerned about this aspect of funding because an early distribution would have a greater effect on it than on a larger plan.[83] Accordingly, legitimate overfunding may occur when a small employer intentionally uses conservative interest rate assumptions in anticipation of early distributions.[84]

This was the position taken by a small employer in *Jerome Mirza & Associates v. United States* where conservative interest rates were allegedly used in order to avoid a shortfall in the event of early distribution or poor investment performance.[85] The Internal Revenue Service took the position that the use of the 5% interest rate assumption was unreasonably low.[86] In view of the fact

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80. *See* H.R. CONF. REP. NO. 495, 846, *reprinted in* 1987 U.S.C.C.A.N. at 2313-1592.

81. *See* VEAL & MACKIEWICZ, *supra* note 57, § 12.1.2, at 207-08 (1989) (discussing plan terminations generally and more specifically, reversions to the employer).

82. *See infra* notes 85-88 and accompanying text.

83. *See* STEVEN T. ITELSON, SELECTION OF INTEREST ASSUMPTIONS FOR PENSION PLAN VALUATION 2 (1991) (Society of Actuaries No. 460-23-91).

84. *See* discussion *infra* part III (discussing overfunding in general).

85. In Jerome Mirza & Assoc. v. United States, 692 F. Supp. 918 (D. Ill. 1988), *aff'd,* 882 F.2d 229 (7th Cir. 1989), *cert. denied,* 495 U.S. 929 (1990), the plan used a 5% rate, permitting larger deductions. The Service successfully challenged the use of the 5% rate and imposed a less conservative rate of 8% in light of the fact that the plan's assets were invested in certificates of deposit yielding at least 11%. *Id.* at 923.

86. *See id.* at 920. The taxpayer argued that in order to ensure that the plan would

that Mr. Mirza was one of two participants in the plan, concern about an early distribution appears legitimate, however.[87] Moreover, the volatile investment climate which existed in the 1980's could have also contributed to the employer's assessment of the riskiness of less conservative assumptions. To illustrate, if the *Mirza* plan assumed an interest rate of 8% and a retirement age of 65 and actually had an investment yield of 5% and one of the participants died at age 55, the plan would not have enough money to pay the death benefit. Consequently, it would be forced to terminate. While death at 55 is unlikely, it is nevertheless not unreasonable to fund for premature death in small plans where a mortality assumption is meaningless.[88] Therefore, accelerated funding in this situation appears to be the lesser of the two evils: too many assets versus too few assets.

In addition to the interest rate assumption and the number of plan participants, the composition of the work force can also contribute to the existence of excess plan assets.[89] If the work force is growing and young, contributions will build up more rapidly than benefits because retirement benefits are being paid less frequently than contributions are being made. If the group is older the reverse is true. Since the economy has generally been expanding, and the work force has been working longer, and remaining healthier, many defined benefit plans have had favorable plan experience; this is reflected in the greater numbers of better funded or "overfunded" defined benefit plans. In contrast, those sectors of the economy that have been less fortunate, such as the steel industry, have experienced declines in the funded ratios of their pension plans;[90] consequently, they are less able today to meet the increased funding liabilities of their aging population than they were

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have sufficient assets on hand when Mr. Mirza retired 12 years later, his use of a 5% interest rate assumption was reasonable considering the historical investment experience of other plans. *Id.* at 923.

87. For discussion on the appropriateness of small defined benefit plans, see Norman Stein, *Some Policy Implications of the IRS' Small Defined Benefit Plan Audit Program*, 55 TAX NOTES 1407, 1408-09 (1992).

88. *See* MCGILL & GRUBBS, *supra* note 19, at 365-66 (discussing the valuation of small plans).

89. *See* LANGBEIN & WOLK, *supra* note 34, at 228 (discussing the impact of work force composition on plan valuation).

90. *See* PENSION BENEFIT GUARANTY CORPORATION, PROMISES AT RISK: REPORT AND RECOMMENDATIONS ON SINGLE-EMPLOYEE TERMINATION INSURANCE PREMIUMS 36 (1987) (explaining the involuntary termination of LTV's Republic Steel pension plan due to its failure to meet funding requirements).

in the past. Considering the goal of the preferential tax treatment of pension plans, it would be far better policy to permit plans to accelerate funding during thriving times than to defer these greater percentages of funding to future years when money may or may not be available.[91]

Therefore, before reaching the conclusion that accelerated funding undermines pension policy, it is necessary to identify the motivations for overfunding. In some situations overfunding is a reasonable response to legitimate security concerns.[92] In other circumstances it is an unavoidable result of the principles of actuarial science.[93] In any case, neither a preoccupation with the inexactness of actuarial science nor the possibility of asset reversions should be allowed to taint the perception of advanced funding methods or minimize the financial security these methods can provide.[94]

C. The Occurrence of Asset Reversions on Termination

Notwithstanding the intense debate over the subject of asset reversion, the actual incidence of asset recovery is relatively small.[95] Reports by the Pension Benefit Guaranty Corporation (PBGC) show that in 1985, when asset reversions peaked, employers recovered only $6 billion of a total of approximately $14 billion potentially recoverable assets.[96] Since that time, the occurrence of reversions has steadily declined.[97] In 1987, there were only 270 terminations with asset reversions in excess of 1 million dollars as compared to 582 terminations in 1985.[98]

Seemingly, there is also a misconception about the relationship

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91. The current liability concept, as distinguished from accrued liability, limits the employer's ability to fund for expected cost of living adjustments (COLA's) and increases in benefit limitations. This funding limitation shifts a greater portion of funding to a later time. *See* I.R.C. § 412(c)(7) (1988) (defining current liability to exclude unpredictable, contingent events).

92. *See supra* notes 82-84 and accompanying text.

93. *See supra* notes 53 and 81 and accompanying text.

94. *See infra* part III (discussing overfunding in general).

95. *See* LANGBEIN & WOLK, *supra* note 34, at 649 (citing statistics on plan terminations).

96. PENSION BENEFIT GUARANTY CORPORATION, ANNUAL REPORT TO THE CONGRESS, FISCAL YEAR 1988, at 10 [hereinafter PBGC ANNUAL REPORT]. For terminations by plan years, see also OFFICE OF PENSION & WELFARE BENEFITS PROGRAM, U.S. DEP'T OF LABOR, THE HANDBOOK OF PENSION STATISTICS 1985, at 311 (Richard A. Ippolito & Walter Kolodrubetz, eds., 1986) [hereinafter PENSION STATISTICS].

97. PBGC ANNUAL REPORT, *supra* note 96, at 10.

98. EBRI ISSUE BRIEF, *supra* note 14, at 10.

between overfunding and voluntary terminations. Of the 5% to 10% PBGC-insured defined benefit plans that annually terminate, apparently only a small number of employers terminate their overfunded defined benefit plans in order to recover the excess assets.[99] Many more terminations result from mergers and acquisitions where the acquiring company seeks to simplify its benefit structure by having one retirement plan.[100] Other plan terminations occur in response to changes in the employees' preferences; termination permits the employer to establish a different type of plan more suited to the employees' choice.[101] Financial hardship is also responsible for many terminations.[102]

These facts and figures suggest that the availability of recoverable assets is not a strong temptation for employers to terminate their pension plans and that, more often than not, terminations occur as a result of ordinary business concerns rather than the employer's desire to recover the excess assets. Consequently, the concepts of overfunding and reversions are separate and distinct and should be viewed as such. The conclusion that all excess assets will inevitably revert to the employer on plan termination fails to acknowledge that plan termination is not directly linked to overfunding and that motives for accelerating funding are varied.[103] Premised on the recognition that overfunding and asset reversion are not necessarily related, the next section of this Article explores alternative approaches to the reversion problem, all of which shift the emphasis from the funding of ongoing plans to the recovery of tax gains on plan termination.

II. RESTRICTING ASSET RECOVERY WITHOUT DISCOURAGING ACCELERATED FUNDING

As discussed in the first part of this Article, accelerated funding is considered harmful because it is believed to create an incentive for employers to terminate their pension plans in order to recapture surplus assets. Plan participants may have accepted lower wages and saved less in reliance on their expected retirement bene-

99. *See* MCGILL & GRUBBS, *supra* note 19, at 5-8.

100. VEAL & MACKIEWICZ, *supra* note 57, § 1.3.1.

101. *Id.* § 1.3.4 (describing the increased desires of employees for the termination of plans and for more individual choice).

102. *Id.* § 1.3.2.

103. *See infra* part II (discussing how to restrict asset recovery without discouraging accelerated funding).

fits, so that plan termination arguably leaves employees worse off than had there been no plan at all or had the plan been less generously funded.[104] Moreover, the recovery of excess plan assets enables the employer to enjoy accelerated deductions and obtain tax-subsidized gains attributable to the tax-free build-up of investment earnings over the life of the plan.[105] For these reasons, some policymakers view asset reversions as inconsistent with public policy and accordingly believe that they should be prohibited, discouraged, or at least more closely regulated.[106] Other policymakers see asset reversions as a necessary condition of pension planning.[107] The latter group contends that severe restrictions on or prohibitions against asset reversions may discourage employers from establishing and maintaining defined benefit plans.[108]

The pension law has responded to the concerns of these opposing views by permitting reversions but imposing excise taxes on recovered amounts.[109] Policymakers recently sought to further reduce the incidence of reversions by discouraging the accumulation of excess contributions in ongoing plans by imposing an additional excise tax on nondeductible contributions.[110] The combination of these tactics has substantially curbed the number of asset reversions.[111] Despite the effectiveness of these measures, this approach fails to utilize the most direct method of regulating asset reversions, since it not only reduces the incidence of asset recovery but also that of accelerated funding as well.[112] Part II of this Ar-

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104. *See* Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century, in* SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 188-89 (Jack L. VanDerhei ed., 1987).

105. *See* discussion *infra* part III (discussing reasons for overfunding, including tax benefits).

106. *See, e.g., Hearings, supra* note 9, at 20 (statement of Senator Metzenbaum).

107. *See id.* at 118 (statement of David M. Walker, Aging Executive Director, PBGC).

108. *See id.*

109. ERISA, § 4044(d)(1), 29 U.S.C. § 1344(d)(1) (1988), provides for distributing to the employer residual assets once all liabilities of the plan have been satisfied. I.R.C. § 4980 was enacted in 1986 and provided for a 10% excise tax on reversions. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1132, 100 Stat. 2085, 2478-79. In 1988, it was amended to increase the tax to 15%. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6069, 102 Stat. 3342, 3702. The Revenue Act of 1990 amended I.R.C. § 4980(a) to increase the excise tax on reversions to 20% in general, and to 50% if no replacement plan exists. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 12001-02, 104 Stat. 1388, 1388-562 (1987).

110. *See* I.R.C. § 4972(a) (1988); *see also supra* notes 59, 96-97 and accompanying text (discussing the new excise tax and the decrease in reversions and terminations).

111. *See supra* notes 96-97 and accompanying text (citing statistics of reduced reversions).

112. *See* discussion *infra* part II.B for a discussion of more direct methods of asset

ticle addresses the question of whether asset reversions can be prevented or deterred by methods which do not preclude accelerated funding.

A. *Reversion Requirements*

While proposals have been made to allow withdrawals of surplus assets from ongoing plans,[113] plan termination is presently a prerequisite for the recovery of surplus assets.[114] This makes it possible to regulate asset recovery on plan termination. Such an approach appropriately shifts the emphasis from overfunding to recapturing tax gains associated with recovered amounts. Prior to exploring possible alternatives to current reversion law, however, it is necessary to review the controversy surrounding the concept of asset reversions in order to better understand why the subject commands so much attention from policymakers. Even today, with forceful deterrents to overfunding and asset reversion in place, the subject continues to be highly controversial.[115]

Employers are permitted to recover excess assets only when the plan document explicitly provides for reversions and the reversions do not violate any provision of the law.[116] Additionally, for tax qualification under Internal Revenue Code section 401(a), plans are required to provide that in the event of plan termination the accrued benefits of all affected employees must be nonforfeitable to the extent that they are funded at the date of termination.[117] For example, if an employee is only 20% vested in her accrued benefit, she would normally be entitled to only 20% of her accrued benefit;

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recovery.

113. *See* Jeannie L. Pilant & James T. Tilton, *The Pension Reversion Controversy and the 'Buck Letter': Another Round*, 26 TAX NOTES 1147 (1985) (arguing in favor of the Buck Letter which was an advisory letter from the IRS concluding that surplus assets from defined benefit plan would be transferred to a profit sharing plan). The Buck Letter has been withdrawn by the IRS. VEAL & MACKIEWICZ, *supra* note 57, § 12.7.

114. ERISA, § 403(c)(1), 29 U.S.C. § 1103(c)(1) (Supp. IV 1992). Amounts contributed by mistake can be recovered by an employer within a specified period from an ongoing plan. ERISA, § 403(c)(2)(A), 29 U.S.C. § 1103(c)(2)(A) (1988 & Supp. IV 1992).

115. *See* LANGBEIN & WOLK, *supra* note 34, at 661-64 (discussing competing arguments).

116. 29 U.S.C. § 1344(d)(1) (1988). Even when the employer reserves the right to terminate the plan, the abandonment of a plan within a few years after its establishment is evidence that the plan was never a bona fide program for the exclusive benefit of plan participants and thus, violates the exclusive benefit rule. Treas. Reg. § 1.401-1(b)(2) (as amended in 1976). Therefore, all tax benefits are lost.

117. I.R.C. § 411(d)(3) (1988 & Supp. IV 1992) denies tax qualification under § 401(a) unless a plan provides for 100% vesting of all accrued benefits on plan termination.

however, on plan termination, she becomes entitled to 100% of her accrued benefit.

Notwithstanding these requirements, some pension experts continue to believe that plan participants are adversely affected by plan termination because of the lost opportunity for future accruals under the plan.[118] Further, unlike annual contributions, termination benefits are based on current salaries rather than higher, projected salaries. Consequently, a participant's retirement benefit will generally be less than it would have been had the plan not terminated.[119]

The Select Committee on Aging and the Subcommittee on Labor-Management Relations of the Committee on Education and Labor of the U.S. House of Representatives prepared a 1985 report which described a situation in which a participant's retirement benefit was substantially reduced as a result of plan termination.[120] The report describes how without prior notice the participant's plan filed to terminate and recapture 10 million dollars in excess plan assets. The participant had expected to work until age 65, at which time he would have received a pension benefit of $800 dollars a month for life. However, on plan termination his accruals ceased, and the benefit was cashed out at $35,000, the actuarial equivalent of a $300 a month life annuity, payable at age 65. Thus, the employee at age 65 will receive $6,000 a year less in retirement income than he would have had the plan continued.[121] To approximate this result, assume that the benefit formula for the plan was 2.5% times years of service times average compensation for the highest three years. Also assume that the employee commenced employment at age 48 with a starting salary of $10,000, that the participant's salary increased at 5% per year, and that the plan terminated 10 years later. Thus, on plan termination, the participant's salary was $16,300, and the accrued benefit under the plan was $3,882 per year, or approximately $324 per month payable at age 65. Had the plan not terminated, however, the accrued benefit at age 65 would have been $9,285, or approximately $774 per month payable at age 65.[122] Thus, there is a

118. *See, e.g.*, Richard A. Ippolito, *Issues Surrounding Pension Terminations for Reversion*, 5 AM. J. TAX POL'Y 81, 83-87 (1986) (arguing that the termination of a plan can harm workers).

