Guaranty Fund for Private Pension Obligations

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Chapter 1

The Setting

The primary purpose of a pension plan is to provide old-age income to retired workers and their widows, the income to continue throughout the remaining lifetime of the individuals involved. The plan may, and frequently does, provide benefits in the event of the employee’s death, extended disability, or withdrawal from the working force prior to retirement. Under a noncontributory plan, the employer (or group of employers, in the case of a multiemployer plan) assumes sole responsibility for providing the benefits contemplated under the plan, although some or all of the cost of the plan may ultimately be shifted\(^1\) to the employees (through lower wages), the consumers (through higher prices), or the tax-paying public (through tax deductions). Even under a contributory plan, the employer generally assumes the principal burden of financing the benefit structure. Thus, for the sake of simplicity, the objectives envisioned for the pension plan will be referred to as the employer’s undertaking, even though the covered employees may share in the financing of

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\(^1\) It may be argued that under a collectively bargained plan, the employees consciously absorb the estimated cost of the plan by accepting lower cash wages. By the same line of reasoning, one could assert that these employees would bear the cost of a guaranty program.
the plan and participate (through their elected representa­
tives) in its administration.

NATURE OF THE EMPLOYER'S UNDERTAKING

The obligation assumed by an employer in establishing a pension plan may take one of two forms: an undertaking to set aside funds on a specified basis or an undertaking to pro­vide benefits in accordance with a specific schedule. Under the first approach, the employer does not undertake to pro­vide retirement and other benefits in accordance with a fixed scale of benefits, although the scale of contributions will normally be set in the light of an anticipated level of benefits. The contribution commitment may be stated as a percentage of the compensation of covered employees, as an amount per hour or day of work, or in terms of some productivity factor. Regardless of how the commitment is expressed or deter­mined, the employer's obligation to the plan is deemed to be completely fulfilled when he pays over the appropriate sums, even though the assets of the plan eventually prove insuffi­cient to provide the projected level of benefits.

Under the second approach, the employer ostensibly commits himself to contribute whatever sums are necessary to provide the benefits payable pursuant to a formula or schedule set forth in the plan. The plan may call for a unit of benefit for each year of credited service, a composite benefit equal to a specified percentage of compensation (for the entire period of employment, or the years immediately preced­ing retirement), or a composite benefit expressed as a flat dollar amount. The plan usually recognizes, and gives credit for, some or all of the service performed for the employer in question prior to the inception of the plan; and subsequent benefit liberalizations are generally made retrospective as to
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years preceding the plan amendment, both practices giving rise to an unfunded accrued liability that would be the primary source of loss to any guaranty arrangement. Except for collectively bargained plans, the employer reserves the right to alter, modify, or terminate the plan at any time—and for any reason. Moreover, he generally reserves the right to suspend, reduce, or discontinue contributions to the plan, whether or not previous contributions have been sufficient to provide all benefits credited to date. Finally, it is customary for the employer to limit his obligation in the event of plan termination to contributions already made to the plan. In other words, if the plan terminates, the participants and pensioners must look to the accumulated assets for the satisfaction of their claims. In a relatively small number of cases, largely confined to the petroleum and steel industries, the employer guarantees to provide all accrued benefits (sometimes only vested benefits) in the event of plan termination, in effect pledging the corporate resources to the satisfaction of accrued pension claims.

METHODS OF FINANCING

In order to meet the benefit commitments, explicit or implicit, generated under a pension plan, the employer generally sets aside funds with a bank or insurance company in amounts and at times roughly commensurate with the rate at which the pension costs accrue. In other words, the employer, through an independent funding agency, usually accumulates funds for the payment of pension and related benefits in advance of the dates when the payments are due, a practice known as funding. The general procedure is to fund

2 During the first few years of a plan's existence, it can be terminated without retroactive tax penalties only for reasons of "business necessity."
currently accruing benefits during the accounting period in which they accrue. Benefits credited for service prior to inception of the plan are funded, if at all, over an extended period, usually ranging from 12 to 40 years. If the employer is to get a current tax deduction for these contributions (or advance payments), the moneys must be held under an arrangement that ensures their use for the exclusive benefit of the plan participants or their beneficiaries. This requirement is met through transfer of the funds into an irrevocable trust, generally administered by a bank, or through the purchase of insurance or annuity contracts from an insurance company, including those contractual arrangements under which the funds are not allocated to specific individuals until retirement. In some cases, only the benefits of individuals in a retired status are funded, a practice known as terminal funding.

