United States General Accounting Office

GAO

Briefing Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

PENSION PLAN TERMINATIONS

Recapturing Tax Benefits Contained in Asset Reversions

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-237807

November 22, 1989

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

On April 12, 1989, you requested that we evaluate how effective the current 15-percent excise tax is in recapturing the portion of reverted pension assets that arises from preferential tax treatment. We agreed to calculate the excise tax rate that would offset the amount of the tax preference for a representative sample of recent reversions. On September 12, 1989, we briefed your staff on our preliminary calculations for a small sample. At your request we are providing this interim report, which summarizes and expands on the information we presented at the briefing.

Background

Employers establish pension plans to provide retirement income to their employees. They make contributions to trust funds to pay participants' earned benefits. Employers do not pay income taxes on contributions. Employers are allowed to contribute more to plans than the minimum requirement to avoid being underfunded when participants retire.

To determine the minimum funding requirement, actuaries periodically value plans' assets and benefit liabilities. The actuarial valuations are often based on conservative assumptions about future investment earnings. When plans achieve rates of return on investment higher than expected they accumulate excess assets.

Since 1980, over $20 billion in excess pension assets have reverted to employers from voluntary plan terminations. Even though employers paid income taxes on these reversions, some of the gains were tax subsidized because they resulted from income earned on untaxed contributions.

Recognizing that the normal corporate income tax would usually not be enough to offset the tax subsidy, the Congress imposed a 10-percent excise tax on reversions in 1986, and increased it to 15 percent in 1988. However, since no one has analyzed the actual pattern of tax benefits in a representative set of reversions, the extent to which the excise tax recaptures tax benefits is not known.

Pension tax incentives were intended to encourage employer-financed retirement benefits. Some excise tax advocates argue that the excise tax and normal corporate income taxes should recoup all of the tax benefits embedded in reversions. Otherwise, plan sponsors have an incentive to use pension trusts as contingency savings accounts.

Approach and Methodology

We randomly selected and reviewed 18 cases from the universe of 202 pension plan reversions for $1 million or more that terminated or announced their intent to terminate in 1988.

We constructed a simulation model capable of calculating an offsetting excise tax rate for each reversion case. For the purposes of this study, the offsetting excise tax rate is the rate that would have left employers no better off financially than if the surplus assets had earned the pension fund's pretax rate of return through some alternative use.

The excise tax rate required to recapture or offset pension tax benefits depends heavily on an employer's marginal income tax rate. Marginal tax rates represent the percent of profits that comprise tax obligations. Because no consensus exists on what constitutes the most appropriate measure of marginal tax rates, our assessment used three different income tax rates. Our principal analyses are based on (1) maximum federal statutory tax rates and (2) average effective tax rates. We also conducted an analysis using a constant tax rate of 34 percent, which is the current maximum statutory rate.

Our analysis that utilized statutory tax rates is consistent with the Department of the Treasury's methodology for generating the budget estimates of revenue losses associated with tax provisions for qualified pension plans. We used the rates that prevailed from 1975 to 1988.

However, statutory tax rates often overstate the actual tax consequence firms face because of various tax credits and deductions for certain business activities and expenses. If tax effects are overstated, the excise tax necessary to fully offset pension tax benefits is also overstated. Therefore, we repeated our analyses using industry-based effective income tax rates. These rates could more accurately reflect the actual tax position of employers in the sample.

The maximum statutory tax rate for corporations declined from 46 to 34 percent between 1986 and 1988. To give some perspective on excise tax rates necessary to offset future reversions occurring under today's tax

environment, we conducted our analyses assuming the current corporate tax rate (34 percent) throughout the analysis period.