119. *See* Halperin, *supra* note 104, at 188-90.

120. *See Hearings*, *supra* note 9, at 26.

121. *See id.* at 39.

122. Assuming a 5% salary scale increase, an employee earning $10,000 would earn

benefit loss of $450 per month or $5,400 per year.

The disparity represents the difference in the benefit accrual for ten years of service at the higher projected salary of $21,846 and the benefit accrual for ten years at the lower salary of $15,526 and shows how much of the benefit reduction is attributable to the loss of future salary increases. Therefore, the participant will receive $1,518 per year, or $150 per month, less because the projected salary increases will not occur after the plan terminates. Similarly, comparing the benefit accrual for seventeen years using the projected salary of $21,846 to the benefit accrual using the same salary at ten years shows how much of the benefit reduction is attributable to the loss of future years of service. The retirement benefit is $3,823 per year, or $319 per month,[123] less because the participants credited service will never be greater than ten years after the plan terminates.[124]

Because the difference can be so substantial, policymakers opposed to permitting excess assets to revert to the employer on plan termination view reversions as bad public policy and find the practice inconsistent with pension policy and the specific goals of ERISA. These critics bolster their position by asserting that the participants have bargained for and relied upon their retirement benefits in various ways.[125]

Participants' rights advocates further argue that employee benefits represent a substantial part of compensation. Since employees have accepted lower wages in exchange for their pension bene-

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$16,300 after 10 years (1.05 to the tenth power times $10,000). Averaging compensation from the eighth (1.05 to the eighth x $10,000 = $14,775), the ninth (1.05 to the ninth power x $10,000 = $15,513), and the tenth year (1.05 to the tenth power x $10,000 = $16,289), a benefit accrual formula of 2.5% x years of service times average compensation for the highest three years would be $15,526 and produce an accrued benefit of $3,882 per year or approximately $324 per month (.025 x 10 x $15,526 = $3,882). Had the plan not terminated, the participant's accrued benefit would have been based on 17 years of service (65 - 48 = 17). The average compensation from the highest three years would have been $21,846 ($20,789 + $21,829 + $22,920 divided by 3). The accrued benefit would have been based on compensation from year fifteen, sixteen, and seventeen producing $9,285 per year or $774 per month (.025 x 17 x $21,846 = $9,285).

123. The difference between $9285 (.025 x 17 x 21,846) and $5462 (.025 x 10 x 21, 846) per year and between $774 (9285 [divided by] 12) and $455 (5462 [divided by] 12) per month.

124. These two components total a $5,403 differential. Rounding accounts for the discrepancy in this figure and the approximate $6,000 annual reduction referred to on the previous pages of this discussion.

125. *See* Ippolito, *supra* note 118, at 83-87.

fits.[126] Accordingly, these advocates believe that the participants are entitled to the surplus assets on plan termination, at least to the extent that the participants have funded the excess assets with reduced wages.[127]

There are various theories which explain how lowered wages fund the cost of plan benefits.[128] One view is that plan participants have given up wages equal to the value of the benefits which they accrue each year.[129] Thus, the participants' annual wages are implicitly reduced by the present value of each year's pension accrual.[130] To illustrate, assume that a plan provides a normal retirement benefit of $10 per month per year of service payable at age 65.[131] At the end of one year, an employee who is 30 years old would have earned a pension benefit of $10 per month, payable at age 65. Assume also that this benefit has a present value of $80. The participant's current salary under this theory would have been reduced by $80 in the first year for the first year's pension accrual.[132]

Other theorists explain that the reduction in participant wages equals the level payment needed to fund the *projected* benefit.[133] Under this view, current wages are reduced by the level amount necessary to fund the amortization of the participant's expected benefit. For example, in the illustration above, the participant's projected monthly benefit based upon 35 years of service is $350, and the first year's amortization of this benefit is about $315. As a result, the employee's wages would have been reduced by $315 annually.[134] Consequently, after one year, on plan termination the employee should be entitled to a benefit[135] almost four times greater than the $10 per month benefit accrued under the plan.[136]

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126. *See id.* at 97-98.

127. *Id.* at 105, 109 (stating that if plan termination is the breaking of an implied contract between the firm and workers, arguably the reversion belongs to the workers and a legal mechanism should be created so plans can be made irrevocable trusts).

128. *See* VEAL & MACKIEWICZ, *supra* note 57, § 12.1.1, at 204-05 (summarizing several theories of how lowered wages fund benefit plans).

129. *Id.* at 205.

130. Under this theory, wage reductions would increase as employees grew older.

131. This example is taken from VEAL & MACKIEWICZ, *supra* note 57, § 12.1.1, at 204.

132. *Id.* at 205.

133. *Id.*

134. *Id.*

135. The employee would be entitled to $315 adjusted for one year's interest.

136. *See generally* RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY (1986) (comparing the benefits an employee expects from a pension plan to the benefit he

Another reason some see asset reversion as bad pension policy is that not only are wages driven down in exchange for the pension plan, but personal savings suffer from reliance on the expected benefits. Plan participants rely on the permanence of the plan, the financial security of the plan, and the promised benefits of the plan. As a result, their savings are not as much as they would have been without the expectation that the plan would provide for them in their retirement.[137] Thus, on plan termination employees do not get the retirement benefits for which they have paid, nor the ones upon which they have reasonably relied.

Plan termination causes less damage when an employer establishes a new plan, called a replacement plan, that covers the same participants.[138] However, the participants may still suffer because, if there is a reversion, the newly established plan will have fewer assets. This resolution in assets raises a number of concerns. First, participants could have less protection against bad investments and other financial uncertainties.[139] Second, the replacement plan is more likely to terminate involuntarily due to insufficient plan assets. Finally, the new plan is less likely to grant the ad hoc increases typically[140] given to offset the effects of inflation.[141]

In situations where the replacement plan is a defined contribution plan rather than another defined benefit plan,[142] older employees may suffer an even greater loss. While having defined contribution plan coverage over one's working life can be as good

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will receive if the plan terminates).

137. *Id.* at 10-11 (stating that workers do replace a part of their savings outside a pension with pension savings).

138. For a description of replacement plans, see MCGILL & GRUBBS, *supra* note 19, at 580 (discussing "Reestablishment Terminations").

139. The replacement plan would, of course, still have to satisfy the minimum funding standard and the prohibition against the reduction of accrued benefits to qualify for the tax benefits afforded under ERISA. *See supra* text accompanying notes 3-6 (summarizing qualification requirements and tax benefits under ERISA).

140. For detailed discussion of the frequency and rate at which post retirement adjustments are made, see *supra* note 77, 177-79.

141. A few plans have automatic cost of living adjustments in their benefit formulas. The court in Shaw v. International Ass'n of Machinists and Aerospace Workers Pension Plan, 563 F. Supp. 653 (C.D. Cal. 1983), *aff'd*, 750 F.2d 1458 (9th Cir. 1985), concluded that where there is such a provision, the right to future adjustments comprises part of the participant's accrued benefit. *Id.* at 657. Thus, plan participants were entitled to cost of living adjustments. *Id.* at 659. In the absence of such provision, the employer will often voluntarily amend the plan in order to provide the ad hoc increases. However, on plan termination these adjustments are not considered part of the accrued benefit.

142. *See supra* notes 15-16 and accompanying text (explaining the difference between the defined benefit plan and the defined contribution plan).

as having defined benefit plan coverage,[143] having the defined benefit plan early in one's working life and the defined contribution plan later is probably the worst of both worlds. This can be seen by comparing the two types of plans.

A defined benefit plan and a defined contribution plan which anticipate the same investment return and share the same goals of replacing income upon retirement would call for equal contributions[144] spread over the employee's lifetime.[145] On plan termination, however, the plans produce vastly different accrued benefits.[146] In a defined benefit plan, the amount accumulated from expected salary increases and cost of living adjustments is generally not considered part of the accrued benefit and, therefore, would revert to the employer on plan termination.[147] In contrast, in a defined contribution plan, these amounts are part of the account balance and are distributed to the participants. Therefore, on plan termination, most participants in a defined benefit plan would experience a reduction in their expected benefit[148] and would be entitled to a smaller amount than that provided under a defined contribution plan with similar goals for retirement income.[149]

The defined benefit/defined contribution plan combination is undesirable for some plan participants because the benefits of employees closer to retirement in a defined benefit plan have greater funding costs given that there is less time for the contribution to build-up; therefore, the employer must make greater contributions on behalf of older participants. However, in a defined contribution plan, contributions are made to individual accounts and ordinarily reflect a given percentage of compensation regardless of age; therefore, no mechanism exists to make up for the accrued benefits

143. *See* Halperin, *supra* note 104, at 184 (stating that there is a parallel between defined benefit plans and defined contribution plans only if the contribution plan is a "target benefit" plan); MCGILL & GRUBBS, *supra* note 19, at 115-16 (defining target benefit plans); *infra* note 148.

144. *See* Halperin, *supra* note 104, at 184-86.

145. *See infra* notes 152-55 and accompanying text (discussing risk factors associated with each type plan).

146. On plan termination, the accrued benefits in defined benefit plans are based on current salary; in ongoing plans, funding is based on projected salary which includes cost of living adjustments and salary increases. *See supra* notes 95-99 and accompanying text.

147. *See supra* notes 104-08 and accompanying text (describing impact of termination on benefits).

148. *See* Halperin, *supra* note 104, at 185 (describing the disadvantages of defined benefit plans upon termination for longer term employees).

149. Fully accrued retirement benefits would not be affected.

which would have resulted from future accruals under the defined benefit plan. This situation renders a replacement plan of the defined contribution type largely ineffective in its ability to meet the employee's original expectations.[150]

Subject to statutory limitation, defined benefit plans may provide greater accruals for later years of service.[151] This practice, known as backloading, effectively gives older participants larger accruals. For example, a benefit formula may provide 1.75% of compensation for the first 15 years and 2.0% for the remaining years. Thus, in addition to the loss of future accruals and salary increases, the older participant may lose the backloaded portion of her accruals when a defined benefit plan is replaced by a defined contribution plan.

A further reason why older plan participants may experience a greater loss when their defined benefit plan is replaced with a defined contribution plan is the shift in investment risk that accompanies the change in plan type.[152] In a defined contribution plan,

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150. *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 849 (1993) (stating that an individual covered by a defined benefit plan loses pensions benefits by leaving her current employer due to the way pension benefits are calculated under defined benefit plans). Similarly, an employee remaining with an employer who replaces a defined benefit plan with a defined contribution plan would suffer similar results. Romano states that another disadvantage to defined contribution plans is that the employee bears the risk of having insufficient retirement income. *Id.* While not focusing on the perspective of the older worker, Romano concludes that the advantages of defined contribution plans outweigh their disadvantages. *Id.* at 850.

151. I.R.C. § 411(b) provides three alternative methods for determining accrued benefits. I.R.C. § 411(b)(1)-(3) (1988 & Supp. IV 1992). Subsection (1), the 3% rule, provides that at least 3% of the projected retirement benefit must accrue each year; subsection (2), the 133 1/3% rule, provides that no benefit accrual rate may vary more than 133 1/3% from the preceding year's rate, and subsection (3), the fractional rule, provides that the benefit accruing in any one year be prorated with respect to the number of years to normal retirement. *Id.* However, a plan may use any formula for computing accrued benefits as long as the accrued benefit is not less than one of the three methods prescribed in the Code. The purpose of the benefit accrual requirements is to prevent excessive backloading of accrued benefits in defined benefit plans, a practice which can be used to evade vesting requirements.

152. In a defined benefit plan where the assets are pooled in one trust and a fixed benefit is promised to plan participants on retirement, independent of investment performance, it is the employer who bears the investment risk. George B. Swick, *Pension Industry: What Role?*, *in* SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 123, 142-44 (Jack L. VanDerhei ed., 1987) (listing the pros and cons of defined benefit and defined contribution plans from both employee and employer perspectives). For example, if investment performance is less than expected, the employer increases contributions. Thus, the defined benefit plan provides greater security and predictability to the employees. In a defined contribution plan where the employer makes annual contributions into the individ-

the employer sets up individual accounts for each participant and contributes a predetermined amount to each account, usually without regard to age or service.[153] The assets are invested, and at retirement the entire balance of the account is paid to the participant. Thus, it is the employee in the defined contribution arrangement who bears the investment risk. Only younger employees will have sufficient remaining service to hold their investments for longer periods of time enabling them to take advantage of more risky vehicles which historically have better performance over the long run.[154] Their accounts, having more time to absorb market risk, will experience greater investment yield. Older participants, however, are compelled to invest conservatively because they are approaching retirement and cannot afford to choose the riskier, but more lucrative, investment instruments.[155] Therefore, on plan termination, older participants may experience a greater reduction in their defined benefit plan benefit and will enjoy smaller accumulation under the replacement defined contribution plan than younger participants similarly situated.

Despite the various forms of hardship that employees may experience as a result of plan termination, those who advocate permitting reversions view proposed laws in favor of participant's rights as inequitable.[156] They maintain that these laws are unfair to the employer because the employer must make up the difference when plan projections underestimate actual cost but cannot benefit when actuarial estimates exceed actual plan experience.[157] They

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ual accounts of plan participants and the entire balance of the account is distributed to the participant at retirement, it is the employee who bears the investment risk. *Id.* If investment performance falls short in a defined contribution plan, the benefit falls below expectations.

153. The "target-benefit plan" is a type of defined contribution plan that contains a defined benefit formula, but the benefit stated in the formula is merely an assumed benefit. MCGILL & GRUBBS, *supra* note 19, at 115-16 (defining target benefit plans). The amount of the annual contribution is determined by an actuarial factor that varies by age; however, once the amount of the contribution is established, the contribution becomes the important factor and the stated benefit is ignored. Thus, favorable investment performance is still essential in determining the amount of benefits payable under this type of plan. *See id.* at 126.

154. For discussion of the investment characteristics of pension plans, see *id.* at 449-58.

155. Douglas A. Love, *ERISA: The Law Versus Economics*, 25 GA. L. REV. 135, 141 (1990).

156. *See* VEAL & MACKIEWICZ, *supra* note 57, at 202-06 (arguing against critics of reversions on equitable grounds).

157. The employer generally benefits from favorable plan experience in an ongoing defined benefit plan because the minimum contribution requirement for the next plan year

contend that under these conditions, employers will be unwilling to assume the additional risks and administrative burdens of establishing and maintaining defined benefit plans.[158] It is not surprising that these critics view the "wrong" resolution of the reversion controversy as a potential threat to defined benefit pension plans.

