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CRS Report for Congress

H.R. 4: The Pension Protection Act

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Summary

On December 15, 2005, the House of Representatives passed H.R. 2830, the Pension Protection Act, by a vote of 294-132. On November 16, 2005, the Senate passed S. 1783, the Pension Security and Transparency Act. On March 3, 2006, the Senate again passed the Pension Security and Transparency Act by unanimous consent as an amendment in the nature of a substitute to H.R. 2830.[1] Conference negotiations between the House and Senate commenced on March 8, 2006. On July 28, 2006, the House passed an amended version of the Pension Protection Act — renumbered as H.R. 4 — by a vote of 279-131. The bill was passed by the Senate on August 3 by a vote of 93-5 and was signed into law by the President as P.L. 109-280 on August 17, 2006.

The Pension Protection Act (PPA) reforms the funding rules for defined benefit pensions; requires employers to disclose more information about pension funding; restricts benefit payments and accruals in underfunded plans; and clarifies, prospectively, that cash balance pension plans do not violate legal prohibitions on age discrimination in employee benefits. The bill imposes a fee of $1,250 per participant per year on bankrupt employers that terminate their pension plans and turn their pensions over to the Pension Benefit Guaranty Corporation. The fee applies for three years after a firm emerges from bankruptcy. "Shutdown" benefits may be paid only from pensions that are at least 60% funded and treated as benefit increases for purposes of applying PBGC insurance guarantees. This report will not be updated.

Funding Requirements for Single-Employer Pension Plans. The Pension Protection Act increases funding requirements for defined benefit pension plans and shortens the period over which funding shortfalls must be eliminated. In general, it requires plans to fund 100% of their "funding target," which under prior law was referred to as the plan's "current liability." The funding target is the present value of all benefits — including early retirement benefits — that plan participants have earned as of the beginning of the plan year. The plan must amortize any funding shortfalls over seven years. Under prior law, a plan's unfunded liability could be amortized over periods of 5

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[1] For a description of the Pension Security and Transparency Act, see CRS Report RS22221.

to 30 years. Under the PPA, a plan's funding requirement is the present value of the benefits expected to be earned during the year by active participants (the plan's "normal cost") plus payments to amortize over seven years any pre-existing unfunded liability, less any permissible credit balance for prior contributions. The 100% funding target will be phased in at 92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011 and later years. The phase-in will not apply to plans that are underfunded to the extent that they are subject to the deficit reduction contribution rules in 2007. Those firms will have a 100% funding target beginning in 2008.

Plans considered "at-risk" of default will be required to use specific actuarial assumptions in determining plan liability. A plan will be deemed at-risk if it is unable to pass either of two tests. Under the first test, a plan is deemed to be at-risk if it is less than 70% funded under the "worst-case scenario" assumptions that the employer is not permitted to use credit balances to reduce its cash contribution and that employees will take the most expensive form of benefit and retire at the earliest possible date. If a plan does not pass this test it will be deemed to be at-risk *unless* it is at least 80% funded under standard actuarial assumptions. This latter test will be phased in over four years, starting at 65% in 2008 and rising to 70% in 2009, 75% in 2010, and 80% in 2011. If a plan passes either of these two tests, it will not be deemed to be at-risk; however it will still be required to make up its funding shortfall over no more than seven years. At-risk plans will be charged a "loading factor" of 4% of the plan's liabilities plus $700 per participant, which will be added to the plan sponsor's required contribution to the plan. The loading factor of 4% of plan liability plus $700 per participant will apply for at-risk plans that were also at-risk for two of the previous four years. Plan years prior to 2008 will not count for this determination.

Treatment of Commercial Airline Pension Plans. Firms that are experiencing financial difficulties sometimes freeze their pension plans to reduce expenses. Under a "hard freeze," the plan is closed to new participants and current participants cease to accrue additional benefits under the plan. Under a "soft freeze," the plan is closed to new participants, but current participants continue to accrue benefits for each additional year of service under the plan. Under the PPA, airlines that have put their pension plans under a "hard freeze," are allowed 17 years to fund their initial pension liabilities, rather than the seven-year period allowed non-airline plan sponsors. In addition, such airlines will be allowed to use a discount rate of 8.85% in calculating plan liabilities, which is higher than current market interest rates and therefore would reduce plan liabilities.[2] The law allows other airlines, including those that opt for a "soft freeze" of their plans, a total of 10 years rather than seven years to fund their initial unfunded liabilities. In either case, a plan termination premium of $2,500 per plan participant per year will be charged to the airline for three years if it terminates its pension plan during bankruptcy. The plan sponsor would pay the premium after emerging from bankruptcy.

