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Multiemployer Pension Plans: The Section 415 Benefit Limits

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Summary

Section 415(b) of the Internal Revenue Code sets limits on the maximum dollar benefit that can be paid from a tax-qualified pension plan. It also sets a limit on the percentage of a participant's salary that can be replaced by pension benefits. In 2001, the maximum annual pension benefit that can be paid from a defined benefit pension plan is the lesser of $140,000 or 100% of the average annual compensation over a participant's highest 3 consecutive years. The dollar limit is actuarially reduced for early retirement (before the Social Security normal retirement age). These limits are designed to prevent tax abuse and to avoid overly generous pension benefits subsidized at taxpayer expense. Multiemployer pension plans have been seeking relief from §415(b) limits, arguing that benefit formulas in these collectively bargained plans are not related to compensation, and the §415 limits unfairly reduce the pensions of low and middle income workers.

In the 107th Congress, the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA), signed into law on June 7, 2001 (P.L. 107-16), included provisions to exempt multiemployer plans from the §415(b) limit of 100% of the average compensation of an individual's highest consecutive 3 years beginning in 2002. In addition, EGTRRA eliminates the requirement that defined benefit plans make actuarial adjustments to annuities that start from ages 62 to 65. (This report will not be updated.)

Background

Most retirement income plans are employment-based. Only about half the workforce is covered by employer pension plans. Federal law does not force employers to offer retirement plans, but those that do must comply with the Employee Retirement Income Security Act (ERISA) of 1974 (P.L. 93-406) and the Internal Revenue Code in order to gain favorable tax treatment of the plan. ERISA sets standards for coverage, funding, vesting of benefit rights, fiduciary responsibilities, and information disclosure. The tax code replicates ERISA rules as standards a plan must meet to qualify for tax preferences, and limits contributions and regulates benefit distributions. The purpose of these tax rules

is to limit the federal revenue foregone through tax preferences and to assure that tax-advantaged plans help workers broadly in a fair, nondiscriminatory way. Since revenue foregone from deferral of taxes on plan contributions and investment earnings amounts to the largest federal *tax expenditure*, modest changes in pension limits yield immediate revenue gains or losses.

Section 415 of the Internal Revenue Code limits the annual benefit that may be paid from tax-qualified pension plans. The particular limits on contributions and benefits that apply to a qualified pension plan depend on whether it is a defined benefit plan or a defined contribution plan.[1] Paragraph (b) of Section 415 sets limits on benefits paid from defined benefit plans. The public policy purposes for these limits are: (1) to guard against *overly generous* pension benefits such as those top executives might get; and (2) to restrict the total size of tax-qualified pension plans in order to limit the federal revenue foregone for this purpose.

History of §415 Limitations

The §415(b) dollar limit was first established when the Employee Retirement Income Security Act (ERISA) was enacted in 1974. Prior to that time, there was no specific dollar limit on pension benefits, but an income tax provision limited pensions to no more than 100% of compensation. The dollar limit originally was set by ERISA at $75,000 but was permitted to grow with inflation. By 1982, it had reached $136,425. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 (P.L. 97-248) scaled it back to $90,000 to reduce federal revenue loss and froze it at that level until 1988, when it again was inflation-indexed. The limit grew to $118,800 in 1994 but became subject to new *rounding down* rules in 1995 that were also designed to stem revenue loss. The dollar limit is now increased for inflation in multiples of $5,000. An inflation adjustment increased the §415(b) dollar limit to $120,000 in 1995. It rose to $125,000 in 1997, $130,000 in 1998, $135,000 in 2000, and $140,000 in 2001.

The maximum annual benefit payable in 2001 for someone retiring at age 65 is the lesser of $140,000 or 100% of the participant's highest consecutive 3-year average compensation. If retirement benefits begin before the Social Security normal retirement age (currently age 65 but scheduled to increase gradually to age 67 beginning in 2000), the $140,000 limit is reduced actuarially to reflect the longer payout period.[2] Conversely, the limit is increased for benefit payments commencing after the participant has reached Social Security normal retirement age. Furthermore, the dollar limit and the 100% of compensation limit are proportionately reduced for a participant with less than 10 years of plan participation.

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[1] A *defined benefit* plan uses a formula that ties benefits to either a worker's salary or a specific dollar amount and is funded on a group basis. A *defined contribution* plan invests employer and employee contributions in individual accounts from which benefits are paid when participants retire.

[2] In 1975, a 55-year-old could receive a $75,000 annual pension (no actuarial reduction required); in 1999, despite 24 years of inflation, the most an employee of a private-sector business can receive at that age is about $57,200 (after §415 limits and actuarial reduction for early retirement).