Regardless of whether one believes asset reversions undermine the tax incentives designed to encourage employers to maintain pension plans or that asset reversions are the entitlement of employers who assume the additional responsibility of maintaining defined benefit plans, the voluntary nature of establishing private pension plans makes it necessary for policymakers to find a middle ground and enact laws which respond to the concerns of employees and employers alike. Moreover, because it is unlikely that either side will ever persuade the other, policymakers must continue to look for a compromise which not only makes each group happy in the short run, but also promotes good pension policy over the long run.

As noted, prior to 1990, the law permitted reversions of amounts in excess of the funds needed to cover the plan's accrued liabilities, but imposed a 15% excise tax[159] on the recovered amounts. The effectiveness of this compromise depends on the specific goals of policymakers as well as their views on the relative importance of competing interests. In some situations the excise tax on recovered assets was not sufficient to offset the tax advantages associated with recovered amounts,[160] thus, the employer received a windfall on plan termination. In other situations,

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is reduced by the experience gain. *See* MCGILL & GRUBBS, *supra* note 19, at 449 (describing investment characteristics of defined benefit plans). This result occurs only in ongoing defined benefit plans since the employer usually would not make any subsequent contributions to a terminating plan.

158. Defined benefit plans are administratively more difficult to maintain because they rely on actuarial calculations. Although defined benefit plans offer an employer flexibility in the funding of a plan, the employer assumes the investment risk of the plan assets. *See* Swick, *supra* note 152. Additionally, in a defined benefit plan, the employer must pay an annual premium to the Pension Benefit Guaranty Corporation (PBGC). *See* MCGILL & GRUBBS, *supra* note 19, at 124 (detailing advantages and disadvantages of plan approaches).

159. *See supra* notes 109-10 and accompanying text.

160. *See* General Accounting Office, *Pension Plan Terminations: Effectiveness of Excise Tax in Recovering Tax Benefits in Asset Reversions* (July 1990) (Report to the Chairman, Subcomm. on Oversight, House Comm. on Ways and Means) [hereinafter GAO Report] (not addressing policy objectives seeking to prohibit or restrict asset reversions, but examining the effectiveness of the current excise tax and concluding that the excise tax failed to recapture tax benefits from asset reversions).

the excise tax approximated the gain resulting from the tax favorable treatment of the excess in the plan; as a result, the employer was presumably no better or worse off than had the amounts which led to the excess assets never been contributed to the plan. In yet other situations, the excise tax exceeded the tax savings attributable to the recovered assets; consequently, to the extent that an employer could anticipate this possibility, the excise tax served as a deterrent from deliberately overfunding in order to ultimately recover the excess assets on plan termination.

In no situation, however, did the flat 15% excise tax directly provide additional protection for plan participants.[161] Thus, to the extent that participants' rights advocates sought not only to eliminate the employer's windfall but to provide more protection for plan participants, the reversion laws prior to 1990 were insufficient. On the other hand, to the extent that the excise tax deterred employers from recapturing excess plan assets, the employers' rights advocates believed that the recovery restrictions were unfairly imposed on plan sponsors.

B. Alternative Solutions

New legislation aimed at regulating the employer's ability to recover surplus assets on plan termination could more directly address asset recovery without discouraging overfunding.[162] The passage of laws that: (1) limit the recovery of assets to certain amounts or (2) restructure the excise tax on recovered assets to recapture tax gains attributable to those amounts would achieve this goal by making surplus assets less accessible and reversions less attractive on plan termination. The degree to which these proposals

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161. The excise tax on reverted amounts may have deterred some employers from recapturing surplus assets; however, the GAO Report indicates that in most cases the 15% excise tax rate was insufficient to recapture the tax benefits associated with the recovered surplus. GAO Report, *supra* note 160, at 4. It was inadequate as a deterrent for employers who overfunded their plans with the intention of recovering them later on plan termination. Moreover, employers were economically better off after the reversion than had the excess funds never been contributed to the plan.

162. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1131(c)(1), 100 Stat. 2085 (1986). This legislation, which proposes to control reversions by eliminating overfunding, employs an indirect approach to resolving the reversion problem. In response to the continuing reversion controversy, effective January 1, 1987, Congress imposed a new excise tax on surplus amounts in ongoing plans. By decreasing the assets available for recovery, the number of reversions automatically decreased. Under this law, excess contributions are nondeductible and subject to a 10% excise tax for as long as the plan's assets exceed the plan's liabilities.

are applied would indicate whether these solutions were being used to recapture tax gains, to protect the interests of plan participants, or to deter the incidence of asset reversions.

1. Limiting the Amount of Assets Recoverable on Plan Termination

While current law attempts to balance the interests of employers and employees, pre-ERISA laws were less responsive to the employees' interests and overwhelmingly favorable to the employer's interests under state trust laws.[163] In some instances, reversions were allowed even in cases where the plan contained no express language giving the employer the right to excess assets.[164] Some of these cases received Congressional attention with plan participants appearing as witnesses at two pension reform hearings.[165] As a result of this deference to employers, the initial drafts of ERISA contained provisions prohibiting the reversion of plan assets to employers from plans that terminated without government approval.[166] Eventually, however, these provisions were eliminated, and the final drafts explicitly authorized employers who reserved reversion rights in their plan documents to recover the remaining assets.[167] The recovery was subject to the satisfaction of all liabilities and to the limitations outlined in section 4044(d) of the Internal Revenue Code which guaranteed employees a portion of the return on their contributions.[168]

The principal statutory limitation on reversions is currently found in section 401(a)(2) of the Code. This section provides that

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163. VEAL & MACKIEWICZ, *supra* note 57, § 12.2.

164. *See, e.g.*, Lynch v. Dawson Collieries, Inc., 485 S.W.2d 494, 495 (Ky. 1972) (awarding excess to company because express language regarding "erroneous actuarial calculations" simply meant a variance between actual plan experience and its reasonably anticipated experience).

165. During the formative stages of ERISA, a dispute arose between the Elgin Watch Company and its employees regarding title to residual assets and raised new concerns regarding the issue of reversions. The Elgin Watch Company established a defined benefit plan that was jointly funded by both the employer and the employees. In 1958, the company determined that the plan was overfunded and discontinued making its contributions. The employees continued making their contributions until 1973 when the plan terminated with a surplus of 12 million dollars which the employer claimed. Plan participants sued for the right to the excess funds arguing that they, rather than the employer, were entitled to the surplus amounts. *See generally Hearings*, *supra* note 9, at 96-97 (statement of Michael S. Gordon) (describing the background of the Elgin Watch Company dispute).

166. VEAL & MACKIEWICZ, *supra* note 57, § 12.2.

167. *Id.*

168. *Id.*

a reversion of excess assets is prohibited until all liabilities to participants and their beneficiaries are satisfied. Section 1.401-2(b) of the regulations interprets section 401(a)(2) and is based on explicit language from its legislative history It provides that the employer is permitted to recover on plan termination any balance that is due to "erroneous actuarial computation."[169]

The Internal Revenue Service interprets the term "erroneous actuarial computation" very broadly [170] It effectively characterizes all assets in excess of the plan's liabilities as "erroneous actuarial computation." However, it is possible for the Internal Revenue Service to be more restrictive in its interpretation of "erroneous actuarial computation" and find that some excesses are not due to actuarial error. The narrower interpretation would prevent the employer from recovering these excesses on plan termination.

Under the narrower interpretation, erroneous actuarial computation can be described as the difference between actuarial predictions and actual experience. When a plan has favorable plan experience as, for example, higher investment returns or greater nonvested turnover, the actuarial error produces an actuarial gain. Similarly, when a plan has unfavorable experience, the actuarial error produces an actuarial loss. In contrast, excesses that occur as a result of plan termination are distinguishable and are not the result of the difference in actuarial estimates and actual plan experience. These excesses represent the difference in the calculation of ongoing plan liabilities and those at termination.[171] As noted earlier, a plan's ongoing liabilities are based on projected salary in-

169. *See* Norman P. Stein, *Reversions From Pension Plans: History, Policies, and Prospects*, 44 TAX L. REV. 259, 284 (1989) (criticizing pension reversions from the perspective of tax policy issues).

170. *See* Rev. Rul. 83-52, 1983-1 C.B. 87 (determining the amount that may be returned to an employer upon the termination of a defined benefit plan in accordance with the nondiversion requirement of I.R.C. § 401(a)(2)).

171. For example, assume a trust has accumulated assets of $1,500,000 at the time of termination at which time it is determined that $1,450,000 will satisfy all of the liabilities under the plan. Further assume that the surplus of $50,000 arose because non-vested turnover brought about fewer actual forfeitures than expected. This $50,000 is therefore the amount the employer may recover as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as the result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because it is not the result of an erroneous actuarial calculation. *See* Treas. Reg. § 1.401-2(b) (1980). By analogy, excesses which result from the employer's decision to change from a permanent saving arrangement for its employees to a terminated one are thus distinguishable and are not attributable to erroneous actuarial calculation.

creases; liabilities at plan termination are based on current salaries.[172]

The regulations, in fact, suggest that any unintended excess from conservative actuarial predictions is an actuarial error and belongs to the employer on plan termination, whereas any unintended excess that arises on plan termination from the use of projected cost methods is not actuarial error and belongs to the plan participant.[173] This distinction is supported by the fact that the plan's actuary has no discretion to fund for termination. Rather, the underlying basis of an actuarial cost projection is the assumption that the plan is a permanent arrangement and that the plan benefits will never be eliminated or reduced for any reason. The plan's cost is not reduced for the possibility that the plan will prematurely terminate. Wages are reduced in amounts which reflect the permanence of the plan. Therefore, excess assets arising on plan termination result from the employer's miscalculation of the permanence of the plan, not from the actuary's erroneous computation.[174]

The regulations appear to distinguish excesses attributable to favorable plan experience from excesses attributable to the use of projected cost funding methods.[175] However, in a set of 1984 guidelines on asset recoveries, the Internal Revenue Service announced an interpretation of the regulation that effectively rejected the actuarial error limitation. Revenue Ruling 83-52 articulated the position that an employer could recover all plan assets in excess of the value of accrued benefits at the time of termination.[176] The Service, thus, adopted the view that all assets remaining in a plan after all liabilities had been satisfied were to be treated for purposes of the statute as if they occurred due to actuarial error.[177]

At the time, the Service could not have anticipated the potential magnitude of the resulting reversion problem. Perhaps, the administrative ease of this interpretation persuaded the Service to adopt this position, or the Service relied on the argument that

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172. *See supra* notes 118-19 and accompanying text.

173. The regulation explicitly indicates that gains resulting from a change in the benefit structure of the plan or a change in the eligibility requirements could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation. Treas. Reg. § 1.401-2(b)(1) (1980).

174. *See* Stein, *supra* note 169, at 282-84 (describing that surplus assets due to some types of employer action do not result from actuarial error).

175. Treas. Reg. § 1.401-(2)(b)(1) (1980).

176. Rev. Rul. 83-52, 1983-1 C.B. 87.

177. Stein, *supra* note 169, at 282-83.

restricting the employer's ability to recapture excess plan assets could adversely affect the establishment of defined benefit pension plans. Despite the possible rationales, permitting asset reversions on plan termination without regard to the source of the excess assets enabled employers to recover significant amounts of assets that were not the result of erroneous actuarial calculations.[178]

Reversion policy would not be as liberal if the Service enforced the regulation's actuarial error provision. This limitation would prevent employers from recovering excess assets not arising from favorable plan experience. The employer's windfall on plan termination would decrease to the extent that the surplus was not recoverable. Moreover, plan participants would benefit from the non-recoverable portion. For example, it would be possible to require that the non-recoverable portion of surplus assets be used to provide pro rata benefit increases to all plan participants. Thus, retirement benefits would more closely approximate the amount which the participants paid and which they expected to receive.

The actuarial error limitation appears to be a more equitable approach than current reversion policy for two reasons. First, it improves the employees' position on plan termination. The employee no longer loses amounts attributable to projected wage increases and cost of living adjustments. The actuarial error limitation prohibits these amounts from being recovered by the employer and, therefore, increases the accrued benefits of plan participants on plan termination.[179] Second, it reduces the employer's windfall. The employer is still permitted to recapture excess plan assets but only to the extent that they are truly attributable to actuarial error.[180]

An approach that looks to actuarial error is more consistent with the objectives of ERISA than current law because it limits the recovery of excess plan assets without discouraging legitimate accelerated funding, a practice which achieves ERISA's goals of increasing savings and providing greater security for plan participants. Moreover, to the extent that such an approach allows the employer to recover excess assets resulting from actuarial error, it encourages employers to establish and maintain defined benefit plans.

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178. *Id.* at 262.

179. *Id.* at 273-75.

180. Of course, the amount that the employer ultimately recovers is subject to an excise tax to adjust for the tax build-up on the excess amounts. A regular tax cannot accomplish such an adjustment. *See* discussion *infra* text accompanying notes 221-23.

However, enforcement of a true actuarial error limitation on reversions could have its own problems. Limiting employer recovery to the excess amounts attributable to erroneous actuarial error may encourage employers to manipulate their plan assumptions. For example, an employer might use a very low investment yield assumption and a very low salary increase projection. As a result, on plan termination, a greater portion of the surplus assets can be attributed to erroneous actuarial calculation rather than to termination liability. These manipulations enable the employer to recover more of the surplus. Since the interest rate assumption has a greater impact on plan cost than any other assumption, there is room for substantial funding flexibility under such schemes.[181]

In order to compensate for this weakness, this solution requires greater scrutiny of interest rate assumptions on audits conducted by the Internal Revenue Service and stricter standards for the reasonableness of actuarial assumptions.[182] The reasonableness of actuarial assumptions is a contained problem that can more easily be resolved than the far-reaching difficulties presented by current recovery practices.

Admittedly, given all the legislation in this area, it may be difficult, if not impossible, for the Internal Revenue Service to change its interpretation of the statute. A reinterpretation could more effectively be accomplished through Congressional action.

The policy of discouraging terminations by limiting the employer's ability to recover surplus assets on plan termination to amounts caused by actuarial error is but one way to resolve the question of who is properly entitled to the surplus assets. Other proposals regarding asset reversions do not address the asset ownership issue at all and focus entirely on reducing the employer's windfall on plan termination. Such proposals require the use of all or much of the residual assets on plan termination to increase the benefits of plan participants regardless of actuarial error.[183]

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181. *See* STUART G. SCHOENLY, PENSION TOPICS 10-11 (1991) (Society of Actuaries No. 460-24-91).

182. *See supra* note 54 and accompanying text.

183. *See, e.g., Hearings, supra* note 9, at 58 (statement of Donald S. Grubbs, Jr., Consulting Actuary, Buck Consultants, Inc.) (proposing solution that permits employer withdrawal but limits withdrawal amounts to protect secured benefits).

