Internal Revenue cumulative bulletin

1974-3 supplement

Committee Reports and Congressional Record Excerpt Relating to: Public Law 93-406 Employee Retirement Income Security Act of 1974

Department of the Treasury
Internal Revenue Service

In This Issue

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Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue Rulings represent the conclusions of the Service on the application of the law to the entire state of facts involved. In those that are based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and confidential information are deleted to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The regulations, rulings, decisions, procedures, Public Laws, etc., published in the weekly Internal Revenue Bulletins 1974-26 through 1974-52 have been consolidated and are published in Internal Revenue Cumulative Bulletin 1974-2.

Public Law 93-406 the Employee Retirement Income Security Act of 1974 and related Committee Reports, which were not published in a weekly Internal Revenue Bulletin, are published in Cumulative Bulletin 1974-3.

Cumulative Bulletin 1974-3 Supplement contains additional Committee Reports and excerpts from the Congressional Record relating to Public Law 93-406.

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provide (1) finding lists of items published in the Bulletin, (2) digests of Revenue Rulings, Revenue Procedures, and other published items, and (3) topical indexes of Public Laws, Treasury Decisions, and Tax Conventions.

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Congressional Record—March 29, 1974

Senate Report No. 93-127[1]

1st Session

RETIREMENT INCOME SECURITY FOR EMPLOYEES ACT OF 1973

APRIL 18, 1973.—Ordered to be printed

Mr. WILLIAMS, from the Committee on Labor and Public Welfare, submitted the following

REPORT

[To accompany S. 4]

The Committee on Labor and Public Welfare, to which was referred the bill (S. 4) to strengthen and improve the protections and interests of participants and beneficiaries of employee pension and welfare. benefit plans, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

I. Synopsis

The provisions of S. 4 are addressed to the issue of whether American working men and women shall receive private pension plan benefits which they have been led to believe would be theirs upon retirement from working lives. It responds by mandating protective measures, and prescribing minimum standards for promised benefits.

The purpose of S. 4 is to prescribe legislative remedies for the various deficiencies existing in the private pension plan systems which have been determined by the Senate Subcommittee's comprehensive study of such plans. This legislation would authorize the establishment within the Department of Labor of an Office of Pension and Welfare Plan Administration which would implement specified and required standards of vesting, funding, reinsurance, disclosure and fiduciary standards, and a voluntary program of portability of vested pension credits. That office would also be charged with enforcement of the provisions of the Act.

The Act imposes minimum vesting requirements in pension plans, whereby employees, after eight years of service, will be entitled to a vested nonforfeitable right to 30% of their accrued pension benefits, and, thereafter, each year will acquire an additional 10% to such right

[1] The page numbers in this volume are the same as the page numbers in the official publication of this report.

until, at the end of 15 years' service, they will be entitled to 100% vested benefits. Where plans are determined by the Secretary of Labor to contain vesting formulas which provide a degree of vesting protection as equitable as the vesting schedule in the bill, compliance with the statutory vesting schedule may be waived by the Secretary. Pension plan participants would be vested in the accrued pension benefits attributable to service with their employer performed both before and after the effective date of the Act.

Under specified circumstances, where the vesting requirements would increase costs or contributions to an extent that "substantial economic injury" would result to the employer and to the participants' interests, the Secretary may defer compliance with the vesting provisions for a period not to exceed five years.

The Act establishes minimum funding requirements for pension plans to assure that all unfunded pension liabilities of the plan will be funded over a 30-year period. However, the Secretary of Labor is authorized to permit variances from such funding requirements to plans which qualify under appropriate conditions.

It establishes a voluntary program for portability of pension credits through a central fund, whereby employees of participating employers may transfer vested credits from one employer to another upon change of employment.

A plan termination insurance program is established to guarantee that vested pension credits of employees will be paid upon termination of a pension plan when there are not sufficient assets to pay the workers' vested benefits. It insures benefits already earned and vested under the terms of the pension plan, prior to the date of enactment.

The bill prescribes new and stringent rules of conduct required for trustees and fiduciaries administering employee benefit funds, and prohibits conflicts of interest and various specific parctices to prevent actual or potential misuse of such funds.