Under a relatively small percentage of plans, the employer pays the benefits directly to retired employees, with no advance funding through intermediaries. Some of these plans are large, but the great majority are associated with small firms. Occasionally, the basic pension plan of an employer will be funded, with additional benefits being provided on a current disbursement or pay-as-you-go basis. This method of financing would create complications for a pension guaranty arrangement.

Under existing law, an employer is under no legal obligation to fund his accruing pension costs, and he may deduct as an ordinary and necessary business expense reasonable payments to retired employees or their beneficiaries. However, if he wants to enjoy the tax treatment accorded "qualified" pension plans, which would include exemption from current taxation of investment earnings on plan assets, he must as a minimum fund the normal (or current) cost of the plan plus interest on the initial supplemental liability at the rate as-
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sumed in the calculation of the liability. This requirement, which is believed by some authorities to be applicable only during the first 10 years of a plan’s existence, is designed to discourage a firm from establishing a pension plan with the deliberate intention of terminating it within a few years. The Internal Revenue Service does not inquire into the adequacy of the cost estimates underlying the funding payments, its chief concern being protection of the federal revenue against excessive tax deductions.

Traditionally, the actual contributions to a pension plan (or, under a current disbursement plan, the actual payments to benefit recipients) have been construed to represent the cost of the plan for both tax and general accounting purposes. That is, pension costs have been accounted for on a cash basis rather than the accrual basis associated with most business transactions. In November, 1966, the Accounting Principles Board of the American Institute of Certified Public Accountants, following several years of intensive study and discussion of the accounting aspects of pension plans, took the position that beginning January 1, 1967, pension costs should be accounted for on an accrual basis. The costs are to be computed in accordance with one of the generally acceptable actuarial cost methods (described in Appendix A of Opinion No. 8), using reasonable actuarial assumptions and reflecting the other conclusions of the Opinion. The Opinion stated that the annual provision for pension cost should not be less than the total of normal cost and an amount equivalent to interest on any unfunded prior service cost, plus, if necessary,

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4 Ibid., para. 24.
an additional sum calculated in such manner as to ensure the full accrual over a 20-year period of the costs associated with vested benefits.\(^5\) The annual provision for pension cost should not be greater than the total of (1) normal cost, (2) 10 percent of the initial past service cost (until fully amortized), (3) 10 percent of the amounts of any increase in prior service cost arising out of an amendment of the plan (until fully amortized), and (4) interest equivalents on the difference between pension charges and amounts funded.\(^6\) As intimated by item (4) above, the appropriate pension charges are to be made whether or not corresponding payments are made to the funding agency (bank or insurance company). If contributions to the plan are less than the amounts charged to expense, whether attributable to normal cost or prior service costs, the difference is to be shown on the liability side of the balance sheet and described in a manner to make clear that it does not constitute a legal obligation. An excess of contributions over expense charges is to be reflected on the asset side as a deferred charge.

The employer's income tax deductions are still based on his contributions to the pension plan rather than expense charges per se.

The new accounting rules apply to all types of pension plans—defined contribution as well as defined benefit plans and unfunded as well as funded plans. It is especially significant that future pension cost accruals under an unfunded plan must be reflected in the employer's balance sheet, which may induce the employer to adopt the practice of funding his pension obligations. The accountants' recommendation

\(^5\)\textit{Ibid.}, par. 17. However, the additional sum need not exceed the amount that would be necessary to amortize the initial past service liability over a 40-year period.

\(^6\)\textit{Ibid.}, par. 17.
that unfunded pension charges under any type of plan be reflected in the balance sheet is likely to cause all employers to fund at a rate at least equal to that at which the pension costs accrue. It may, of course, lead to the practice of computing cost accruals to the lowest acceptable level, thus inhibiting funding. In any event, it should be recognized that in the typical case the employer's legal liability if the plan should terminate is limited to the amounts already contributed, even though the balance sheet may show an excess of expense charges over funding payments.