2. Increasing Excise Taxes on Asset Reversions

Discouraging reversions without deterring overfunding can be achieved by increasing the excise tax on all amounts recovered by plan sponsors on plan termination. This can be accomplished by increased fixed rates or adjustable rates.[184] The primary purpose of the excise tax on reversions is to recapture the tax-subsidized gains left unaddressed by a regular income tax. To the extent that the excise tax exceeds the tax benefits, employers will be reluctant to recapture excess plan assets on plan termination. More importantly, they will not likely set out to do so. Thus, unlike the actuarial error limitation, higher excise taxes do not directly limit the employer's ability to recover surplus assets but do so indirectly by making the recovery more costly and less attractive to employers.

The Tax Reform Act (TRA) of 1986 adopted this indirect approach and imposed a flat 10% excise tax, later increased to 15%,[185] on all excess amounts recovered by employers from qualified pension plans.[186] However, in a July, 1990 study, the General Accounting Office (GAO) reported that the 15% rate was not sufficient to recapture the tax benefits associated with amounts recovered on plan termination.[187] The report concluded that the excise tax rate would need to be between 17% and 55%, varying with the facts of the case in order to recapture the value of the tax-free build-up of recovered amounts.[188]

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184. An increased adjustable, or variable rate schedule could be designed to apply different rates for different circumstances. For example, investment types, period of time over which the plan was overfunded, and the employer's marginal tax rate could all be used to determine which of the scheduled rates should apply.

185. I.R.C. § 4980 (1988 & Supp. IV 1992).

186. There is an exception for amounts that could have been recovered without termination. For example, in the case of a mistaken calculation, the employer is permitted to recover contributions made as a result of the miscalculation within a certain period after the contribution is made if the plan so provides. *Id.* § 4980(c)(2)(B) (1988); Rev. Rul. 77-200, 1977-2 C.B. 98.

Also, if a contribution is made conditioned on qualification of the plan and the plan subsequently does not qualify, then the contribution may be returned to the employer within one year of the denial of qualification. *See* ERISA, 29 U.S.C. § 1103(c)(2)(B) (1988); Rev. Rul. 60-276, 1960-2 C.B. 150.

187. *See* GAO Report, *supra* note 160, at 11.

188. The results from the 55 cases studied indicated that the mean average for the excise tax rate needed to recover pension tax benefits was about 37% and the median was about 39%. In 96% of the cases, the appropriate rate equaled or exceeded a 20% rate, in 75% of the cases the rate equaled or exceeded a 30% excise tax rate, and in 27% of the cases the appropriate rate for recapture equaled or exceeded a 45% rate. *Id.* at 4-5.

The tax-free build-up of plan assets is a function of many variables. The build-up depends on such factors as the period over which the overfunding extended, where the excess assets were invested, and the rate at which the investment income was normally taxed.[189] Consequently, it is impossible to determine a fixed amount that can accurately reflect the tax benefits received by employers on all recovered amounts in all circumstances. A fixed rate will always be less precise than an individual calculation, although it is much easier to administer and enforce. Alternatively, the use of an increased variable rate schedule, adjusted for different time periods, types of investment, and investment taxation can provide more accuracy than a flat rate and greater administrative ease than individual calculation.[190]

If the goal is not to deter reversions, but only to recapture lost revenue, a case by case method evaluating the exact tax benefits an employer receives upon asset recovery is necessary to determine with some precision the appropriate excise tax rate. For example, an employer who invests excess plan assets in investments subject to the maximum income tax rate, with all other things being equal, would receive a greater tax benefit and, accordingly, have a higher excise tax. Similarly, the excise tax rate would be lower if the assets were sheltered in the pension plan for a shorter period of time. If the rates were individually calculated, the excise tax would not create a disincentive for employers to accelerate the funding of their pension plans. Economically, employers would be no better or worse off after plan termination for having overfunded their plans.[191] An individually assessed tax is considerably more difficult to administer than a fixed rate or an adjustable rate; however, using the results of the actuarial valuations[192] to obtain information on the period over which the excess assets existed, the amount

189. *Id.* at 2-3.

190. Effective October 1, 1990, the Omnibus Reconciliation Act of 1990 changed the excise tax rate. *See infra* part II.B.3 (discussing combination approach of Omnibus Reconciliation Act).

191. While an individually-calculated excise tax may not deter employers from overfunding their ongoing plans, the excise tax may still act as a disincentive for employers who wish to terminate their plans. In other words, rather than having to pay the excise tax on the reverted assets at plan termination, the employer may elect to continue the plan. However, this is a different consideration from deterring the employer from overfunding ongoing plans.

192. The actuarial valuation is the process that involves the determination of existing liabilities, the plan's available assets, and a funding arrangement for future contributions to meet the obligations under the plan. *See supra* part I.

of excess, and other relevant information could make the implementation of a case-by-case approach feasible.[193]

A significant shortcoming of an increased excise tax approach is that plan participants do not necessarily benefit from surplus assets as they would under methods like the actuarial limitation model.[194] Nevertheless, this approach is an effective method of addressing reversions on plan termination without directly restricting the accelerated funding of ongoing plans. It also presents a worthwhile alternative to the erroneous actuarial calculation approach discussed in the previous section of this Article.

3. Current Law Under the 1990 Omnibus Reconciliation Act—A Combination Approach

The Omnibus Reconciliation Act of 1990 (OBRA) relies on a combination approach to limit the recovery of excess assets on plan termination. It merges an increased excise tax rate with an optional provision for using a portion of the surplus to increase plan participants' accrued benefits as a quid pro quo for reduced rates. The Act amends existing law by raising the 15% excise tax to 20% if the employer transfers 25% of the total assets received on plan termination to a qualified replacement plan or provides a pro-rata benefit increase using at least 25% of the recovered assets.[195] A 50% excise tax applies to recaptured amounts if the employer does not establish a qualified replacement plan or declines to provide the stated pro-rata benefit increases.[196]

Because the 20% excise tax is not calculated according to the actual amount of tax-subsidized benefits that an employer receives from recovered amounts, the new law may be inadequate in recapturing tax gains. Moreover, while the 50% flat rate may theoretically be adequate in most cases, as a practical matter, it will probably never be applied. If the employer opts to use 25% of the

193. For a more detailed discussion on individual measurement, *see infra* part III.

194. *See* discussion *supra* part II.B.1 (discussing effort to limit asset reversion to employers under actuarial method).

195. Qualified replacement plans are plans established by the employer in connection with a plan termination where at least 95% of the active participants in the terminated plan remain as participants in the replacement plan. Pro-rata benefit increases in the accrued benefits are those increases which result from a plan amendment made in connection with a plan termination which have an aggregate present value of at least 20% of the maximum amount which the employer could receive as an employer reversion. I.R.C. § 4980(d) (1988 & Supp. IV 1992).

196. Omnibus Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987).

surplus assets for plan participants and pays a 20% excise on the surplus, the employer recovers 55% of the surplus.[197] If the employer opts to pay the 50% excise tax, the employer recovers only 50% of the surplus. Therefore, on plan termination, the new law effectively places a 45% tax on excess amounts when 25% is used for plan participants and 20% is used to replace the tax benefits. Thus, at 20%, the new excise tax rate will permit the Treasury to recoup 5% more tax gains from the recovery of assets than the prior 15% rate.

Equally important as the higher excise tax rate is the option given to employers under the new law to pay lower rates in exchange for increased participant benefits. While the voluntary aspect of the option to redirect recovered amounts to plan participants implies that the law, to some extent, is still premised on the belief that the employer has greater title to surplus amounts, the new act strongly encourages the employer to use a portion of the surplus assets for the benefit of plan participants. A fixed percentage, however, especially a 25% one, cannot accurately approximate the expected retirement benefits of plan participants. As a consequence, many employees may still receive substantially fewer retirement benefits than that for which they paid, while the employer recovers as much as 55%[198] of the surplus.

Because of this preferential treatment of employers, the new act's optional use requirement, like current recovery practices, is viewed by participants' rights advocates as inconsistent with ERISA which provides that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries."[199] Therefore, depending on one's view, OBRA may be regarded as merely a starting point.

While the new act may fail to fully respond to some of the critical issues presented by asset recovery on plan termination, it at least focuses in part on the recapture of tax gains and the allocation of excess assets to plan participants. The enactment of similar laws which recognize that participants are also entitled to a portion of the excess assets should cause policymakers to rethink their skepticism on overfunding and accept accelerated funding as desir-

197. 100% less 25% to plan participants less 20% excise tax equals 55%, the amount of surplus which passes to the employer.

198. *See supra* note 11 and accompanying text (discussing concept of asset reversion).

199. 29 U.S.C. § 1103(c)(1) (Supp. IV 1992).

able for plan participants. As a result, accelerated funding may be eventually viewed as consistent with ERISA's goal of providing more security for plan participants. The next section of this Article explores whether accelerated funding, in the absence of plan termination, is consistent with public interest and pension policy.

III. OVERFUNDING IN THE ABSENCE OF PLAN TERMINATION

As noted earlier, one of the reasons for the recent emphasis on deterring "overfunding" is to minimize the incidence of asset reversion on plan termination by reducing excess assets in ongoing plans.[200] However, long before the subject of asset reversion was debated, Congress imposed limitations on how much an employer could deduct for contributions made to a pension plan.[201] These limitations demonstrate Congress' belief that the public interest is not best served by extending tax benefits for unlimited contributions made to qualified plans, even in the absence of the threat of asset reversion.

While Congress has historically discouraged excess contributions to private pension plans by limiting deductions, it has also promoted the establishment of private pension plans by affording them substantial tax advantages.[202] The purpose of the favorable tax treatment of qualified pension plans is to provide employers with an incentive to maintain private plans that enable lower and moderate income employees to secure adequate savings for retirement. As a way of assuring that employers will make good on their promises to provide retirement benefits to plan participants, Congress imposed minimum levels of funding as a prerequisite to the retention of tax benefits.[203]

Before determining whether the funding limitations and preferential tax treatment are effective in accomplishing the desired results, it is necessary to know the specific goals of policymakers and the extent to which they are willing to subsidize these goals. Therefore, without regard to the asset recovery issues discussed in the previous section, this segment of the Article examines current pension law as it relates to the tension created by the maximum

200. *See supra* text accompanying note 11.

201. *See generally* Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, Public and Private Pension Programs Report to the President on Private Employee Retirement Plans (January 1965) [hereinafter President's Report].

202. For a discussion of the tax advantages of qualified plans, see *supra* part I.

203. I.R.C. § 412 (1988 & Supp. IV 1992).

funding limitation and the minimum funding requirements as well as alternatives to the current law which may better implement their sometimes conflicting goals.

A. Tax Incentives

When an employer believes that tax benefits will reduce the cost of a retirement plan, the employer generally will be more receptive to the idea of establishing a pension plan for the benefit of its employees. Accordingly, in order to encourage the establishment of more pension plans, Congress provided incentives in the form of preferential tax treatment to employers who establish and maintain qualified pension plans.[204]

The Treasury Department treats the tax advantages given to private pension plans as a tax expenditure and regularly prepares estimates of the revenue lost from the favorable tax treatment of pension plans. Estimates for 1990 indicated that the tax expenditure for private pension plans exceeded 48 billion dollars and will reach 61 billion dollars in 1994.[205] These figures are computed by subtracting the taxes paid on pension distributions in a given year from the foregone taxes attributable to the exclusion of employer contributions and plan earnings in that same year.[206]

Employer contributions and the interest earned on such amounts are effectively substitutes for current wages. A comparison between an employee's tax liability when the employer pays wages exclusively in the form of cash wages and when the employer pays in the form of both wages and qualified pension plan contributions reveals the magnitude of the tax advantages given to pension plans. The favorable tax treatment given to qualified pension plans provides the worker who receives part of her compensation in the form of deferred pension payments with a higher after-tax income over her lifetime. This reduction in lifetime taxes for employees covered by qualified plans represents substantial amounts of foregone revenue and proves to be a costly subsidy from the feder-

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204. See discussion *supra* part I for a description of the tax advantages for qualified plans.

205. STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1990-1994 (Comm. Print 1989).

206. The estimate of foregone revenue includes the revenue lost from the difference in lower tax rates at retirement as compared to the higher rates which would be effective if the contributions were taxable to the participants during their working years. Since the difference in the highest rate and the lowest rate is not as great as in previous times, this component of foregone revenue is not as critical as in prior years.

al government.[207]

To numerically illustrate this point, assume that an employer made a contribution to a qualified plan of $100 on behalf of an employee in the 28% tax bracket. The employee will not pay taxes on the contribution until later when she receives it in the form of a retirement benefit. At retirement, however, she may be on a fixed income, and accordingly, in a tax bracket lower than her current one. For example, instead of presently paying $28 in taxes on a contribution of $100, she will pay $15 some 20 years later when she retires.[208] The Treasury thereby loses $13. It will also lose the difference in the present value of $15 and its future discounted value 20 years from today. The employee will rarely have to pay the amount of taxes that she would have had the tax liability not been deferred. Of course, the portion of the tax advantage attributable to the change in tax bracket occurs only when the marginal income tax rate at retirement significantly decreases as assumed in this example.[209]

To ensure that rank and file employees actually benefit from qualified pension plans and are not discriminated against in favor of highly compensated employees, Congress set limits on the accrual disparity of a plan's benefit for low and high paid workers.[210] Despite these limitations, however, much of the tax expenditure for pension plans still disproportionately benefits higher paid employees.[211] Because retirement benefits are often salary related, higher paid employees generally receive larger retirement benefits.[212] Moreover, the higher tax brackets of higher paid employees also contribute to the disparity between the tax benefits they receive as compared to those received by lower paid employees.[213] Therefore, not only is the tax subsidy for retirement bene-

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207. *See* ALICIA H. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 50 (1982) (stating that the Treasury loses roughly $15 billion annually on special tax concessions to private pension plans).

208. 15% is the lowest rate which could be effective at retirement provided present rates do not change. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 13 (6th ed. 1991).

209. By contrast, if tax rates go up the Treasury will experience a windfall.

210. I.R.C. § 401(a) (1988 & Supp. IV 1992) provides that the contributions or benefits provided by a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated. See also I.R.C. § 410(b) (1988) which requires that qualified plans operate in a nondiscriminatory manner.

211. *See* MUNNELL, *supra* note 207, at 45.

212. *See id.*

213. Pension amounts vary more than proportionally with wages. In 1978 the median

fits extremely costly, but it subsidizes greater benefits for higher paid employees.

The deferral of tax liability is equivalent to an interest-free loan from the Treasury to the employee, the higher the tax bracket of an individual, the greater the loan.[214] Using the above example, if the employee is in the 15% tax bracket, the annual interest-free loan from the Treasury would be $.15 on each dollar of contribution. An employee in the 28% tax bracket would receive an interest-free loan of $.28 on each dollar of contribution.

Regardless of how one characterizes the tax benefits, the revenue lost from the preferential tax treatment of employer contributions and pension fund earnings is significant.[215] Notwithstanding this substantial cost, the underlying reasons for the tax incentives are seldom questioned because saving for retirement is generally accepted as a goal worthy of support. The extent to which it is desirable to grant such benefits does, however, give rise to various limitation issues.