Certain pension plans are exempt from some §415(b) limits. Specifically, plans maintained by governments and tax-exempt organizations and qualified merchant marine plans are not subject to the early retirement adjustments required for retirements before the Social Security normal retirement age. Instead, these plans determine early retirement actuarial reductions in benefits from age 62 and are covered by a provision that prevents an early retirement pension benefit from being reduced below $75,000. Governmental plans are also exempt from the 100% of high-3 pay limit, as well as from survivor and disability pension dollar limitations that otherwise apply to early retirements and to employees with less than 10 years of plan participation. Qualified police and firefighter pension plans are exempt from any early retirement actuarial reduction of benefits.

Multiemployer Pension Plans

A multiemployer pension plan is a collectively bargained arrangement between a labor union and a group of employers in a particular trade or industry. These plans cover groups of workers in the unionized sector of such industries as trucking, building and construction, clothing and textiles, food and commercial workers, among others. The coverage continues when they change jobs if the new employment is with a participating employer. These plans offer a means for workers in industries where job change is frequent to build up pension rights over a career. Over 10 million workers are covered by multiemployer plans, as are millions more of their family members.

Unlike plans covering salaried employees which base pension benefits on compensation (e.g., 2% of final average pay for each year of service), multiemployer pension plans usually determine pension amounts by multiplying the number of years of covered service by a flat dollar amount. Although the dollar amount in these formulas sometimes varies with an employee's earnings or service, the predominant method used, according to the U.S. Bureau of Labor Statistics, is to multiply a uniform (single) dollar amount by years of service. Employer contributions to multiemployer plans are set through collective bargaining and are usually based on the number of hours worked by union employees. In many collective bargaining negotiations, the employer offers a per-hour total compensation amount, and it is left to the union to decide how to allocate this compensation among cash wages, pension, health and other benefits.

Multiemployer plans typically provide the same annual retirement benefit to all participants with the same amount of service, regardless of pay level. As a result, multiemployer pension plans tend to be more advantageous to lower paid workers with long service. However, the §415(b) limits can lower significantly the pension benefits of workers who: (1) retire early; (2) have unstable employment and fluctuating wages; or (3) earn low wages over long periods of covered employment.

Problems Beneficiaries Have With §415 Limits

Participants of multiemployer pension plans face different problems with the §415(b) limits. Benefits in multiemployer plans are not linked to wages. Thus benefits often are more generous to low-wage workers than to higher-wage workers in the same plan. However, under the 100% of high-3 compensation limit, many low-wage workers could see their pension benefits lowered by the §415(b) limit. In addition, the physically demanding nature of the work of industries covered by multiemployer plans can result in

workers retiring at age 50 or 55 after 30 years of heavy physical labor. In such cases, a worker's pension benefit would be actuarially reduced, significantly lowering the worker's benefit as the result of a provision in §415(b). The following examples illustrate the types of problems facing multiemployer plan participants.

The problem multiemployer plan beneficiaries face from the §415(b) 100% of high-3 pay limit can be illustrated by the following example. In the case of a multiemployer plan in the construction-industry that has negotiated a pension benefit equal to $80 a month for every year of service, a worker with 35 years of covered service could be eligible to receive a monthly pension of $2,800 (35 x $80), or $33,600 annually. The regular hourly wage rate for workers participating in the plan is $16, or $32,000 a year if work is available for 2,000 hours per year. However, in this industry workers rarely work a full 2,000 hours in a year due to seasonal unemployment and downturns in the industry. In recent years, plan participants have only been working an average of 1,450 hours a year, therefore, earning an average of about $23,200 a year. If the average consecutive high-3 wage of such a worker who reached the 35-year maximum pension contribution was only $23,200, under the collectively bargained agreement the worker would be entitled to the maximum pension benefit of $33,600. However, the §415(b) 100% of high-3 pay limit would prohibit the worker from receiving a pension benefit of more than $23,200. Thus, in this example the worker's annual pension benefit would be reduced $10,400, or about $867 a month, a 31% reduction.

Similarly a low-wage worker's pension benefits also could be lowered significantly by §415(b) below what was provided in a collectively bargained agreement. High benefits and relatively low pay may have become a more acute problem in some plans, where unions have granted benefit increases while available work in the industry — and the higher pay that comes with it — has declined. Special problems can also arise in multiemployer plans that allow more than 1 year of service to be earned in a calendar year, so that if an individual worked heavy overtime and regularly accumulated a large total number of hours worked per year, even at relatively low wages, the accrued pension could exceed the average high-3 compensation limit. In addition, the inclusion of a low earnings year in the 100% of *consecutive* high-3 annual average compensation limit can lower a worker's pension benefit.