Results in Brief

For the majority of cases, a 15-percent excise tax did not fully offset the tax benefit portion of asset reversions (see app. I). The excise tax rates necessary to fully recapture pension tax benefits had a wide variance. The results of our analyses are summarized below:

- Under statutory tax rates, the excise tax rate required to recapture tax benefits exceeded 15 percent in 17 of 18 cases. The offsetting excise tax rates ranged from 14 to 84 percent, and the median rate was 34 percent (see fig. 2.1).
- Under effective tax rates, the excise tax rate needed to offset tax benefits exceeded 15 percent in 12 of 18 cases. The offsetting excise tax rates ranged from −7 to 65 percent, and the median rate was 24 percent (see fig. 2.2).
- Under the current maximum corporate tax rate, the excise tax rate required to recapture tax benefits exceeded 15 percent in 14 of 18 cases. The offsetting tax rate ranged from 7 to 72 percent, and the median rate was 29 percent (see fig. 2.3).

The offsetting excise tax rate is sensitive to variations in the way different types of income are taxed. Plans that primarily obtained their investment income from sources that normally were subject to the maximum statutory tax rate, such as interest from corporate bonds, had the highest offsetting tax rates. Conversely, plans that mainly derived their income from sources that normally were subject to the lower capital gains tax rate, such as stock price appreciation, had the lowest offsetting tax rates.

Conclusion

Tax policy favors defined benefit and other pension plans to encourage employers to provide retirement income security for workers. The intent of the Congress is potentially circumvented when employers terminate pension plans and use excess assets for purposes other than for funding retirement benefits. If pension plan tax benefits are not fully recaptured from reversion cases, an incentive exists for plan sponsors to use pension trusts as contingency savings accounts.

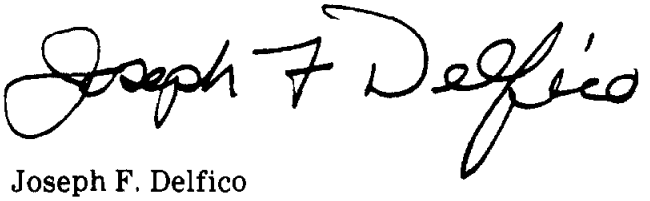
For our sample, a 15-percent excise tax rate levied on employers claiming asset reversions was generally not high enough to offset pension-

related tax benefits. A 15-percent excise tax is least effective at recapturing tax benefits from plans that, by investing in assets normally subject to the highest marginal tax rates, most effectively utilized the tax-exempt status of pension trusts.

Because the offsetting excise tax rates depended on plan asset allocation and marginal income tax rates, no single tax rate is optimal for every reversion case. For our sample, the offsetting tax rates had a wide variance, ranging from −7 to 84 percent.

We are sending copies of this report to other interested congressional committees and we will make copies available to others who request them. If you have any questions concerning this report please call me on (202) 275-6193. Other major contributors to this briefing report are listed in appendix III.

Sincerely yours,



Joseph F. Delfico
Director, Income Security Issues
(Retirement and Compensation)

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Abbreviations

IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation

Introduction

Tax policy favors defined benefit and other pension plans in order to encourage efficient savings for retirement. A defined benefit plan promises to pay a certain benefit, based on a specified formula, to each participant at retirement. Consequently such plans prefund in order to avoid being underfunded when participants retire.[1]

Although employer contributions to tax-qualified plans are tax deductible, the essence of the tax preference stems from permitting investment earnings from pension trusts to accumulate tax free. The favorable treatment granted to the accumulated earnings in qualified pension plans affects the federal revenue base more than any other tax preference; a loss that the Joint Tax Committee estimated at $58 billion for fiscal year 1988.

Many assumptions are used in funding pension plans, including estimates of rates of return on plan assets and, in most cases, assumptions about salary increases. Often plan sponsors use conservative assumptions about investment earnings in estimating the contributions necessary to meet the plan's projected liability, as such, the amount required to prefund the liability increases accordingly.

One requirement for a pension plan to qualify under the tax code is that the plan be intended to be permanent. However, federal law permits employers to terminate their pension plans, pay each participant only the benefits that had accrued up to termination date, and keep all residual assets.