B. Limitations on Favorable Tax Treatment

In an effort to reduce the tax expenditure for retirement savings and to cap the tax benefits enjoyed by an individual worker, Congress placed limitations on individual benefit accruals, particularly those of highly compensated employees. Section 415 of the Internal Revenue Code provides that the maximum annual benefit paid from a tax-qualified defined benefit plan is limited to the lesser of 100% of the participant's average compensation or $90,000.[216] The driving force behind this limitation appears to be the recognition that excessively large retirement benefits disproportionately benefit highly compensated employees who do not need tax subsidies to encourage them to save for retirement.[217]

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annual pension for those with an annual income of $19,000 or greater was approximately 10 times greater than the median for those with an annual income under $6,000. *See* PENSION STATISTICS, *supra* note 96, at 131.

214. *See* Halperin, *supra* note 6, at 512 (discussing the hidden interest advantages arising when tax liability is deferred).

215. *See* MUNNELL, *supra* note 207, at 50 (estimating losses to the Treasury as a result of tax benefits from plans).

216. The $90,000 is indexed for inflation so that the number in effect for 1991 is $108,963. I.R.C. § 415(d) (1988).

217. *See* MUNNELL, *supra* note 207, at 51 (recognizing that the favorable treatment of qualified plans gives lower paid employees the incentive to save for retirement); *see also* Halperin, *supra* note 6, at 539 (describing benefits for highly paid individuals as an "un-

Congress further reduced the tax expenditure for pension benefits by placing limitations on the rate at which employers can fund for and deduct plan costs. The funding limitations are found in section 412 of the Internal Revenue Code.[218] Section 404, working in conjunction with section 412, establishes the annual limitation on deductible employer contributions.[219] It provides that the employer may always contribute the amount necessary to comply with the minimum funding requirements of section 412, but in no event is the employer entitled to a deduction greater than the applicable full funding limitation.[220] Thus, section 404, unlike section 415, affects the rate at which an employer can deduct the costs of pension benefits without affecting the size of individual pension benefits.

Section 404(a)(1)(E) provides that the excess of any amount contributed over the maximum deductible limit for the year can be carried over to the following year.[221] The 10% excise tax on nondeductible contributions applies, however, for as long as a plan is overfunded and serves to offset any tax benefits attributable to the overfunded amounts as well as to penalize the employer for overfunding.[222] Therefore, the excise tax could put an employer who contributes in excess of the deductible limitation in a worse position than if the employer had not made additional contributions to the plan.[223] Consequently, for all practical purposes, the imposition of the excise tax on nondeductible contributions has rendered the carryover option sufficiently unattractive to eliminate it as a business option.

While the reasons for the funding limitations may be valid, the effects of imposing additional restrictions on the maximum funding limitations in ongoing pension plans must be weighed against the overall goal of encouraging employers to maintain financially secure plans. As more individuals encounter increasing

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warranted subsidy [that] undermines the incentives created by Congress").

218. I.R.C. § 412 (1988 & Supp. IV 1992) (providing the minimum funding standards).

219. I.R.C. § 404(a) (1988 & Supp. IV 1992) (providing limitations on deductions for employer contributions to plans deferring employee compensation).

220. I.R.C. § 412(c)(7) (1988).

221. The carryover, combined with the next year's annual contribution, is deductible in the following year subject to that year's maximum deductible limit. A contribution carryover that is not deducted in the first year in which it may be deducted is lost forever. However, there is no limit to the amount of carryover nor to the number of years to which the carryover may be applied until fully deducted. I.R.C. § 404(a)(1)(E) (1988).

222. *See* I.R.C. § 4972 (1988).

223. *See infra* part E for a numerically illustrated application of the excise tax.

difficulty in saving for retirement, the incentives to maintain and establish financially secure pension plans become more important.[224] Allowing employers to accelerate funding for legitimate reasons will give employers more flexibility in structuring their tax liability, and will also create additional financial security for plan participants in the long run.[225] The latter result is thus socially desirable and consistent with the specific funding goals of ERISA.

C. *The Limitation Policy of Section 404*

The funding limitations are based upon the theory that an employer obtains too great a subsidy if given the flexibility to accelerate funding beyond certain levels. As noted, in order to limit the favorable tax treatment of retirement benefits to appropriate amounts, Congress limited both the individual benefits of plan participants and the rate at which employers can fund for the plan benefits. Thus, the funding limitations appear to define a reasonable cost allocation of socially desirable levels of retirement income.

Viewed in isolation, section 415, which pertains to the limitation of individual benefits rather than to that of overall deductibility,[226] is generally beyond the scope of this Article. However, just as section 404 attempts to identify an appropriate level for deductible employer contributions, section 415 attempts to define the appropriate level of replacement income for which the deductions are allowed.[227] Section 404(j), added to the Code in 1982, incorporates by reference the section 415 benefit limitation so that these two provisions operate together. Section 404(j) provides, in pertinent part, that in computing the allowable deductible amount in a given plan year, no amount in excess of the 415 limitation on defined benefit plans may be considered for deduction purposes.[228] Thus, an employer may not deduct under section 404 a benefit which cannot accrue under section 415. This outcome sug-

224. Saving is more difficult for reasons such as inflation, which decreases the value of the dollar. Also, consumer credit arrangements that allow people to consume beyond current earnings make saving more difficult.

225. Employers can achieve additional funding flexibility by providing in the plan document that the employer will annually contribute the minimum amount required by ERISA's minimum funding standard as well as any other amount the employer might determine in its discretion.

226. I.R.C. § 415 (1988 & Supp. IV 1992).

227. Halperin, *supra* note 104, at 162.

228. I.R.C. § 404(j)(1)(A) (1988) provides that "in the case of a defined benefit plan, there shall not be taken into account any benefits for any year in excess of any limitation on such benefits under section 415 for such year."

gests that, while the deductible contribution limitation is separate from the accrual limitation, both limitations attempt to eliminate the favorable tax treatment of disproportionately large retirement benefits in qualified plans. The policy behind both limitations is to identify the levels of retirement income for which Congress believes preferential tax treatment is appropriate.

Legislative history indicates that prior to the enactment of Code section 415, policymakers were concerned about the cost and distributional effects of the favorable tax treatment of qualified plans. Specifically, the concern was that the tax expenditures associated with pension plans were not being used as intended, that they were being used for purposes other than to help low to moderate income earners save for their retirement. It was feared that tax expenditures were being used primarily to provide an opportunity for employers and highly paid individuals to avoid their tax liability. These concerns, addressed currently by section 415, were expressed as early as 1965 by the President's Committee on Corporate Pension Funds.[229] The Committee called for the imposition of an appropriate dollar limitation on contributions to qualified plans in order to prevent abuse and restrict favored tax treatment to reasonable amounts. The Committee determined that it was not appropriate to help finance by means of special tax treatment excessively large retirement benefits.[230]

The statutory language of section 415, however, does not fully comport with congressional concern over the extremely large benefits of highly compensated employees. Section 415 limits annual benefits to the lesser of full compensation or $90,000.[231] Yet, section 415 makes no exception for disproportionately large benefits that accrue to lower paid employees and also subjects their benefits to the 100% compensation limitation.[232] Had Congress wanted to make allowances for a situation in which lower paid employees stood to receive a larger benefit, the limitation could easily have been defined in terms of a fixed or indexed dollar amount. Similarly, an exception for the deduction of such benefits could also have been permitted under section 404. Thus, with respect to section 415, Congress was concerned with limiting the retirement benefits of all employees, regardless of their levels of compensation, in

229. *See* President's Report, *supra* note 201, at 59.
230. *Id.* at 62.
231. I.R.C. § 415(b)(1) (1988).
232. *Id.*

order to reduce revenue loss as well as to provide a savings process that produces retirement benefits commensurate with the participant's salary history.

Therefore, encouraging the work force to save adequately for old age maintenance appears to be but one of the goals of pension policy; another is limiting tax-subsidized retirement income to specific levels of savings. In addition to restricting excessively large benefits, the section 415 limitation seeks to establish a guideline for identifying what amount constitutes a true pension, and by direct implication, what amount represents the true annual cost of such benefits.

While it is difficult to identify what a true pension is, section 415 indicates that retirement savings should neither be greater than one's earnings during a working career nor excessively large. The general goal of pension policy is to ensure a lifestyle during retirement as comfortable as the lifestyle enjoyed during the participant's working career. Consequently, Congress does not attempt to help workers save for retirement benefits that exceed 100% of their current earnings.[233] Moreover, section 415's limitation on annual compensation in excess of $200,000 indicates that at high levels of income, individuals are expected to save on their own;[234] they are not encouraged to do so by tax subsidies.

In its enforcement of the funding limitations, the Tax Court has determined that it is inappropriate for actuaries to recognize indexed adjustments to increase the funding limitations even when they are specifically scheduled in the Code. In *Feichtinger v. Commissioner*,[235] the Tax Court rejected the advanced funding of automatic cost-of-living adjustments and adhered to the dollar limitation on the benefits payable under a defined benefit plan.[236] The court held that the benefit limitations of section 415 were intended to prevent taxpayers from financing large pensions at public expense through the use of qualified pension plans.[237] In the court's view, allowing benefit deductions for the advanced funding of benefits in excess of the current limitations, even if the contributions reduced plan costs later, would not further the underlying

233. *See* I.R.C. § 415(b)(1)(B) (1988) (limiting annual benefit paid to 100% of the participant's average salary).
234. *See* I.R.C. § 401(a)(17) (1988).
235. 80 T.C. 239 (1983).
236. *Id.* at 249-250.
237. *Id.*

goals of the benefits limitation policy.[238]

The automatic cost-of-living adjustments to which the court referred are found in sections 415 and 401 of the Code. Section 415(d) provides an automatic adjustment to the benefit accrual limitation under section 415 in order to recognize future inflation.[239] Section 401(a)(17) allows future increases to the $200,000 annual compensation limitation.[240]

While an actuary is not permitted to anticipate indexed increases for funding purposes, the actuary is allowed to use a salary scale increase to estimate future plan experience in connection with the use of certain projected cost methods.[241] However, taking future salary increases into account has the same effect as taking expected automatic increases into account. In both instances, the actuary is funding for benefits expected to accrue in future years. Both situations result in higher contributions and deductible limits. Nevertheless, policymakers perceive the indexed adjustments for inflation and the use of a salary scale projection to anticipate increases in compensation as distinct concepts. It appears that the major difference in the two concepts is that projected salary increases anticipate future plan experience. Accordingly, the employer and its actuaries are better able to judge whether a salary scale is reasonable based upon historical data or the employer's own business judgement. Apparently, policymakers believed that it would be inappropriate for Congress to set limitations on salary increases if they in fact reasonably represented the compensation upon which the retirement benefit would ultimately be based. For this reason, employers are allowed to fund for projected wage increases to ensure that there will be enough assets on hand to provide the benefits when they become due.

In contrast, Congress provided indexed increases in the Code to avoid the need to amend certain provisions every year. They are in the Code solely for convenience and are not intended to have any effect until their respective effective dates.[242] In other words,

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238. *Id.*

239. I.R.C. § 415(d) (1988).

240. I.R.C. § 401(a)(17) (1988). The Internal Revenue Code prohibits a plan's actuary from considering the indexed amounts in their plan assumptions. I.R.C. §§ 404(j), (*l*) (1988).

241. Under some actuarial cost methods the actuary does not assume a salary scale adjustment, while under others the actuary is required to do so. *See* SCHOENLY, *supra* note 181, at 11.

242. *See, e.g.*, I.R.C. § 415(d) (1988).

unlike current section 415 limitations, which are attempts to define appropriate levels of retirement income based upon present economic conditions, the indexed amounts describe a level that is viewed as inappropriately high under current conditions. Allowing employers to recognize the indexed amounts would make these amounts the effective savings levels and would represent amounts considered excessive under current conditions.

As discussed in part I, funding methods allocate current costs and amortized portions of past service cost over the life of the plan. Future plan costs are not funded in advance.[243] This means that costs relating explicitly to future costs, as well as ones disguised as past service cost, may not be pre-funded. The unlawful prepayment of future service costs, or the misallocation of past service costs,[244] are believed to cause excessively large benefit accruals. One method of misallocating past service liability is through the use of extremely "frontloaded" benefit formulas which provide for the accrual of significantly larger benefits during the early years of participation. There is concern that these formulas can be used to avoid the statutory amortization periods for past service liabilities by substituting larger benefit accruals for earlier years instead of giving credit for past service.[245] As a result, current costs in the initial years of the plan would be larger, making the deductible contribution level greater than if credit for past service had been given and its cost amortized over a period of at least ten years as required by law.[246] The Internal Revenue Service has been particularly concerned about this tax avoidance scheme in connection with smaller employers. Because of small numbers of employees, these employers are not as concerned as larger employers about the anti-discrimination rules that force employers to give the same benefit to all plan participants. In re-

243. *See supra* notes 17-26 and accompanying text (explaining the system by which the plan is funded).

244. A plan gives past service credit when it recognizes service before the establishment of the plan. Past service cost is the liability of a pension plan for the benefits attributable to past service credit. *See* MCGILL & GRUBBS, *supra* note 19, at 270-76.

245. *See, e.g.*, Jerome Mirza & Assoc. v. United States, 692 F. Supp. 918, 921-22, (C.D. Ill. 1988) (stating that § 415 "requires the plan to reasonably allocate the benefit between past and present service"), *aff'd* 882 F.2d 229 (7th Cir. 1989), *cert. denied*, 495 U.S. 929 (1990).

246. *See supra* notes 24-25 and accompanying text discussing 30-year amortization. Ten years is the shortest period over which supplemental costs can be amortized. Ten-year amortization would produce larger deductions than the longer amortization periods provided in the statute.

sponse, the Service has indicated that it will reduce the deduction to appropriate amounts when it determines that this scheme has been used in order to prevent taxpayers from circumventing the deduction limitations under section 404.

While the Service has taken a hard-line position on past service allocations,[247] the distinction between past service credit and future accruals is unclear at best. It is a difficult, if not impossible, task to determine when an employer has concealed past service credit with larger benefit accruals. Any time an employer has generous benefit accruals or does not backload the plan's benefit formula, there could be a case of misallocating past service credit. While it is difficult to distinguish between past service credit and current liability, it is equally difficult to understand why such a classification is ever necessary. If one believes that reduced wages in fact fund the benefits provided by private pension plans, then from the employee's perspective, there is no difference between past service costs and future accruals.[248] The projected benefit is simply the funding goal of the plan. According to this view, all costs to the participant are future costs. As such, there is no need to distinguish past service from future service. There is also no need to impose additional restrictions on the deductibility of past service cost. Section 404(a)(1), which limits the employers annual contribution, would be sufficient.[249]

On the other hand, if one believes that past service benefits are entirely related to past periods of service, then current compensation would not be reduced to fund past service costs. Theoretically, compensation from previous periods would have been cut to fund the benefits attributable to past service. Therefore, under this theory, past service costs, regardless of the amount, should be immediately deductible.[250]

Perhaps one of the reasons employers are required to amortize the cost of past service liability, as opposed to immediately deduct-

247. *See Mirza*, 629 F. Supp. at 922-23 (finding the taxpayer's interest rate assumption under 26 U.S.C. § 412(c)(3) to be unreasonable).