Valuation of Assets and Liabilities. Under prior law, a plan sponsor could determine the value of a plan's assets using actuarial valuations, which can differ from the current market value of those assets. For example, in an actuarial valuation, the plan's investment returns could be "smoothed" (averaged) over a five-year period, and the

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[2] Actuaries estimate that each percentage point increase in the discount rate reduces the present value of pension plan liabilities by 10% to 15%.

average asset value could range from 80% to 120% of the fair market value. Smoothing is permitted because pension plans are considered long-term commitments, and smoothing reduces volatility in the measurement of plan liabilities and assets that can be caused by year-to-year fluctuations in interest rates and the rate of return on investments. Smoothing of interest rates and asset values therefore reduces the year-to-year volatility in the plan sponsor's required minimum contributions to a defined benefit pension plan. The PPA narrows the range for actuarial valuations from 90% to 110% of the fair market value of assets and reduces the maximum smoothing period to two years.

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

Under the PPA, plan sponsors must determine the funding target using three interest rates, which will be based on when the benefits are projected to be paid: in less than five years, in five to 15 years, or in more than 15 years. The Secretary of the Treasury will determine these rates, which will be derived from a "yield curve" of investment-grade corporate bonds.[3] Interest rates will be averaged over a three-year period under a formula using 50% of the rate from the most recent plan year, 35% of the rate from the previous plan year, and 15% from the plan year before that. The use of the yield curve will be phased in at 33% in 2008, 66% in 2009, and 100% thereafter. This methodology will permanently replace the four-year average of corporate bond rates established under P.L. 108-218, which expired December 31, 2005.

Contribution Limits and Credit Balances. The PPA will allow plan sponsors to contribute more to their pension plans than they could under prior law. It sets the maximum tax-deductible contribution at 180% of the plan's current liability. Within certain limits, sponsors will be able to offset required current contributions with previous contributions. However, these so-called "credit balances" can be used to reduce the plan sponsor's minimum required contribution to the plan only if the plan's assets are at least 80% of the funding target, not counting prefunding balances that have arisen since the new law became effective. Existing credit balances and new prefunding balances must both be subtracted from assets in determining the "adjusted funding target attainment" percentage that is used to determine whether certain benefits can be paid and whether benefit increases are allowed. Credit balances also have to be adjusted for investment gains and losses since the date of the original contribution that created the credit balance.

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

Lump-Sum Distributions. Federal law requires defined benefit pensions to offer participants the option to receive their accrued benefits in the form of an annuity — a series of monthly payments guaranteed for life. Some defined benefit plans also offer participants the option to take their accrued benefit as a single lump sum at the time they separate from the employer. The amount of a lump-sum distribution from a defined benefit pension is inversely related to the interest used to calculate the present value of the benefit that has been accrued under the plan: the higher the interest rate, the smaller the lump-sum and vice versa. Under prior law, lump-sum distributions were calculated using the average interest rate on 30-year Treasury bonds. The interest rate on long-term Treasury securities has historically been lower than the average interest rate on long-term investment-grade corporate bonds because bond markets generally consider U.S. Treasury securities to be free of the risk of default.

The PPA requires plan sponsors to calculate lump-sum distributions using three interest rates based on investment-grade corporate bonds. As a result, participants of different ages will have their lump-sum distributions calculated using different interest rates. Other things being equal, lump-sum distributions paid to workers nearer to retirement will be calculated using a lower interest rate than would be used for younger workers. As a result, all else being equal, an older worker will receive a larger lump-sum than a similarly situated younger worker. The interest rates used to calculate lump sums will be based on *current* bond rates rather than the three-year *weighted average* rate used to calculate the plan's funding target. The new rules for calculating lump sums will be phased in over five years. Plans that are funded at less than 60% will be prohibited from paying lump-sum distributions. Plans funded at 60% to 80% can pay no more than half of an accrued benefit as a lump-sum distribution.

PBGC Premiums for Single-Employer Plans. The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to insure pension benefits under private-sector defined benefit pension plans. The PBGC is funded by premiums paid by plan sponsors and investment returns on the assets held in its trust fund. It receives no appropriations from Congress. The PBGC does not have the legal authority to set its own premiums, which are set in law by Congress. The PBGC receives two types of premiums from plans sponsored by individual employers: a per-capita premium that is charged to all single-employer defined benefit plans and a variable premium equal to $9 per $1,000 of underfunding (0.9%) charged to underfunded plans. The Deficit Reduction Act of 2005 (P.L. 109-171) increased the per capita premium from $19 per year to $30 per year, beginning in 2006. Future premiums will be indexed to average national wage growth. Under prior law, a plan was exempted from the variable-rate premium of $9 per $1,000 of underfunding if it was not underfunded in any two consecutive years out of the previous three years. Under the PPA, the variable premium will be assessed on all underfunded plans, regardless of the plan's funding status in earlier years.