When stock and bond markets rally, plans that have been generously funded, based on conservative estimates of rates of return, can experience a dramatic growth in assets. If the employer then terminates the plan and satisfies a liability limited to the benefit each participant has earned to date, instead of the long-term liability for which it prefunded, the excess amount, or "surplus," realized can be considerable. Some employers have voluntarily terminated their overfunded defined benefit pension plans—termed asset reversions—and used the excess funds for nonpension purposes.

Recognizing that normal corporate income taxation may not offset tax subsidized gains generated through reversions, the Congress imposed a

[1] In contrast to defined benefit plans, the pension benefits from defined contribution plans are based on the amount of money accumulated in the participant's individual account, not on a predetermined formula.

10-percent excise tax on reversions in 1986, and increased it to 15 percent in 1988. However, because the excise tax rate is not based on analytical considerations, the extent to which it fully recaptures tax benefits is uncertain.

The reversion amount is partly attributable to the favorable tax treatment of pension trusts. If the tax-subsidized portion of reversions is not fully recaptured, the termination-for-reversion decision is potentially biased in favor of termination. This could lead to a greater number of plan terminations than would otherwise occur.

From a pension policy standpoint, a principal concern about asset reversions stems from the adverse effects on plan participants' pension income.[2] Companies that have terminated plans for reversions usually established new pension plans to replace the terminated plan. However, plan participants can suffer substantial losses in expected pension benefits when (1) the replacement plan does not provide for past service credit, (2) the replacement plan is a defined contribution plan, or (3) there is no replacement plan.

Although the number of asset reversions has leveled off since 1985, the past 3 years were marked by a trend. For the period 1986 through 1988, the percentage of reversions that resulted in either a defined contribution replacement plan or no replacement plan rose from 54 to 77 percent. Moreover, of all plan participants affected by reversions, the percentage involved in this group increased from 43 to 60 percent.

Since 1980, employers have claimed nearly $20 billion in excess pension assets through asset reversions. An offsetting excise tax would have left the employers no better off financially than if the funds had been treated as ordinary corporate reserves for tax purposes. Based on recent reversion amounts, each percentage point difference between the current excise tax rate and the rate that would more fully recover the tax advantage equates to an annual $20 million transfer of wealth from the Treasury to pension plan sponsors.[3]

[2]Another concern is the potential increased risk imposed on the Pension Benefit Guaranty Corporation and plan participants covered under defined benefit replacement plans because successor plans have a smaller asset-to-liability ratio.

[3]This assumes that the tendency of employers to claim reversions would have been unresponsive to a higher excise tax rate. For some employers, a higher excise tax rate would have discouraged them from terminating, thereby reducing the revenue recaptured by the tax.

Effect of Tax Advantage on Investment Return

Comparable to an individual retirement account, the tax treatment of pension trusts permits employers who terminate for reversions to augment their after-tax rate of return. The effect that the tax advantage for pension trust has on the rate of return can be separated into two distinct components, a compounding effect and a tax rate effect.

The compounding effect is the addition to the after-tax rate of return that exists because investment return earned on untaxed pension contributions is permitted to accumulate without being eroded by taxes. In contrast, the investment return earned on regular corporate reserves is taxed each year. Consequently, the taxed portion does not contribute to the return on future investment earnings.

The tax rate effect is realized when a sponsor's tax rate at the time of the reversion is lower than its tax rate at the time the deductions for contributions were taken. The decrease in marginal income tax rates from 46 to 34 percent between 1986 and 1988 could have added about 22 percent to the after-tax rate of return of each reversion case.

Objective, Scope, and Methodology

The Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, expressed concern about whether the current excise tax rate is sufficient to recapture the portion of asset reversions that resulted from tax benefits. At the Chairman's request, we examined recent reversions to assess how effective the 15-percent excise tax is in recapturing the financial gains that resulted from the tax-free accumulation of pension fund earnings.

Because the offsetting excise tax is directly related to the investment earnings that the pension trusts realized, our analyses required data on plans' financial performance. We obtained this information from the Internal Revenue Service (IRS) Form 5500 reports for the plan years 1975-89. The Form 5500 is a financial status report for pension plans filed annually since 1975 by plan sponsors with 100 or more participants.