248. For a discussion of the effect of pension contributions on current wages, see *supra* notes 126-36 and accompanying text.

249. I.R.C. § 404(a)(1) (1988 & Supp. IV 1992) provides, in pertinent part, that deductions for contributions are limited to the full funding limitation for the year in which the contribution was made.

250. Generally, the maximum amount an employer may deduct in a plan year is the sum of the normal cost and an amount sufficient to amortize the unfunded past service liability over ten years. See *supra* part I.A.2 for a discussion on current funding law.

ing it, is the concern that taxpayers, if allowed to deduct past service cost at once, would be able to anticipate changes in the tax rates and accordingly reduce their overall tax burdens.[251] In other words, when rates were expected to rise, making deductions more valuable, employers would defer their funding of past service costs by electing longer amortization periods. When rates were expected to fall, making deductions less valuable, employers would fund for past service immediately. However, this problem could be solved with transitional rules that minimize such windfalls. For example, when tax rates increase, an employer would be prohibited from increasing the rate at which she funded the past service cost beyond a certain percentage.

A full exploration of the extent to which the funding limitations and their underlying policy depend on the distinction between past service and future service is beyond the scope of this Article. With the exception of this section of the Article, the limitation issues addressed throughout this paper are based solely upon future service costs, costs attributable to service that begins on the date the plan is established.

One of the most troubling aspects of allowing current deductions for the advanced funding of future benefits is that employers receive a present tax advantage for contributions which have not yet accrued to plan participants. Thus, under current law, if the participant separates from service early[252] or the plan terminates prematurely, amounts used to fund the future benefits could be reallocated to the employer, notwithstanding the fact that the employees paid for the benefits with reduced wages and the employer received favorable tax treatment for the non-accrued amounts.[253]

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251. Rev. Rul. 64-159, 1964-1 C.B. 164.

252. Generally, when a participant separates from service before five years, the employer is permitted to forfeit the nonvested portion of the participant's accrued benefit. In a defined benefit plan, forfeitures are used to reduce the employer's contributions in subsequent plan years. If a plan funds for nonaccrued benefits, such amounts would not be included in the participant's vested accrued benefit. These amounts would be considered experience gain if the employee were to terminate employment early. Thus, the employer would then be able to use immediately the excess amounts to reduce annual plan contributions. Unlike vested accrued benefits, if the employee were to return, such amounts most likely would not be reinstated, although they were paid for with the participant's reduced wages. Consequently, restricting funding to accrued benefits prevents employers from forcing employees to save more than they are entitled to receive. *See* DAN M. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS, 126-29 (3d ed. 1975) (discussing the impact on benefit rights due to withdrawal from a plan prior to retirement).

253. For a discussion on reversions, see *supra* part II.A.

When deductions are limited to accrued benefits, the employees' wage reduction better represents the benefits which they are entitled to receive. As a result, when participants separate from service early or on premature plan termination, the employer's potential windfall is reduced.

Alternatively, if one believes that wages are not reduced to fund future accruals, then arguably the contributions for such amounts are not truly savings for retirement. Employer contributions to qualified plans are deductible by the employer at the time the contribution is made, but are not taxed to the employee until the benefits are ultimately distributed.[254] The rationale for the deductibility of the contributions is that they represent compensation, payable at retirement or some other future event.[255] The employee receives compensation in the form of both current wages and deferred wages. Consequently, present wages are reduced to the extent that there are deferred wages. Therefore, employer contributions to pension plans are ordinary business expenses and, as such, are deductible like other forms of compensation.[256] However, if current wages are not actually reduced to fund the retirement benefits, then it would be inappropriate to allow employers to take present deductions for their contributions because these amounts do not represent deferred compensation.

Another reason for promoting a policy that disallows deductions for amounts that have not yet accrued is to reduce forced savings. Under a policy that permitted deductions for future accruals, employees who prefer to use a larger portion of their compensation for immediate consumption would effectively be forced to save even more from their current wages for retirement.[257] The current policy permits employers to force workers to save for retirement only to the extent that the employees are entitled to receive the benefits. The policy restricts the employer's ability to

254. Rev. Rul. 64-159, 1964-1 C.B. 164, interprets Treas. Reg. 1.404(a)-1(b) to provide that contributions may be deducted under I.R.C. § 404(a) only to the extent that they are "ordinary and necessary" expenses and are "compensation for personal services actually rendered."

255. Other distributional events may include, for example, death or early retirement. *See* I.R.C. §§ 401(a)(9), (14) (1988 & Supp. IV 1992).

256. Ordinarily, such amounts would be taxable to the employee at the time the employer took the deduction. However, see *supra* notes 5-6 and accompanying text for a discussion of the preferential tax treatment of amounts contributed to a qualified pension plan.

257. *See* Ippolito, *supra* note 118, at 84-85.

force employees to save for benefits which they may or may not receive.[258] Therefore, in addition to eliminating a potential windfall for the employer, the prohibition on deductions for future accruals effectively limits the level at which employers will decide to reduce wages for purposes of funding retirement savings.

D. Motivation to Accelerate Funding

Because an employer subject to federal income tax is usually reluctant to contribute more than can be deducted in a plan year, the availability of a deduction is important in the decision of how much to contribute. An employer's current tax position may determine whether she elects to accelerate funding or not. For example, an employer may choose to minimize contributions in years where there is little or no taxable income, and maximize contributions in years where there is ample income against which deductions can be applied.[259] An employer who has substantial profits, but limited cash due to commitments such as future plant expansion, may find it advantageous to reduce annual contributions to the minimum level. On the other hand, an employer in a strong cash position may recognize that an additional dollar paid this year reduces required contributions in future years and may decide to make accelerated contributions in excess of the minimum contribution level. Prior to the imposition of the 10% excise tax on non-deductible contributions,[260] an employer in this situation may have even elected to make contributions in excess of the maximum deductible limitation in order to take advantage of the tax-free build-up.[261]

When an employer's after-tax rate of investment outside the plan is approximately equal to the expected before-tax rate of return inside the plan, it is unlikely that an employer with discretionary funds would choose to put them in a pension plan. Under these circumstances, the employer could invest the money outside the plan at comparable after-tax interest rates and keep the money available for immediate use.[262] Even when the inside rate has a

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258. See *supra* note 18 for a description of accrued benefits on plan termination in a defined benefit plan.

259. *See* MCGILL & GRUBBS, *supra* note 19, at 415-21 (discussing funding patterns).

260. I.R.C. § 4972(a) (1988).

261. *See supra* notes 206-07 and accompanying text.

262. The prohibited transaction rules prevent employers from removing contributions made to a pension plan for any reason other than the exclusive benefit of plan participants. *See supra* note 44 and accompanying text; *see also supra* note 114 (describing an exception for amounts contributed by mistake).

slightly greater expected return than the outside rate, an employer may not be inclined to relinquish control of the funds for a small difference.[263] Thus, for the employer making the decision to overfund solely on the basis of expected investment return, the inside rate would have to be substantially greater in order for an employer to make additional contributions to a pension plan.

An employer's borrowing cost may also determine whether and to what extent the employer will choose to increase the level of plan funding. Because the earnings on pension plan assets are not taxable,[264] an employer is likely to borrow money in order to make larger contributions to the plan if she expects the before-tax investment return inside the plan to be greater than the after-tax rate at which she borrowed.[265] Thus, after comparing the cost of incurring additional debt to the expected rate of return for additional contributions made to the plan, an employer may choose to borrow and accelerate funding. The employer's marginal tax rate is an important factor in this comparison and determines whether increases in plan funding in conjunction with borrowing is desirable.

The employer's size is yet another factor that influences whether and to what extent the employer views accelerated funding as beneficial.[266] A small employer with few plan participants might be motivated to accelerate funding to take advantage of the greater tax benefits which result. Any increase in profits directly affects the small employer's economic position whereas with large companies, the increase in profits affects the economic position of the shareholders. In addition, smaller employers often hire family members and friends; consequently, they may feel a commitment beyond that required by the law to ensure that adequate funds are available when they become due. As a result, smaller employers are more likely than larger employers to invest additional funds in the plan in order to improve its financial stability.

Small plans are often the subject of Internal Revenue Service audits. It is generally believed that in order to take larger deductions than ordinarily permitted under section 404, employers of small companies deliberately accelerate funding by using the most

263. See *infra* part II.E for further discussion on investment rates.

264. *See supra* notes 5-6 and accompanying text.

265. Halperin, *supra* note 6, at 515-19 (explaining the relative advantages and disadvantages of accelerated pension fund payments and their impact on the employer's tax position).

266. *See* ITELSON, *supra* note 83, at 2.

conservative actuarial assumptions that they can justify.[267] Because a change in the interest rate assumption will usually affect the valuation results more than a change in any other assumption, the interest rate assumption is closely scrutinized on audit.[268]

Notwithstanding the fact that many small employers are interested in using their pension plans to minimize tax liability, the actuaries of small plans are very likely to select conservative or simplified interest assumptions purely for actuarial reasons.[269] A conservative selection is appropriate for smaller employers because yearly fluctuations in plan experience are likely to be greater, plan experience does not provide a meaningful match for decrements, and a statistically valid salary scale cannot be derived in very small groups.[270] In some cases, neither a salary scale nor a pre-retirement mortality assumption is even used. Thus, the use of more conservative interest rate assumptions is necessary in order to compensate for these factors, which, although not reliably determinable, ultimately affect the funding status of the plan.[271]

The inability to readily offset actuarial error is characteristic of smaller plans because the number of employees in a plan affects the degree of self-correction for erroneous actuarial assumptions. In order to minimize the risk of inadequate funding, a smaller employer may wish to have more assets on hand than required by law.[272] For example, a small plan that provides an early death benefit may have insufficient funds in the event of a premature death. Pay-out of the accrued benefit would occur sooner than anticipated thereby depriving the plan of adequate time to build up to the expected level. As a result, there may not be sufficient assets. The smaller employer will be unable to contend with such actuarial errors unless the plan's funding has been accelerated either by using conservative interest rate assumptions or by contributing in excess of the 404 deductible contribution limitation. In contrast, a large plan has a more variable structure so that actuarial error can be spread over more lives and more experience. In a

267. See Stein, *supra* note 87, for discussion of the appropriateness of defined benefit plans for small employers because of their ability to take large deductions as a result of using conservative assumptions and favorable funding methods.

268. It has been determined that a 1/4% change in the interest rate assumption results in a change of about 6% in liabilities. SCHOENLEY, *supra* note 181, at 13-14.

269. ITELSON, *supra* note 83, at 2.

270. *Id.*

271. *Id.*

272. *Id.* at 5.

large plan there is seldom a realistic fear of having insufficient assets due to actuarial error.

Another set of circumstances which makes it necessary for actuaries to choose conservative actuarial assumptions is the disallowance of funding for benefits that are not yet in the plan. Benefit increases attributable to inflation, or the indexed section 415 maximum benefit limitation, cannot be taken into account for funding purposes.[273] Again, in smaller plans where an increase in plan cost is more critical, the actuary must compensate for the plan's inability to recognize inflation in the benefit structure by using conservative interest assumptions.[274]

When a plan's assets are depleted because of inaccurate assumptions, the plan experiences a loss which, on an amortized schedule, causes annual contributions to increase when all other things are equal.[275] However, if productivity declines substantially, due to the loss of one of two employees, for instance, there may not be sufficient profits from which to make the additional annual contributions. The plan may be forced to terminate because of financial hardship, and would do so with insufficient assets.

Intentional overfunding can be accomplished by making contributions over the deductible limitation or by using conservative actuarial assumptions.[276] Intentional overfunding may result from a desire either to avoid current tax liability or to ensure additional funding security for the plan. Because these two motivations are not mutually exclusive, it is conceptually difficult to separate them. To the extent that overfunding is aimed at avoiding tax liability, the funding limitations do not create a hardship; however, to the extent that they deter employers from providing additional security for plan participants, they are unduly burdensome.

While it is not the case that nonconservative assumptions routinely produce funding deficiencies, experience losses do frequently occur.[277] To the extent that we allow employers, small

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273. See *supra* notes 239-42 and accompanying text for discussion on the effect of indexed cost-of-living adjustments on the funding limitations.

274. *See* ITELSON, *supra* note 83, at 5.

275. *See* MCGILL & GRUBBS, *supra* note 19, at 383-85 (discussing additional funding requirements for single employer plans arising when a plan has an underfunded current liability).

276. *See supra* notes 64-67 and accompanying text (discussing limits on contributions); *supra* notes 77-80 and accompanying text (discussing OBRA's limitations on interest rate assumptions).

277. *See* LANGBEIN & WOLK, *supra* note 34, at 229 (discussing the impact of actuarial

and large alike, to establish defined benefit plans, pension policy should allow employers to fund for such events.[278] Flexibility to accelerate funding could prove to be critical for some employers and employees when faced with experience losses. Therefore, employers who choose to do so either by using conservative assumptions or by contributing over the maximum deductible limitation should not be penalized.

The remaining portion of this Article focuses on the funding security motivation rather than the tax avoidance motivation for intentional accelerated funding. It explores an alternative to the flat 10% excise tax on nondeductible contributions which neither favors nor disfavors legitimate accelerated funding.

E. Plan Investment Performance

Where bias against accelerated funding stems from the belief that the deferral of taxation on pension fund earnings prompts employers to make excessively large contributions to their pension plans, the overfunding theory is highly speculative. This conclusion assumes that the tax advantages afforded to private pension plans make investment inside a plan preferable to investment outside a plan. This would be the case if: (1) money not invested in a plan were usually invested in nondeductible sources, or (2) the rate of return on investments inside plans were equal to that outside the plans. However, these two assumptions are seldom, if ever, true.

Generally, an employer will compare investing additional amounts in the plan with other *profitable* uses of the available funds. In order to avoid tax liability, an employer might consider tax-exempt municipal bonds as an alternative to the taxable savings account, for example. The employer who chooses to remain in business believes that additional money put into the business yields a better return than passive investments; therefore, alternative uses such as plant or equipment expansion are generally preferable to a taxable savings account or other passive, taxable investments.[279]

Due to risk constraints and tax consequences, investment prac-

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assumptions of interest rate).

278. *See* Stein, *supra* note 87, at 1407. Stein discusses the possibility of prohibiting the establishment of small defined benefit plans. However, until the establishment of small defined benefit plans is restricted in this manner, concern over their abuse should not affect the entire funding world.

279. *See* VEAL & MACKIEWICZ, *supra* note 57, at 207 (asserting that the argument that companies build up surplus pension fund assets fails to take into account managerial decision-making which considers other profitable investments).

tices of pension plans typically differ from those of taxable funds. Pension trust investment managers are "primarily growth-oriented and stress long-term price appreciation and capital preservation" over current dividends and interest returns.[280] Consequently, most employers do not believe that, in the short-run, putting additional money into their pension plans would be more profitable than putting it elsewhere.