Limits on Benefits in Underfunded Plans. The PPA will limit certain forms of benefit payments and the accrual of new benefits in underfunded plans. Plans funded at less than 60% will not be permitted pay lump-sum distributions, and the law prohibits further benefit accruals in plans funded at less than 60%. Once a plan is funded above 60%, the employer — and the union in collectively bargained plans — will then decide how to credit past service accruals. "Shutdown" benefits are pension payments made to employees when a plant is shut down. They typically are negotiated between employers

and labor unions, and usually are not prefunded. The PPA prohibits shut-down benefits in plans that are funded at less than 60% of full funding.[4] The law prohibits any increase in benefits under a plan that is less than 80% funded, unless the benefits are funded by the employer immediately. In plans considered to be at risk of default, assets set aside in trust funds to pre-fund deferred compensation for highly-compensated employees will be taxable as income to those employees.

Disclosure Requirements. The PPA requires plan administrators to provide an annual "funding notice" within 120 days of the close of the plan year to each participant and beneficiary and to any labor organization representing participants. Plan sponsors also will have to include more information on the Form 5500 that they file annually with the Internal Revenue Service, including an explanation of the actuarial assumptions used to project future retirements and asset allocations.

Section 4010 of ERISA provides that plans underfunded by $50 million or more must file a report with the PBGC. The PBGC is prohibited by law from releasing this information to the plan participants or the public. The PPA will require any plan sponsor with a funding ratio under 80% to file form 4010 with the PBGC. The plan sponsor will be required to notify participants that a Form 4010 has been filed with the PBGC.

Rules for Multiemployer Plans.[5] Under the PPA, multiemployer plans will have to amortize unfunded prior service liability over 15 years, rather than over 30 years as under prior law. The new law increases the maximum tax-deductible contribution for multiemployer plans to 140% of current liability. It will require plan trustees to improve the funding of the plan by one-third within 10 years if a plan is less than 80% funded, or if it will experience a funding deficiency within seven years. It prohibits benefit increases if the increase would cause plan funding to fall below 65%, and it imposes benefit restrictions on multiemployer plans that are less than 60% funded.

Investment Advice. The PPA permits qualified "fiduciary advisers" to offer investment advice to participants in defined contribution plans, such as those authorized under §401(k) of the Internal Revenue Code. Eligible plans will be exempted from certain rules governing prohibited transactions under ERISA and the Internal Revenue Code. The adviser may be affiliated with the investment funds offered in a §401(k) plan, but he or she must meet disclosure and qualification requirements and must provide notice of fees, material affiliations, any limitation on the scope of advice, and services provided with respect to the advice. The PPA requires fiduciary advisers for employer-sponsored plans such as 401(k)s to base their recommendations on a computer model that has been certified and audited by an independent party, and it requires fiduciary advisers for non-employer plans such as IRAs to charge a flat rate fee for one year (with no computer model). The Department of Labor, in consultation with the Treasury Department, will study whether a computer model exists to tailor professional investment advice to an individual's needs based on their financial and family circumstances and taking into account the full range of investment options available. If they cannot certify that such a

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[4] In 2004, the 6th U.S. Circuit Court of Appeals ruled that the PBGC could set a plan termination date that would prevent the agency from being liable for shutdown benefits. In March 2005, the U.S. Supreme Court declined to hear the case, leaving the Circuit Court's decision in place.

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

model exists, then advisers will be free to provide advice free from the prohibited transaction exemption as long as they certify in writing that the company has adopted written policies and procedures that ensure that the investment advice provided is in the individual's best interest.

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

Other Defined Contribution Plan Provisions. The PPA makes permanent the higher annual contribution limits for IRAs and qualified retirement plans enacted in 2001 under P.L. 107-16. It establishes a "safe harbor" from nondiscrimination testing for employers who offer automatic enrollment in defined contribution retirement plans. It also allows taxpayers to direct the Internal Revenue Service deposit part of a tax refund directly into an IRA. It makes permanent and indexes to inflation the Savers' Credit, a nonrefundable tax credit for low- and middle-income families created by Congress in 2001, which was scheduled to expire after 2006. It waives the 10% early-distribution penalty for public safety employees who participate in pension plans with a "Deferred Retirement Option Plan" feature and also for military reservists and national guardsmen who are called to active duty for at least 180 days. It will allow tax-free rollovers from the IRA or pension of a deceased individual to an IRA or employer-sponsored plan of a designated beneficiary other than a spouse, and it will allow disabled persons to contribute to an IRA even if they have no earned income.

The PPA prohibits companies from forcing employees to invest any of their own retirement savings contributions in the stock of the employer and allows workers to sell their company stock three years after receiving it in a §401(k) plan. The law clarifies that companies have a fiduciary responsibility for workers' savings during "blackout" periods, when workers are temporarily barred from making changes to their §401(k) investments, and it requires companies to give workers quarterly benefit statements that must include information about their accounts, including the value of their assets, their rights to diversify out of company stock, and information about the importance of maintaining a diversified investment portfolio.