We examined empirical financial performance data from the universe of pension plan reversions for $1 million dollars or more that terminated or announced their intention to terminate in 1988. From this universe of 202 plans, we randomly selected 40 reversion cases. We excluded plans with less than 100 participants, because their Form 5500 reports did not require the level of detail needed for our study. We eliminated other plans because the Form 5500 information was not available. We

obtained sufficient data on 18 plans to conduct these preliminary analyses.

We designed a simulation model to calculate offsetting excise tax for individual reversion cases. For the purposes of this study, the offsetting excise tax rate is the rate that would have left employers no better off financially than if the surplus assets had earned the pension fund's pretax rate of return through some alternative use. For each reversion case, we calculated the balance that would have existed if the same flow of excess funds were treated as taxable corporate investments.

We calculated offsetting excise taxes using the following three income tax rates.

1. Maximum statutory rates. This approach is consistent with Treasury's methodology for estimating revenue losses associated with tax provisions for pension plans.

2. Industry average effective tax rates. This approach recognizes that income tax rates vary depending on the availability of tax credits and allowable deductions and thus may better reflect the actual tax position of firms.

3. A constant tax rate of 34 percent. This method focuses on the excise tax rates applicable to future reversions occurring under the current maximum statutory tax rate.

More detail on the assumptions underlying our model's computations is provided in appendix II.

We obtained information for this briefing report from the Pension Benefit Guaranty Corporation (PBGC), the Departments of Labor and Treasury, and private pension plan administrators.

Our results are not projectable to the universe of plans with asset reversions because the study is based on a limited sample. Consequently, we did not perform tests of statistical significance.

Our review was done in accordance with generally accepted government auditing standards. As requested by your office we did not obtain written comments on this report, but we did discuss our methodology with officials from PBGC and IRS.

Tax Benefit Portion of Asset Reversions Not Recaptured by Excise Tax in Most Cases

For our sample, a 15-percent excise tax recaptured the tax benefit portion of asset reversions in only a few cases (see app. I). Our estimates of the excise tax rate's success in recapturing tax benefits depended on, among other things, income tax rates used to simulate tax effects. Our assessment utilized three different income tax rates. The results are summarized below.

- Under maximum statutory tax rates, the excise tax rate required to recapture tax benefits exceeded 15 percent in 17 of 18 cases. The offsetting excise tax rates ranged from 14 to 84 percent, and the median rate was 34 percent (see fig. 2.1).
- Under effective tax rates, the excise tax rate needed to offset tax benefits exceeded 15 percent in 12 of 18 cases. The offsetting excise tax rates ranged from −7 to 65 percent, and the median rate was 24 percent (see fig. 2.2).
- Under the current maximum statutory tax rate, the excise tax rate required to recapture tax benefits exceeded 15 percent in 14 of 18 cases. The offsetting tax rate ranged from 7 to 72 percent, and the median rate was 29 percent (see fig. 2.3).

The offsetting excise tax rate is sensitive to variations in the way different types of income are taxed. Plans that primarily obtained their investment income from sources that normally were subject to the maximum statutory tax rate, such as interest from corporate bonds, had the highest offsetting tax rates. Conversely, plans that mainly derived their income from sources that normally were subject to the lower capital gains tax rate, such as stock price appreciation, had the lowest offsetting tax rates.

