ERIC

THE ERISA INDUSTRY COMMITTEE

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Advocating the Benefit and Compensation Interests of America's Major Employers

PLAIN ENGLISH EXPLANATION OF THE ERISA FUNDING RULES

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, ERISA and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan. These minimum required contributions are calculated using reasonable assumptions and are equal to the normal cost of the plan plus amounts necessary to amortize over specified periods unfunded past service liabilities, experience gains or losses, waived funding deficiencies, changes in actuarial assumptions, and certain other items. Most defined benefit plans are funded under these original ERISA rules, as modified over time.

A plan that is considered either significantly or persistently underfunded will be subject to an additional set of funding rules. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises in the future. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan, accelerating the pace of pension funding.

The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is between 90% to 100% of the four-year weighted average of certain long-term bonds rates. Through 2001, 30-year Treasury bond rates were used to make this calculation. The Treasury ceased to issue its 30-year bonds on October 31, 2001. For 2002 and 2003, a plan was allowed to use a rate of up to 120% of the 30-year bond average (P.L. 107-147). Congress approved a new bond rate – a composite rate based on high quality, long-term corporate bond rates – for 2004 and 2005 (P.L. 108-218). In 2006 the mandated rate will revert to the defunct 30-year Treasury bond absent further Congressional action. Highly inaccurate and inflated calculations of pension liability would result.

The current liability rules come into play if, using these mandated assumptions, a plan is considered either significantly or persistently underfunded -- that is, (1) if plan assets are less than 80% of current liabilities or (2) if plan assets are less than 90% of current liabilities for two of the last three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

Current liability is also calculated to determine whether a plan sponsor will pay a $19 per participant flat rate premium tax to the Pension Benefit Guaranty Corporation, or whether the sponsor must, in addition, pay a variable rate premium tax based on the plan's unfunded vested benefit liability.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.