It requires additional and comprehensive disclosure of vital data in reports to be filed with the Federal Government, and understandable explanations to workers of their rights and obligations under their pension plans.

The bill makes it unlawful for any person to discharge, suspend, expel, fine, discipline or discriminate against participants in order to interfere with their rights under the plan or the Act or for the purpose of preventing the attainment of their rights under the plan or the Act. It is made a criminal offense to use fraud, force or violence, or threats thereof, in this connection.

Finally, it establishes federal jurisdiction and adequate remedies to both the Government and individual worker for judicial and administrative enforcement of the bill's provisions, including recovery of pension benefits due.

II. Background

History of Pension Plan Regulation

The growth of the private pension industry in the United States, which began before the turn of tle century, had been gradual until the years preceding World War II. By 1925, there were about 400 private pension plans in operation. However, as time progressed and American attitudes and beliefs regarding retirement security changed, as a result of the Depression, and the subsequent passage in 1935 of the Social Security Act and the Railroad Retirement Act, a steady increase in the growth of the private pension plan system began. The wage freezes, imposed during World War II and the Korean conflict, contributed to the acceleration of this growth. Increases in fringe and retirement benefits during these crucial periods became a means of compensating workers in lieu of increased wages, thus making pension benefits a form of deferred wages.

In 1947, stemming from a suit filed with the National Labor Relations Board, the U.S. District Court decided that pensions were a form of remuneration for labor within the terms of the National Labor Relations Act (1935) and, accordingly, they were recognized as mandatory subjects of the collective bargaining process. This decision was upheld by the Seventh Circuit Court of Appeals in 1948 and paved the way for the rapid growth of collectively-bargained pension plans and the expansion of pension benefits to union members. (*Inland Steel Company v. NLRB, 170 F. 2d 247 (7th Cir. 1948), cert. denied, 336 U.S. 960 (1949)*.)

In 1940, an estimated four million employees were covered by private pensions; in 1950, the figure had more than doubled to 9.8 million; in 1960, over 21 million employees were covered; and in 1973, approximately 30 million workers participated. Currently, about one-half of our industrial work force in the United States are members and participants of private pension plans. It is projected that by 1980, 42.3 million workers will be covered by private pension plans. The growth of the assets owned or controlled by pension funds has closely paralleled this expansive growth. Total estimated assets of pension plans have accelerated from $2.4 billion in 1940 to $150 billion in 1973 and are increasing at a rate projected to exceed $250 billion by 1980.

This rapid growth has constituted the basis for legislative efforts by both the federal and various state governments to gain some regulatory jurisdiction over private pension plans to assure effective and equitable performance. Various aspects of pension plans have been affected to some degree by most of the major labor legislation of the twentieth century, including the National Labor Relations Act (1935), the Labor-Management Relations Act (1947), and the Labor-Management Reporting and Disclosure Act (1959). However, not until 1958, with the enactment of the Welfare and Pension Plans Disclosure Act, was legislation effected which was specifically designed to exercise regulatory controls over pension and welfare funds. Based upon disclosure of malfeasance and improper activities by pension administrators, trustees, or fiduciaries, the Act was amended in 1962 to designate certain acts of conduct as federal crimes when they occurred in connection with welfare and pension plans. The amendments also conferred investigatory and various regulatory powers upon the Secretary over pension and welfare funds. In the decade since the amendments were enacted, experience has shown that, despite intermittent enforcement of the reporting requirements and the criminal provisions, the protection accomplished by statute has not been sufficient to accomplish Congressional intent.

The Existing Law

The growth and development of the private pension system in the past two decades has been substantial. Yet, regulation of the private system's scope and operation has been minimal and its effectiveness a matter of debate. The assets of private plans, estimated to be in excess of $150 billion, constitute the only large private accumulation of funds which have escaped the imprimatur of effective federal regulation.

At the federal level, there are essentially three federal statutes which, although accomplishing different purposes and vested within different federal departments for enforcement, are all compatible in their regulatory responsibilities. These are the Welfare and Pension Plans Disclosure Act (29 U.S.C. Sec. 301 et. seq.), the Labor-Management Relations Act (29 U.S.C. Sec. 141, et. seq.) and the Internal Revenue Code (I.R.C. of 1954, Secs. 401–404, 501–503).

