

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 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 assumed 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 account-