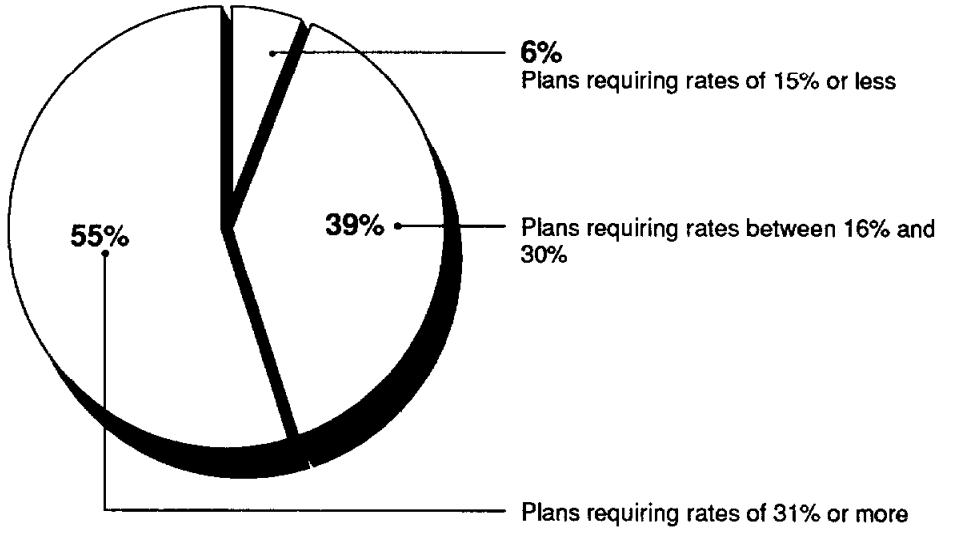
Tax-Recapture From the Excise Tax Under Statutory Tax Rates

Our analysis that utilized maximum statutory tax rates is consistent with the Department of Treasury's methodology for generating the budget estimates of the revenue losses associated with tax provisions for qualified pension plans. The statutory tax rate is the percent of profits that represent income tax obligations. We used the actual rates that prevailed from 1975 to 1988.

As figure 2.1 shows, under statutory tax rates a 15-percent excise tax rarely recaptured tax benefits from reversions in our sample. In fact, the current excise tax fully offset tax benefits in only 1 of 18 cases. Our calculations yielded the following results:

- in 1 of 18 cases a 15-percent excise tax exceeded the rate needed to recapture tax benefits,
- in 15 of 18 cases the excise tax rate required to recapture tax benefits exceeded 20 percent,
- in 10 of 18 cases the excise tax rate needed to offset tax benefits exceeded 30 percent, and
- in 8 of 18 cases the excise tax rate needed to offset tax benefits exceeded 40 percent.

Figure 2.1: Offsetting Tax Rates Using Statutory Tax Statutory Rates



The offsetting excise tax rate's sensitivity to plan asset allocation is readily apparent in our results. Plans that mainly obtained their income from sources that received the least favorable treatment under the tax code tended to have the highest offsetting excise tax rates. For example, the reversion case that had the highest offsetting excise tax rate (84 percent) received more than 99 percent of its investment income from interest-bearing investment vehicles, such as corporate bonds.[1]

In contrast, plans that primarily derived their income from sources that received the most favorable treatment under the tax code tended to have the lowest offsetting excise tax rates. For example, the reversion case with the lowest offsetting excise tax rate (14 percent) received

[1]Between 1975 and 1986 interest payments from corporate bonds were taxed at the highest corporate marginal tax rate of 46 percent.

about 66 percent of its investment income from the sale of corporate stocks and bonds.[2]

Tax-Recapture From the Excise Tax Under Effective Tax Rates

Because of tax savings arising from various credits and tax deductions for certain business expenses, the overall tax obligation of corporations often represents a lower percent of total profits than implied by the maximum statutory rate. Because the effective tax rate is lower, the value of deferring tax payments is diminished, which in turn reduces the excise tax required to offset tax benefits.[3] Therefore, we calculated these rates using the average effective income tax rate for industries similar to each reversion case.