A complete description of the federal regulation affecting the administration of private plans can be found in Interim Report of The Private Welfare and Pension Plan Study, 1971, Senate Report No. 92–634 of the 92d Congress, 2d Session.

After a comprehensive investigation of abuses in the administration and investment of private fund assets, Congress adopted the Welfare and Pension Plan Disclosure Act in 1958. The policy underlying enactment of this Act was purportedly to protect the insterest of welfare and pension plan participants and beneficiaries through disclosure of information with respect to such plans. The essential requirement of the Act was that the plan administrator compile, file with the Secretary of Labor, and send to participants and their beneficiaries upon written request, a description and annual report of the plan. It was expected that the knowledge thus disseminated would enable participants to police their plans. The Act was amended in 1962 to make theft, embezzlement, bribery, and kickbacks federal crimes if they occur in connection with welfare and pension plans. The 1962 amendments also conferred limited investigatory and regulatory powers upon the Secretary of Labor, and required bonding of plan officials.

Experience in the decade since the passage of the above amendments has demonstrated the inadequacy of the Welfare and Pension Plans Disclosure Act in regulating the private pension system for the purpose of protecting rights and benefits due to workers. It is weak in its limited disclosure requirements and wholly lacking in substantive fiduciary standards. Its chief procedural weakness can be found in its reliance upon the initiative of the individual employee to police the management of his plan.

The Labor-Management Relations Act, Sec. 302, provides the fundamental guidelines for the establishment and operation of pension funds administered jointly by an employer and a union. The Act is not intended to establish nor does it provide standards for the preservation of vested benefits, funding adequacy, security of investment, or fiduciary conduct.

Tax deduction benefits accruing to employers are prescribed by the Internal Revenue Code under which the employer is granted a deduction within certain limits for contributions made to a qualified plan, and the investment earnings on such plans are made tax-exempt. To attain "qualified status" under the Code, the plan must be (1) for the exclusive benefit of the participants; (2) for the purpose of distributing the corpus or income to the participants; (3) established in such a manner to make it impossible for the employer to use or divert funds before satisfying the plan's liabilities; and (4) not discriminate in favor of officers, stockholders, or highly-compensated or supervisory employees.

The Internal Revenue Code provides only limited safeguards for the security of anticipated benefit rights in private plans since its primary functions are designed to produce revenue and to prevent evasion of tax obligations. The essence of enforcement under the Code lies in the power of the Internal Revenue Service to grant or disallow qualified status to a pension plan, thus determining the availability of statutory tax advantages. The Internal Revenue Service jurisdiction and enforcement capabilities are solely to allow various tax advantages to accrue to employers who establish and maintain pension plans which can qualify for such tax benefit privileges.

In the absence of adequate federal regulation, the participant is left to rely on the traditional equitable remedies of the common law of trusts. A few states, including New York, Washington, Wisconsin, Massachusetts, and California have codified existing trust principles and enacted legislation which requires in many instances a greater degree of disclosure than required by federal statute.

The fact that statutory rules exist says little as to their efficacy in adjusting inequities that are visited upon plan participants, as evidenced by the hearings before this Committee. In almost every instance, participants lose their benefits not because of some violation of federal law, but rather because of the manner in which the plan is executed with respect to its contractual requirements of vesting or funding. Courts strictly interpret the plan indenture and are reluctant to apply concepts of equitable relief or to disregard technical document wording. Thus, under present law, accumulated pension credits can be lost even when separated employes are within a few months, or even days, of qualifying for retirement.

The proposed bill would, therefore, establish minimum standards of vesting, funding, and fiduciary conduct and also provide for voluntary portability of earned pension credits and a system of compulsory benefit insurance to protect the security of pension rights.

As suggested by the President's Cabinet Committee Report of 1965: "As a matter of equity and fair treatment an employee covered by a pension plan is entitled, after a reasonable period of service, to protection of his future retirement benefit against any termination of his employment." Concern for loss of benefits by workers after long years of labor through circumstances beyond their control was similarly expressed by President Richard M. Nixon on December 8, 1971, when, in a message to the Congress he said, "When a pension plan is terminated, an employee participating in it can lose all or a part of the benefits which he has long been relying on, even if his plan is fully vested . . . even one worker whose retirement security is destroyed by the termination of a plan is one too many."