In addition to the problems with the 100% of high-3 pay limit, participants of multiemployer plans face significant actuarial reductions of their pension benefits for early retirement under §415(b). As noted above, many of the workers employed by industries participating in multiemployer plans, such as the building and construction trades, find that the physical demands of these jobs often require them to retire at younger ages than the Social Security normal retirement age (currently age 65). For early retirements, §415(b) requires the dollar limit of the pension benefit to be reduced actuarially for each year under the Social Security normal retirement age. Assuming an actuarial reduction of 5%, a worker retiring at age 55 could see pension benefits reduced by almost 50% (5% x 10 years) by the §415 limit.

Policy Issues

While §415(b) limits have been around since passage of ERISA, they have become a concern to multiemployer pension plans in recent years. As a result, multiemployer pension plans continue to seek relief from §415(b) limits, particularly the 100% of average high-3 compensation limit. They argue that their benefit formulas are not related to an individual's compensation but are set uniformly for all employees. They also argue that multiemployer pension plans are not easily manipulable for tax avoidance. Since employer contributions to finance these plans are set through collective bargaining, it is argued that these plans cannot be used by individuals or firms as *tax dodges* or tax shelters. If a plan is found to be in violation of these limits, it can be disqualified by the Internal Revenue Service.

An exemption of multiemployer plans from §415 limits could be questioned on the grounds that unions have chosen to structure their pension plans without regard for the limits established for all other pension plans by the Internal Revenue Code. It could be argued that exempting multiemployer plans from §415 limits might lead to an unraveling of limits that were enacted to limit tax preferences for highly compensated workers. Of course, the design of these plans preceded enactment of the §415 limits, so unions may find it difficult to make drastic changes in plan design, given their member's expectations.

Over the years, there have been legislative efforts to waive the §415(b) limits for multiemployer pension plans. The Senate-passed version of the vetoed Balanced Budget Act of 1995 (H.R. 2491) would have exempted both public pension plans and multiemployer pension plans from both the 100% of compensation limit and the early retirement reduction. The House did not have a comparable provision, and the conference agreement did not include the Senate amendment. An exemption from both the 100% compensation limit and the early retirement reduction was later included in the Small Business Job Protection Act (H.R. 3448) signed into law in 1996 (P.L. 104-188), but the exemption was granted only to governmental pension plans.

In obtaining this relief, public plans successfully argued that they were not designed as tax shelters for the highly paid. If their employees have pension benefits exceeding their highest consecutive 3-year salary, they argued that it is because of long careers and relatively generous pension benefit formulas that were designed to compensate for a lack of Social Security coverage. Also, cost-of-living adjustments often increase public pension benefits after retirement. Though relief from the 100% of high-3 pay limit was provided to governmental plans in 1996, no policy reason was given for excluding multiemployer plans from this relief. Perhaps one indication of why the Congress did not enact an exemption for multiemployer plans may have been the estimated cost of such a provision. The Joint Committee on Taxation in March 1996 estimated that exempting governmental plans from the 100% of high-3 pay limit would have a negligible revenue effect, but that the same exemption for multiemployer plans would reduce revenue by $14 million for FY1997-FY2001, and by $36 million for FY1997-FY2006.

The problems faced by participants of multiemployer plans raise some interesting public policy issues. It is important to consider whether federal law should protect multiemployer plan pension benefits, giving them special exemptions from provisions that apply to all other private pension plans. Should the Congress be concerned with providing further favorable treatment for multiemployer plans when such plans already receive the

favorable tax treatment provided all qualified pension plans? Some might argue that it does not serve the public interest to provide such pension plans with additional exceptions to limits that are designed to encourage individuals to continue working until the Social Security normal retirement age. Should participants of multiemployer pension plans be exempt from pension limits that apply to all other pension beneficiaries? Most multiemployer plan participants are eligible to receive Social Security benefits that will supplement their pension benefits. When millions of workers receive no employer-provided pension benefits at retirement age, is it in the public interest to provide participants of multiemployer plans with additional favorable treatment under the tax code that will have the effect of lowering federal revenue?

Legislative Developments

In the 107th Congress, the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA), signed into law on June 7, 2001 (P.L. 107-16), included provisions affecting multiemployer plans beginning in 2002. EGTRRA exempts multiemployer plans from the §415(b) limit of 100% of the average compensation of an individual's highest consecutive 3 years. The dollar limit will increase to $160,000 in 2002, and will continue to apply to multiemployer plans. If an employer contributes to both a multiemployer plan and a single employer plan covering the same participant, the benefits accrued under the multiemployer plan will not be required to be aggregated with the benefits accrued under the single employer plan when applying the 100% of compensation limit to the single employer plan. However, aggregation will still be required for applying the dollar limitation to the participant's benefits. In addition, EGTRRA eliminates the requirement that defined benefit plans make actuarial adjustments to annuities that start from ages 62 to 65.