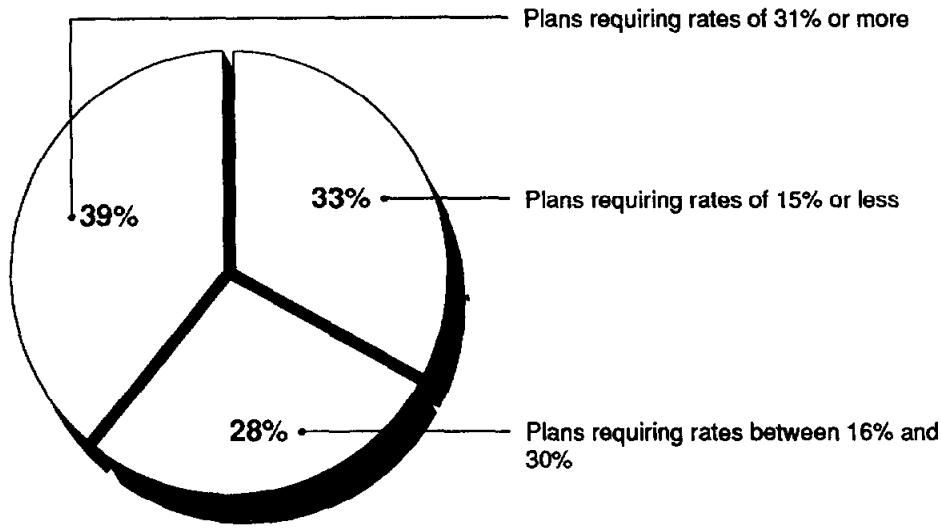
As figure 2.2 demonstrates, under average effective tax rates a 15-percent excise tax failed to offset tax benefits in the majority of cases in our sample. Under these criteria, a 15-percent excise tax succeeded in offsetting tax benefits in just 6 of 18 cases. Our analyses determined that

- in 6 of 18 cases a 15-percent excise tax exceeded the rate necessary to recapture tax benefits,
- in 12 of 18 cases the offsetting excise tax rate exceeded 15 percent,
- in 10 of 18 cases the offsetting excise tax rate exceeded 20 percent, and
- in 7 of 18 cases the offsetting excise tax rate exceeded 30 percent.

[2]Between 1975 and 1986, investment gains from the sale of stocks or bonds (capital gains) were taxed at a 28-percent rate. For this same period, 85 percent of dividend income was excluded from taxation.

[3]We define an effective tax rate as a taxpayer's actual tax liability expressed as a fraction of the firm's taxable income.

Figure 2.2: Offsetting Tax Rates Using Effective Tax Rates



The results show that, all things being equal, effective income tax rates resulted in lower offsetting excise tax rates. Firms taking reversions that faced little or no taxes did not augment their after-tax return much more than they would have if the funds had been invested as regular corporate reserves. Since the tax benefits gained under these circumstances are minimal, the excise tax required to offset such gains is commensurately lower.

Employers in industries with relatively low effective tax rates and who generated significant portions of their income from dividends and capital gains had the lowest offsetting excise tax rates. For example, on average, the five plans with offsetting excise tax rates of 8 percent or less had effective tax rates of about 21 percent and also received about 38 percent of plan income from dividend income and capital gains.

Tax-Recapture From the Excise Tax Rate Under Current Statutory Rate

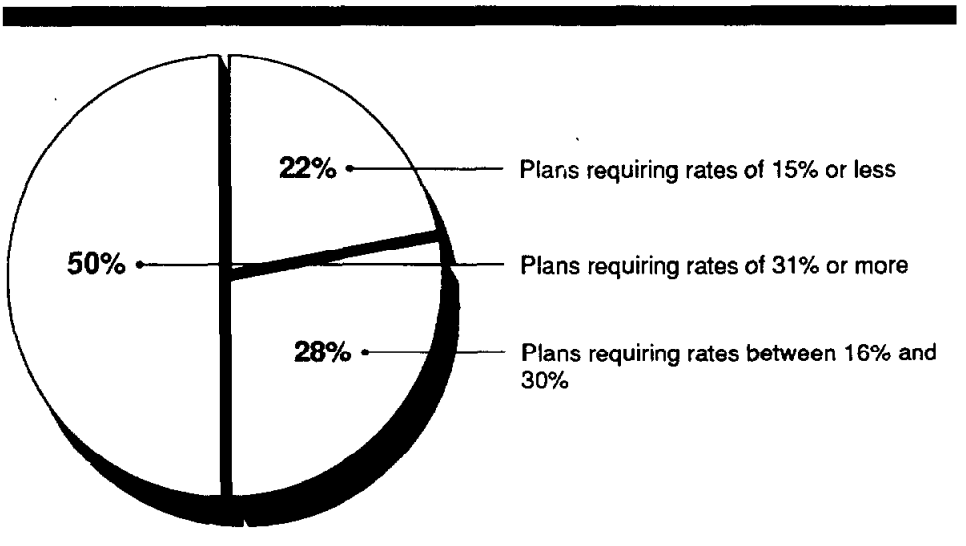
The after-tax rate of return for assets held in a pension trust is increased when marginal tax rates decline between the time pension contributions are made and the time plans are terminated for reversions. Since 1975, the maximum statutory tax rate for corporations declined from 46 to 34 percent. This allowed corporations receiving reversions in 1988 to shelter profits in the pension trust when tax rates were relatively high and defer tax payment on these funds until rates were considerably lower. Some pension plans that have become overfunded since 1988 may terminate for reversions while the corporate tax rate is at its