A study performed by the U.S. Department of Labor showed that over the years of 1968 through 1983, plans subject to ERISA significantly underperformed market bench marks.[281] The total portfolio yield over this period for pension plans used in the study was 6.7%.[282] While this figure was higher than two of the bond indexes used in the study, it was lower than the return on 91-day U.S. Treasury Bills. Inflation over this same period was 7.1%.[283] Thus, the sample of plans studied earned a negative real return.[284] Accordingly, unless the tax advantages offset the lower investment returns, an employer who accelerated funding during this period most likely experienced a lower after-tax return on the additional contributions than it would have in an outside market.

Notwithstanding the apparent tax incentives to do so, most large and medium-sized employers do not accelerate funding by contributing amounts in excess of the minimum deductible limitation to their pension plans.[285] During times of high investment returns, many of these employers decreased their contributions rather than increased them.[286] Therefore, many employers simply do not perceive the tax advantages given to qualified pension plans as an adequate incentive to accelerate the funding of their plans.

While smaller employers are undoubtedly just as interested in maximizing their investment return as medium and large employers, small employers are more inclined to accelerate the funding of their pension plans for such reasons as securing sufficient funds to contend with experience losses and avoiding tax liability.[287] To accomplish these objectives, small employers usually rely on low

280. GAO Report, *supra* note 160, at 14.
281. ITELSON, *supra* note 83, at 15.
282. *Id.*
283. *Id.*
284. *Id.* at 16.
285. *See* IPPOLITO, *supra* note 136, at 159 (noting that most pension plans are underfunded and the resulting tax implications).
286. *See* IPPOLITO, *supra* note 136, at 70 (Table 4-5 and accompanying text).
287. *See supra* notes 266-72 and accompanying text.

investment yield assumptions or conservative funding methods that allow a build-up of greater assets and higher costs over the life of the plan.[288] The fact that many small plans are established primarily to reduce current tax liability has contributed to the perception that there is wide-spread abuse in the form of the manipulation of actuarial assumptions and funding methods, both of which serve to inflate the deductible limits. Thus, the recent emphasis on discouraging accelerated funding has specifically targeted small employers.

Under current law, overfunded amounts are not deductible under section 404 of the Code and are subject to a 10% excise tax for as long as a plan remains overfunded.[289] While these measures are designed to prevent employers from abusing the preferential tax treatment given pension plans, they fail to distinguish legitimate overfunding from abusive overfunding. As long as employers who choose to accelerate funding do not receive additional tax benefits for doing so, the tax system is not undermined by accelerated funding. Since small employers are allowed to adopt defined benefit plans, congressional action should focus solely on eliminating any additional tax benefits from overfunding, rather than on eliminating the practice of overfunding altogether. If Congress is worried about giving tax benefits to employee-owners who have no rank and file workers, enacting a plan size limitation that prohibits such employers from establishing defined benefit plans provides a better solution. In any event, Congress should not allow its concerns about isolated situations to dictate the funding policy for all plans as its recent emphasis suggests.[290] If a different approach were adopted so that overfunding was neither favored nor disfavored relative to the tax treatment of outside investments, employers would have a choice of making additional contributions to their pension plans at no additional cost to the Treasury.

Consider the following example in which there are two employers, Employer 1 and Employer 2. Both employers have contributed the maximum tax deductible amount to their respective defined benefit plans and have $5,000 after-tax dollars to invest. Assume a marginal tax rate of 28% for both employers and an interest rate of 8%.

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288. ITELSON, *supra* note 83, at 2.
289. I.R.C. § 4972(a) (1988).
290. *See supra* note 280 and accompanying text.

Part 1

Employer 1 invests $5,000 in the plan on 1/1/91 with 8% investment return. Assume 28% tax rate and 10% Excise Tax.

1 Date	2 8% Tax-Free Account Balance	3 10% Excise Tax	4 Int. Payment for Excise Tax Borrowed @ 8%	5 Tax Savings from Int. Deduction	6 P.V. of Int. Payment	7 P.V. of Tax Savings
1/1/91	$5,000	—	—	—	—	—
1/1/92	5,400	540	—	—	—	—
1/1/93	5,832	583	43	12	54	15
1/1/94	6,299	630	90	25	106	30
1/1/95	6,803	680	140	39	157	44
1/1/96	7,347	735	194	54	205	57
		$3,168	467	130	522	146

Employer 1 has $7,347 in plan on 1/1/96 and takes deduction for $5,000 on 1/1/96.

Out-of-Pocket Cost:

$3,168 (Column 3; Excise Tax)
+ 522 (Column 6; P.V. of Int. Paid)
$3,690

Savings from Tax Benefits:

$ 146 (Column 7; value of 500 deduction)
+1,400* (value of $5,000 deduction)
$1,546

Net Cost:

$3,690
-1,546
$2,144

*$5,000 (contribution)
x .28 (tax rate)
$1,400 (tax savings)

Part 2

Employer 2 invests $5,000 outside the plan on 1/1/91 in nondeductible fund with 8% investment return. Assume 28% tax rate.

1 Date	2 Taxable Account Balance	3 Interest Income	4 Income Tax Paid on Int. Income	5 (1.0576* x Tax) Interest on Borrowed Income Tax After Tax Deduction
1/1/91	$5,000	$ —	—	—
1/1/92	5,400	400	112	140
1/1/93	5,832	432	121	143
1/1/94	6,299	467	131	147
1/1/95	6,803	503	141	149
1/1/96	7,347	544	152	152
		$2,346	$657	$731

Employer 2 contributes $7,347 to plan on 1/1/96 and takes deduction for $7,347.
Employer 2 has $7,347 in plan on 1/1/96.

Savings from Tax Benefit: $2,057* (value of deduction at 28% for $7,347)

Out-of-Pocket Cost: $ 731 (Column 5; Int. on Borrowed Amount After Tax Deduction)

Net Gain: $2,057
- 731
$1,326

*$7,347 (deductible contribution)
x .28 (tax rate)
$2,057

Employer 2 is better off than Employer 1.

Employer 1 has an additional cost of $2,144.
Employer 2 has a gain of $1,326.

Therefore, there is a $3,470 difference in Employer 1's economic position as compared with Employer 2's.

Part 3
Assume same as Employer 1 except 1% Excise tax. ($5,000 in plan 1/1/91; 8% investment return; 28% marginal tax rate)

1 Date	2 8% Tax-Free Account Balance	3 1% Excise Tax	4 Int. Payment for Excise Tax Borrowed @ 8%	5 Tax Savings from Int. Deduction	6 P.V. of Int. Payment	7 P.V. of Tax Savings
1/1/91	$5,000	—	—	—	—	—
1/1/92	5,400	$54	—	—	—	—
1/1/93	5,832	$58	4	1	6	1
1/1/94	6,299	$63	9	3	11	4
1/1/95	6,803	$68	14	4	16	4
1/1/96	7,347	$73	19	5	20	5
		$316	$46	$13	$53	$14

Employer 3 has $7,347 in plan on 1/1/96 and takes deduction for $5,000 on 1/1/96.

Out-of-Pocket Cost:	$ 316	(Column 3; Excise Tax)
	+ 53	(Column 6; P.V. of Int. Paid)
	$ 369	
Savings from Tax Benefits:	14	(Column 7; P.V. of Savings)
	+1,400*	(value of $5,000 deduction)
	$1,414	
Net Gain:	$1,414	
	- 369	
	$1,045	

*$5,000 (contribution)
x .28 (tax rate)
$1,400 (deduction savings)

Even with Excise tax as low as 1%, Employer 2 is better off than Employer 3:
Employer 2 has a gain of $1,326. Employer 3 has a gain of $1,045. Therefore, there is a $281 difference in Employer 3's economic position as compared with Employer 2's.

Part 4

Assume same as Employer 1 except NO EXCISE TAX. ($5,000 in plan 1/1/91; 8% investment return; 28% marginal tax rate.)

1 Date	2 8% Tax-Free Account Balance	3 No Excise Tax	4	5
1/1/91	$5,000	—	—	—
1/1/92	5,400	—	—	—
1/1/93	5,832	—	—	—
1/1/94	6,299	—	—	—
1/1/95	6,803	—	—	—
1/1/96	7,347	—	—	—
		—	—	—

Employer 4 has $7,347 in plan on 1/1/96 and takes deduction for $5,000 on 1/1/96.

Pocket *Gain* is: $1,400* (deduction for contribution)

*$5,000 (contribution)
x .28 (tax rate)
$1,400 (deduction savings)

Employer 4 is only slightly better off than Employer 2, when same return inside plan is used as that outside:

$1,400
-1,326
$ 74

Note: As discussed on page 57, investment performance outside the plan is generally higher than inside plan. Therefore, it would be unlikely that an employer would have some return inside the plan as outside. See part 5.

Part 5

Assume same as Employer 1 except 7.5% investment return in the plan and 8% investment return outside plan. ($5,000 in plan 1/1/91; 28% marginal tax rate)

1 Date	2 7.5% Tax-Free Account Balance	3 10% Excise Tax	4 Int. Payment for Excise Tax Borrowed @ 8%	5 Tax Savings from Deduction for Int. on Borrowed Amount	6 P.V. of Int. Payment	7 P.V. of Tax Savings
1/1/91	$5,000	—	—	—	—	—
1/1/92	5,375	$538	—	—	—	—
1/1/93	5,778	578	43	12	54	15
1/1/94	6,211	621	89	25	105	30
1/1/95	6,677	668	139	39	155	44
1/1/96	7,178	718	192	54	203	57
		$3,123	$463	$130	$517	$146

Employer 5 has $7,178 in plan on 1/1/96 and takes deduction for $5,000 on 1/1/96. Employer 5 makes additional deductible contribution of $169 to plan so that there is $7,347 in plan on 1/1/96.

Out-of-Pocket *Cost* is:		Savings from Tax Benefits:	
$3,123	(Column 3)	$ 146	(Column 7)
+ 517	(Column 6)	*+1,400**	(value of deduction)
$3,640		$1,546	
169	(add. contribution)	+ *47***	(deduction for additional contribution)
$3,809		$1,593	

Net Cost:

$3,809
-1,593
$2,216

*$5000 x .28 = 1,400

**$ 169 x .28 = 47

Employer 5 is much worse off than Employer 2. Employer 5 has a cost of $2,216 and Employer 2 has a gain of $1,326.

Therefore, there is a $3,542 difference in Employer 5's economic position as compared with Employer 2's.

Part 6

Assume same as Employer 5 except NO EXCISE TAX. ($5,000 in plan 1/1/91; 7.5% investment return; 28% marginal tax rate.)

1 Date	2 7.5% Tax-Free Account Balance	3 No Excise Tax	4	5
1/1/91	$5,000	—	—	—
1/1/92	5,375	—	—	—
1/1/93	5,778	—	—	—
1/1/94	6,211	—	—	—
1/1/95	6,677	—	—	—
1/1/96	7,178	—	—	—
		—	—	—

Employer 6 has $7,178 in plan on 1/1/96 and takes a deduction for $5,000 on 1/1/96. Employer 6 makes additional deductible contribution of $169 to plan so that Employer 6 has $7,347 in plan on 1/1/96.

Pocket Gain is:

-$ 169 (additional contribution)
47** (deduction for additional contribution)
*1,400** (deduction for original $5,000 contribution)
$1,278

*$5,000 **$ 169
x .28 x .28
$1,400 47

Even with no EXCISE TAX and assuming as little as a .5% difference in investment performance, Employer 2 is still slightly better off. Employer 2 has a gain of $1,326 and Employer 6 has a gain of $1,278:

Therefore there is a $48 difference in Employer 6's economic position as compared with Employer 2's.

This example illustrates that even when equivalent interest rates are assumed, under current law, an employer who accelerates funding can be substantially worse off than an employer who invests in an outside market and later makes a contribution to a plan.[291] In the first example, Employer 1 invested $5,000 in the plan on 1/1/91 at which time the plan's assets had already reached the full funding limitation. The contribution therefore will not be deductible until 1/1/96, at which point the employer will take a deduction for the $5,000 contribution. Thus, the employer will have $7,347 in the pension plan and will have incurred an out-of-pocket cost of $2,144.

In the second example, on 1/1/91, the plan's assets had also reached the full funding limitation. Employer 2, however, invested $5,000 in an outside market on 1/1/92 and on 1/1/96 will make a deductible contribution of $7,347 to the pension plan. At this point, Employer 2 will have $7,347 in the plan and will have a pocket gain of $1,326.[292]

In 1996, under the current funding law, which both delays the deduction for the contribution and imposes a 10% excise tax, there will be a $3,690 disparity between Employer 1 and Employer 2.

Part 3 of this example illustrates that an excise tax as low as 1%, assuming these same facts, would still leave the employer who invests the additional $5,000 in the plan worse off than one who invests the same amount outside the plan.

Part 4 of this example shows that the deferral of the deduction alone is not sufficient to offset the additional tax benefit that resulted from accelerating the funding of the plan by $5,000 in 1991 when the investment return outside the plan is as high as inside. Therefore, it is necessary to calculate an excise tax to recapture the additional savings.

Investment returns inside pension plans are generally significantly less than those outside the plan.[293] Part five shows that if a slightly lower investment return of 7.5% is assumed inside the plan, the results are different. The deferral of the deduction and the

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291. It is more realistic to assume that the investment return inside the plan would not be as high as that outside of the plan. *See supra* notes 259-61 and accompanying text. This situation would make the disparity between Employer 1 and Employer 2 even greater. But for purposes of illustration, an 8% interest rate has been assumed in the above example both in and outside the plan.

292. If the employer were to invest in a tax exempt fund, there would be no out-of-pocket cost and the disparity would be greater between Employer 1 and Employer 2.

293. See part II.E for a discussion of Plan Investment Performance.

10% excise tax increases the disparity between Employer 1 and Employer 2. For Employer 5 to have $7,347 in the plan, Employer 5 must incur an out-of-pocket cost of $2,216 (which includes a deductible additional contribution to the plan). This results in a $3,542 difference between Employer 2 and Employer 5 at the beginning of the plan year in 1997.

Finally, part six shows that when a slightly lower investment return inside the plan is assumed, Employer 6 is worse off than Employer 2 even in the absence of an excise tax. The deferral of the deduction alone eliminates the additional savings from accelerated funding. Part six shows that if Employer 6 makes an additional contribution of $169 in order to secure $7,347 in the plan in 1996, Employer 6 will have a pocket gain of $1,278 which is still $48 less than the pocket gain of Employer 2.

In the above illustrations, the period over which the plan was overfunded was relatively brief, five years. Consequently, when a slightly lower investment return is assumed, the tax-free build-up of the contributions does not offset the delayed deduction. In other examples where the excess funds remain in the plan for longer periods of time, an excise tax may be necessary to recover the gain from the tax-free build-up of the contribution.

