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A first step

New tax law gives defined benefit plans a glimmer of hope

by William J. Sohn

A pension law change included in the Taxpayer Relief Act of 1997 is the first new tax law provision in a decade to support defined benefit plans. However, it is only one of many improvements needed before defined benefit plans can flourish again.

The new act provides for a gradual increase in a defined benefit plan's current liability limitation from 150% in 1997 to 170% for plan years beginning in 2005 and later. What does this obscure and highly technical provision mean?

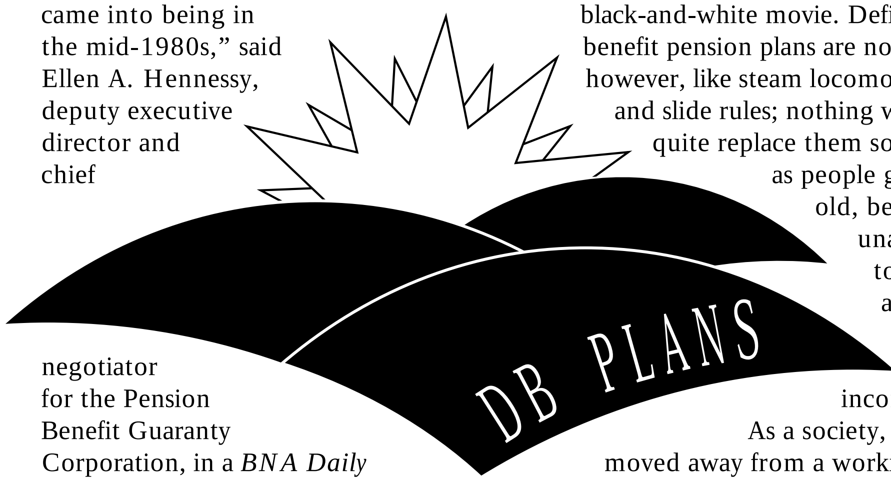
"Current liability" measures the value of pension liabilities accrued to date; the 150% limitation means an employer must stop contributing to the company's pension fund when plan assets amount to 150% of current liability, even if the actuarial cost method based on projected benefits shows an unfunded liability.

The 150% limitation prevents some plan sponsors from putting money into a plan when asset values are high and extra cash is at hand (which is, of course, exactly when contributions are most easily made). The limitation particularly constrains plan sponsors with final-pay plans and young workforces. The net effect is to narrow the range of possible contributions, encourage plan terminations, and discourage the formation of new plans. Many observers working with defined benefit plans would have preferred repeal of the current liability limitation altogether, but the potential loss of revenue led to the provision actually adopted.

Weeding out impediments?

Taken by itself, the revised limitation is of minor importance. It will be helpful to a few larger companies in cyclical industries and others that will be able to make larger tax-deductible contributions; a much smaller number of companies might actually establish new defined benefit plans. Some small companies that maintain pension plans only for the tax deduction will continue to do so a little longer.

What is much more interesting is that a pension law change has finally come along that offers any incentive at all to form defined benefit plans. "This is all incremental in terms of trying to eliminate things that came into being in the mid-1980s," said Ellen A. Hennessy, deputy executive director and chief negotiator for the Pension Benefit Guaranty Corporation, in a *BNA Daily Tax Report* story on Aug. 26, 1997. "We've been trying to weed away those things that people told us were impediments. In the same way that those built up over the years, this is a process of taking them out one by one."



What are the next steps?

To all but the largest plan sponsors, the costs of compliance with ERISA including PBGC premiums make the maintenance of a defined benefit plan an expensive proposition indeed. If we want a viable defined benefit system, we need to strike at the huge administrative overhead. Areas ripe for simplification include the funding rules, the accrual of benefit rules, and the nondiscrimination regulations. Restructuring the PBGC premium so that only sponsors of underfunded plans are required to pay premiums also would do wonders to make defined benefit plans competitive with 401(k) plans.

But even if Congress does the right thing by defined benefit plans, it will take years for the universe of plan sponsors to shift its focus back to designing plans that, by their terms, provide adequate income in retirement. The very idea of a defined benefit plan now seems a bit quaint, rather like a black-and-white movie. Defined benefit pension plans are not, however, like steam locomotives and slide rules; nothing will ever quite replace them so long as people grow old, become unable to work, and need retirement income.

As a society, we have moved away from a working, if flawed, defined benefit model toward a model centered on 401(k) and other capital accumulation plans. These have flourished in the booming stock market. Their adequacy has not been tested in a weak market, let alone a bear market. Only the very young or the very foolish think that giving all our wage earners individual pots of money to invest as they see fit will alone suffice to generate the income needed, when it is needed, to keep millions of old people from falling into poverty.

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