current level. To simulate this effect, we conducted our analysis using a constant income tax rate of 34 percent throughout the analysis period.

Our results, illustrated in figure 2.3, show that a 15-percent excise tax rate did not offset tax benefits in most cases. Under these criteria, a 15-percent rate succeeded in offsetting tax benefits in only 4 of 18 cases. Our calculation yielded the following results:

- in 3 of 18 cases a 15-percent excise tax exceeded the rate necessary to offset tax benefits,
- in 14 of 18 cases the excise tax required to offset tax benefits exceeded 15 percent,
- in 12 of 18 cases the excise tax needed to offset tax benefits exceeded 20 percent, and
- in 8 of 18 cases the excise tax required to offset tax benefits exceeded 30 percent.

Figure 2.3: Offsetting Tax Rates Using the 1989 Statutory Tax Rate



These findings are consistent with the results generated from using effective tax rates. Lowering income tax rates reduced the proportion of tax benefits attributable to the reversion. This in turn lowered the level of the excise tax needed to recapture those benefits. On average, using the current maximum corporate tax rate reduced the offsetting excise tax rate about 22 percent relative to the analysis that used statutory rates.

Offsetting Excise Tax Rates for 18 Reversion Cases

	Offsetting Excise Tax Rates		
Excess assets	**Assuming statutory tax rates**	**Assuming effective tax rates**	**Assuming 1988 statutory tax rate**
$29,577,000	29	6	21
12,850,000	48	35	41
1,489,352	28	26	22
3,358,863	18	7	12
1,000,000	56	49	48
4,044,719	64	41	55
3,041,706	14	−7	7
4,344,108	23	7	15
1,400,000	84	65	72
1,592,509	42	28	36
3,214,719	33	31	29
13,360,865	41	31	36
4,185,527	21	16	18
3,147,226	42	33	31
40,529,264	35	21	28
5,976,469	16	1	8
2,867,229	41	10	33
2,259,448	23	1	18
$7,679,945[a]	**37[a]**	**23[a]**	**29[a]**

[a]Mean.

GAO's Simulation Model

Our model generated an alternative investment scenario that differed from the actual experience of the pension trust only in the imposition of tax effects. However, several points regarding our assumptions about the alternative investment portfolios need clarification.

It is important to note that the portfolio management practices of a pension trust are typically quite different from the investment practices of taxable investment funds. The factors involved in portfolio management decisions include the investor's ability to bear risk, current income needs, and tax consequences. For example, pension trusts are primarily growth-oriented and stress long-term price appreciation and capital preservation. In addition, to take full advantage of the trusts' tax-exempt status, investment managers tilt the asset mix towards the least tax-advantaged assets, such as corporate bonds.

In contrast, corporate investment trusts are primarily income-oriented and stress current dividend and interest return. Accordingly, because earnings on corporate reserves are exposed to taxation, investors weight the portfolio with the most tax-advantaged assets, such as real estate, preferred stock, and municipal bonds.