The case-by-case approach calls for an individual calculation of the appropriate excise tax rate. Under this approach, an excise tax would apply only when the delayed deduction was not adequate to treat employers who invest outside the plan similar to employers who contribute comparable amounts to a plan in excess of its full funding limitation. A determination of the specific effects of the tax benefits afforded to qualified pension plans is necessary in order to calculate such an excise tax rate. The use of an offsetting excise tax such as this creates a need for a substantial penalty or excise tax when the employer fails to indicate that she has made additional contributions, or that she has used extremely conservative actuarial assumptions. This additional tax is necessary to prevent employers from using conservative rates to accomplish overfunding without having to pay the offsetting excise tax affecting overfunded plans. In other words, without a significant deterrent, employers may make conservative projections and take the chance that they will not be discovered on audit rather than voluntarily pay the proposed offsetting excise tax.

The following discussion identifies the extent to which preferential tax treatment of pension plans results in tax gains that should be recaptured when an employer overfunds. It also explores

the conditions which make it advantageous for employers to accelerate funding and proposes an offsetting excise tax that is reasonably easy to administer and enforce.

F. Identifying the Tax Gains That Result from Accelerated Funding

As discussed in part I of this Article, the two tax benefits given to qualified pension plans are the accelerated deduction for the employer and the tax-free build-up of the plan's assets.[294] The immediate deduction of plan contributions can provide a tax planning benefit to employers because they know exactly what the deduction is worth in relationship to their current tax positions. However, it does not truly provide an economic benefit unless income tax rates decrease.[295] A larger current deduction for additional contributions is more valuable to employers if they anticipate that their respective tax rates will fall. That is, the employer would achieve greater tax savings by accelerating funding and taking earlier deductions at the higher tax rates. Conversely, when tax rates are expected to increase, the employer will receive a greater economic benefit by funding more slowly or taking a delayed deduction for current funding so that the deductions could be taken at the expected higher tax rates.[296] Because current rates are relatively low and expected to increase, it seems that employers would not be inclined to accelerate funding in order to obtain immediate deductions. Employers would derive a greater economic benefit by funding more slowly and taking a deduction later so that larger portions of their funding occurs when the tax rates are higher.

Thus, the tax-free build-up of plan assets presumably provides a stronger incentive for employers to accelerate plan funding rather than to defer it.[297] The faster a plan is funded, the more time is available for the tax-free build-up to accumulate. Stated differently, the greater the time between the contribution and its later deduction, the greater the benefit for accelerating funding.[298] In the il-

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294. *See supra* text accompanying notes 4-5; *see also* Halperin, *supra* note 104, at 159-60.

295. *See* Halperin, *supra* note 6, at 521-24 (explaining why this result occurs).

296. *Id.*; *see also* Alvin C. Warren, Jr., *The Timing of Taxes*, 39 NAT'L TAX J. 499, 501-02 (1986) (discussing the economic benefits from timing deductions according to changes in the tax rates).

297. VEAL & MACKIEWICZ, *supra* note 57, at 207 (criticizing the argument that the deferral of taxation of pension fund earnings results in overfunding).

298. Halperin, *supra* note 6, at 510.

lustration above, the period over which the plan was overfunded was five years. Consequently, the tax-free build-up had a limited effect on the employer's economic position. As time passes, however, the tax-free growth will increase resulting in smaller annual contribution requirements. The longer the plan is overfunded, the less the employer will be required to contribute to meet the minimum funding requirements. Consequently, accelerated funding will eventually result in additional tax benefits.

While the single most important goal of the pension program is to encourage rank and file employees who could not ordinarily do so to adequately save for retirement, the funding restrictions placed on pension plans have more than one purpose. The funding limitations ensure that sufficient amounts of assets are available when benefits become payable, and they also limit the cost of the pension program by limiting the tax-free build-up that any one employer can receive in a given plan year.[299]

If the only purpose of the funding limitations were to prevent employers from obtaining additional tax savings, and one believes that the participants in fact fund the pension plans by accepting lowered wages, then the additional tax-free build-up of the contributions would not be disturbing, particularly in situations where there were sufficient numbers of rank and file workers covered by the plan to justify favorable tax treatment. This is so because in a defined benefit plan the retirement benefits are not determined by the investment performance of the plan assets. Consequently, actual retirement benefits are not affected by the rate at which the plan is funded.[300] The additional tax gain from accelerated funding would provide greater savings to the plan participants at a lower cost. By accelerating the funding of the plan, current wages would not have to be cut as much to provide the same retirement benefit.[301] As a matter of pension policy, the additional tax benefits resulting from the longer growth period would not be inappropriate and, in fact, would seem more consistent with the goals of ERISA than the current, funding limitations.

However, limiting the employer's tax benefit is not the only

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299. *See* H.R. Rep. No. 391, 100th Cong., 1st Sess. (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-601, 612 (discussing reasons for pension law).

300. *See supra* notes 17-20 and accompanying text for description of the funding of a defined benefit plan.

301. For discussion of the effect of pension contributions on current wages, see *supra* text accompanying notes 126-36.

purpose for the funding limitations. An equally important purpose is to reduce the cost of the pension program. This reality makes it necessary to reach a different conclusion with respect to the overfunding issue. While the additional tax benefits may leave workers better off, the additional tax benefits, nevertheless, increase the cost of the pension program. Therefore, to the extent that policymakers attempt to reduce tax expenditures for qualified pension plans, accelerated funding is a problem. In looking for alternatives to current law that neither favor nor disfavor overfunding, it is necessary to identify methods by which the additional tax gains attributable to accelerated funding can be properly identified and recovered so that the cost of the pension program does not soar.

G. Alternative Methods to Recapture the Tax Gains Attributed to Overfunded Amounts

Because the most important aspect of the preferential treatment of pension plans is the tax-free build-up of investment earnings, any approach designed neither to favor nor to disfavor accelerated funding would have to recapture gains resulting from the tax-free growth of excess plan assets. The accumulated earnings on excess assets are a function of several variables such as the period over which the plan was overfunded, the investment return, and the employer's marginal tax rate.[302] In order to accurately recover lost revenue, an alternative method of taxation would have to identify and measure all of the relevant factors before recovery could occur.

One way of calculating the additional tax benefit from accelerated funding is to use the plan's actual investment rate of return and compare that to an average outside investment rate. The imposition of an excise tax that annually equates the value of a plan's excess assets with a hypothetical account of the same excess assets that have been invested in comparable outside markets at regular tax rates would accomplish this goal. To compute such an offsetting excise tax, the following calculations are necessary: (1) an annual appraisal of the plan's excess assets; (2) a calculation of the annual growth of the excess assets; and (3) a determination of the yearly tax savings on the tax-free build-up inside the plan based upon comparison to taxable outside sources. An excise tax so calculated could offset the tax-free build-up of the excess contributions while the plan is overfunded. Once the plan ceases to be

302. *See* GAO Report, *supra* note 160, at 5-6.

overfunded, the original contribution, along with the build-up, is deductible.

1. Annual Appraisal of the Plan's Excess Assets

The difference between a plan's assets and a plan's accrued liabilities determines whether the plan is overfunded.[303] A plan's funding position is presently calculated by using the current liability concept which is based upon the present value of accrued benefits rather than the present value of expected benefits.[304] The current liability concept is designed to reduce the deductible contribution level. As a result, employers are required to make greater payments later rather than smaller payments sooner. Because the current liability concept can understate the cost of the plan, it could not reasonably serve as the basis for a policy that facilitates greater funding flexibility. For purposes of designing an alternative method of taxation to liberalize funding practices, it is more appropriate to use the present value of projected benefits, rather than the current liability.

For purposes of identifying funding surpluses, amounts attributable to extremely conservative actuarial assumptions should also be considered. While the use of conservative interest rate assumptions may be justifiable, lower investment yield assumptions nevertheless allow greater contributions and generate greater tax benefits.[305] Unless overfunding is defined also to include amounts resulting from the use of extremely conservative assumptions, employers will be encouraged to overfund using this method as opposed to overfunding by making contributions in excess of the limitations. Because both practices reach the same result, a faster tax-free build-up, employers who accelerate funding by using conservative actuarial assumptions should be treated similarly to employers who accelerate funding by contributing in excess of the full funding limitation.

The case-by-case approach calculates an offsetting excise tax which applies when employers chose to accelerate funding. This offsetting tax is designed to leave the employer neither better off nor worse off for overfunding. The offsetting excise tax could be

303. See *supra* text accompanying notes 67-72 for a discussion of the full funding limitation or "overfunding."

304. *See supra* text accompanying notes 70-72.

305. For a discussion of the use of conservative interest rate assumptions, see *supra* text accompanying notes 77-80.

effective only in cases where the employer *indicates* that the plan is being overfunded by additional contributions or the use of extremely conservative actuarial assumptions. As a result, if the employer were to use conservative assumptions and claim they were reasonable based on the unique facts and circumstances of the plan's investment history, for example, the offsetting excise tax would not apply. Thus, in this situation the employer clearly would be better off by overfunding. To avoid this result, it would be necessary to apply a substantial penalty in situations where conservative rates were used but not acknowledged by the employer. Thus, employers would be discouraged from taking the risk of not being discovered. For example, if an additional tax of 25% were imposed on overfunded amounts which had not been reported, the temptation for the employer to play "audit roulette" would drastically diminish.

In order to implement such a system, employers would have to know what assumptions the IRS considers unreasonable or "unsafe" for purposes of the offsetting excise tax. One solution is for Congress to publish annually "safe harbor" interests rates and other actuarial assumptions. The interest rate assumption could be defined in terms of the effective rates for Treasury notes. Alternatively, these rates could be defined numerically. In any event, assumptions falling outside these guidelines would be in "unsafe harbors." Some employers and actuaries would resist this proposal out of concern that "unsafe harbors" such as these are too restrictive and do not allow for special facts and circumstances which make the use of conservative assumptions reasonable. In response to these types of concerns, it would be necessary to have a process which allowed the employer who uses extremely conservative actuarial assumptions, which in fact are reasonable, to apply in advance for some type of relief.

In order to measure the surplus that results from the use of conservative assumptions, it is necessary to compare contributions based on reasonable assumptions to contributions based on conservative assumptions. Plans using rates that fall in "unsafe" ranges would have excess assets equaling the difference in what would have accumulated under reasonable assumptions and what, in fact, accumulated under the plan's conservative rates. In other words, there is a presumption that the use of actuarial assumptions falling within an "unsafe" range are unreasonable and would have to be justified by the employer or the actuary. The inability to justify such rates would then cause a penalty to apply to the excess

amounts. Without a penalty for the use of unreasonably conservative actuarial assumptions, employers would be encouraged to accelerate funding through the use of conservative rates rather than contributing in excess of the funding limitations. This is so because the conservative rates, if not challenged on audit, would go undetected. As a result, these employers would not be required to pay the offsetting excise tax that they would otherwise have to pay had they made contributions in excess of the funding limitations under the case-by-case approach. In order not to favor employers who accelerate funding over those who do not, the excess should not be currently deductible, and such amounts could be properly carried forward to future plan years.

2. Calculation of the Annual Growth Rate

The portion of plan assets that comprises the additional tax benefit attributable to excess funds is affected by the rate of return on pension assets. Because the tax treatment of income varies widely depending on the type of investment, it is necessary to differentiate among the various sources of plan income in order to properly allocate tax gains to surplus amounts. The investment experience of the plan is annually documented on the schedule B, Form 5500.[306] One method of estimation is to allocate the plan's investment return so that a proportional amount of the growth is attributable to the surplus. For example, assume that a plan has total assets of $100,000 and is overfunded by $20,000. If the average investment income yield on a plan's assets in a given year is 8% or $8,000, 20% or $1,600 of the plan's growth is attributable to the excess assets and, therefore, used for purposes of calculating the offsetting excise tax. Alternatively, pre-determined investment return estimates can be used for this purpose. However, the use of average corporate taxable investments yields would probably overstate the investment return of pension assets because of differences in the respective management practices.

3. Tax Rates and Timing

In order to determine the tax savings received by an employer from the accumulation of excess assets in a plan, it is necessary to

306. Form 5500 includes information on the operation of the plan. Specifically, Form 5500 contains "identifying information, statistics on participants, a balance sheet, a statement of income and expense, and other information about the operation of the plan." MCGILL & GRUBBS, *supra* note 19, at 65.

treat the surplus accumulation as if it had been invested in a taxable instrument outside the plan. The employer's tax rate at the time the plan is overfunded affects the extent to which tax gains result from overfunding and is the real measurement of the tax benefit. Thus, for comparison purposes, one must identify the applicable tax rate which would have applied to the growth of a plan's excess assets had they been invested in an outside taxable instrument. This rate then applies to the earnings of the surplus assets. Because outside investments vary in investment yield, many of which are tax exempt, it is difficult to calculate an overall outside, after-tax rate of return. Here again, an average rate could be used to approximate outside investment performance.

The timing of the offsetting tax is another aspect of this proposal which must be considered. Requiring that the above determinations be made on a yearly basis, or one consistent with the frequency of actuarial valuations, suggests that the tax be imposed at the same time.[307] Thus, if the above determinations are made every two years when the plan's valuations are performed, the tax would become payable at such time.

IV. CONCLUSION

While the excise tax under section 4972 currently applies to all nondeductible contributions, the 10% rate appears to have been determined arbitrarily rather than methodically. As a result, it applies in all overfunded situations regardless of whether a tax gain has actually occurred or not. Under current law, employers have no realistic option of accelerating funding since such action will generally leave the employers worse off.

In contrast, an individually-calculated excise tax would take into account the various items that determine whether and to what extent an additional tax benefit actually results from a given instance of overfunding. The recording and reporting for such a tax are fairly simple and impose little additional burdens on employers, since the underlying calculations needed to make the necessary determinations are already reported in accounting statements, Form 5500, as well as in actuarial valuations.

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307. Sponsors of defined benefit plans are required to perform actuarial valuations every three years. I.R.C. § 412(c)(2) (1988) (giving method for valuing plan assets), and § 6059(a) (requiring an actuarial report to be filed every three years after filing a report following the first year of the plan).

The 10% fixed excise rate or any other fixed rate which better approximates the tax gains generated by excess amounts in pension plans should, however, remain an option for employers who would rather not have the additional recording and reporting responsibility required by an individually-calculated excise tax. Employers should therefore have a choice between accelerating funding or not, as well as a choice between using a fixed excise tax rate or not.

Relative to the tax treatment of comparable investments outside a plan, the proposed offsetting excise tax neither favors nor disfavors accelerated funding. As demonstrated, the disallowance of a deduction in many situations is sufficient to treat, for tax purposes, excess assets invested in a plan similar to amounts invested outside the plan. In the remaining cases, the period of time over which the excess assets are sheltered in the plan causes a greater benefit from overfunding. Thus, it is necessary to measure the tax gains generated by the overfunding and determine an excise tax which accurately recaptures the additional gain. The individually-calculated excise tax accomplishes this task and is administratively feasible since it overlaps other already-existing reporting requirements.