Our analyses may have overstated the tax liabilities that employers would have incurred from an alternate investment of excess pension assets, because we assumed that they would not have altered their portfolio strategy.

Excise Tax Rate Calculations

To compute the offsetting excise tax our model compared the asset reversion, adjusted to reflect corporate income taxes, with a corresponding value generated from the simulated investments. Our assessment required (1) appraising the initial funding surplus, (2) calculating annual plan growth rates, and (3) calculating tax effects.

Overfunding on a Termination Basis

To appraise the initial funding surplus, we computed the plan termination funding position. The termination funding position is the difference between pension assets and benefit liabilities —the cost to purchase annuities or provide lump sum payments to workers and retirees covered by the pension plan or both. A pension plan is overfunded on a termination basis when plan assets exceed benefit liabilities.

Because the interest rates that pension plan administrators use to estimate benefit liabilities can vary widely from plan to plan, we adjusted

benefits reported on the Form 5500 to interest rates used by the Pension Benefit Guaranty Corporation (PBGC). PBGC's rates are based on annuity purchase prices and, therefore, provide a more realistic estimate of plans' funding status. These adjusted estimates of benefit liabilities were then compared with the plan asset data reported on the Form 5500 report to determine the plans funding positions.

Earnings Growth Rates

The assumptions underlying the financial performance of our comparative investment scenario are symmetrical to the pension trust's investment profile. Our model based fluctuations in the alternative investment fund on the annual rates of growth realized by the pension trusts.

Because the tax treatment of income varied depending upon its origin, we had to differentiate between various sources of plan income. Our analysis assumed that, on an annual basis, the constituents of income—such as dividends and interest payments—between the pension trust and simulated portfolio are in balanced proportions. For example, if interest constituted 20 percent of income from pension trust investments during a plan year, we assumed that 20 percent of the investment return gained from the simulation was also attributable to interest for that year.

Historic Statutory Tax Rates

Our analysis using the federal statutory tax rates is consistent with the Department of the Treasury's methodology for estimating revenue losses associated with tax provisions for qualified pension plans. However, because this measure, among other things, does not properly account for deferred tax payments, few pension experts believe that these "revenue loss" estimates are equivalent to the increase in federal receipts that would accompany the repeal of pension tax preferences. Therefore, we also analyzed the excise tax rate using effective income tax rates.[1]

Effective Marginal Tax Rates

To conserve resources, we used estimates of effective corporate tax rates realized by firms in industries similar to those in our sample rather than researching the annual tax position of individual reversion cases. When effective tax rates were unavailable for a particular year, we used the federal statutory rate. Because these industry-wide averages are not based on a randomly selected statistical sample, the extent to which

[1]Tax Analysts, Effective Corporate Tax Rates 1978-1987, Forrest D. Marovelli, Arlington, Virginia.

these effective tax rates reflect the tax position of firms in our sample is uncertain.

Future Reversions and the Current Tax Code

The federal tax code has been significantly revised since 1975. For our sample, the buildup of surplus pension assets generally occurred when the statutory tax rates were considerably higher than the current rate. Between 1986 and 1988, the maximum statutory income tax rate for corporations declined from 46 to 34 percent. During this same period, the maximum tax rate on capital gains increased from 28 to 34 percent.

Although this report does not speculate on future corporate tax rates, revenue-enhancement efforts currently focus on closing loopholes, eliminating deductions, and limiting credits. Plans developing excess assets after 1988 may terminate having been under a single statutory corporate tax rate.

Tax on Retained Earnings

In addition to regular corporate taxes, our calculations recognized the special tax assessment on corporate reserves when they accumulate beyond specified limits—termed the accumulated earnings tax. This penalty surtax is intended to discourage stockholders from using corporations to avoid personal tax on dividends by retaining earnings in the corporation rather than distributing these earnings as dividends. The tax is imposed on the income of a corporation in any year its retained earnings accumulate past prescribed levels. Accumulated earnings tax is avoided by either declaring dividends or proving that the earnings are earmarked to meet reasonable business needs.

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