Prior Legislative Action

Prior inquiries and studies by the Senate into the administration and operations of the private pension plan system in the United States were made by the Subcommittee on Welfare and Pension Funds, Committee on Labor and Public Welfare under authority of Senate Resolution 225, 83d Congress, and Senate Resolution 30, as extended by Senate Resolutions 200 and 232 of the 84th Congress. That comprehensive investigation, which concluded with a final report to the Senate on April 16, 1956, had been primarily directed to determine whether federal legislation was necessary to protect the financial interests of participants in welfare and pension plans. The study also involved an appraisal of the functions exercised by federal agencies over private pensions, as well as the adequacy of state controls. It concluded with various findings and recommendations to the Senate, and, more specifically, calling for enactment of federal legislation to compel registration, disclosure and periodic reporting of welfare and pension plans in the United States. The Subcommittee intended that Congress provide for greater legislative protection for beneficiaries of pension plans through detailed public disclosure of the administration and operation of private pension plans.

Subsequently, the Subcommittee on Welfare and Pension Plans in the 85th Congress, 1st Session, conducted public hearings on legislative proposals. These measures proposed to establish the federal regulatory controls contemplated by the prior Subcommittee findings and recommendations. The records of these prior hearings and reports made by the Senate have been given meticulous and concerned analysis by this Subcommittee, and have furnished immeasurable and invaluable assistance in the inquiry which led to S. 4.

The prior investigations by the Senate culminated with the enactment of the Welfare and Pension Plans Disclosure Act on August 28, 1958. Its main objective was to require welfare and pension benefit plans covering more than 25 employees to file a description of the plan and pertinent financial reports with the Department of Labor, and to furnish participants and beneficiaries, upon request, with a description of the terms of the pension plan and summary of financial data pertaining to the plan. On June 18, 1962, amendments became effective that furnished the Secretary of Labor with enforcement authority and the power to require bonding of plan personnel who handle plan funds or assets. Various criminal penalties were added to the Act to apply to embezzlement, bribery, and other criminal actions which threaten the security of the funds of private pension plans.

During the 89th Congress, the Senate Special Committee on Investigations, the Senate Finance Committee, and the Joint Economic Committee each held investigatory hearings on the subject of pension and welfare plans. The Senate Special Committee on Aging took up the subject in the 90th Congress, as part of a comprehensive study on Developments in Aging, and the House Subcommittee on Labor of the Education and Labor Committee held extensive hearings in the 91st and 92nd Congresses. During the 90th Congress, 2nd Session, the Senate Labor Subcommittee held further hearings on four bills which proposed additional amendments to the Welfare and Pension Plans Disclosure Act, and various other reforms of the welfare and private pension plan system. None of this legislation was enacted.

During the 92nd Congress the Senate Labor Subcommittee under the mandate of successive Senate resolutions conducted sweeping inquiries into the private pension system. These inquiries are described more fully in Section IV of this Report *infra.*

In the 93rd Congress the Senate Labor Subcommittee held legislative hearings on S. 4 on February 15 and 16, 1973 and both the House General Labor Subcommittee and the House Ways and Means Committee conducted hearings in February and March of 1973 on this subject. The House General Labor Subcommittee has issued two interim reports covering its activities to date.

Executive Branch Activity

The Executive branch expressed interest in the private pension plans system when, in March,1962, President John F. Kennedy appointed a Cabinet Committee on Corporate Pension Funds to conduct an investigation of and assessment of laws which govern private pension and other employee retirement income programs. Additionally, the Committee was directed to review legislation and administrative procedures applicable to pension plans. It reported its findings on January 15, 1965, to President Lyndon B. Johnson on various aspects and areas of private pensions which it believed required remedial action. The Presidential Committee concluded that:

> there were no effective prescribed government standards governing welfare and pension plans;
>
> vesting provisions were generally severe and restrictive, or nonexistent;
>
> lack of an adequately comprehensive federal funding requirement plans terminated prematurely, with no insurance to provide for payment of accrued benefits to workers; and
>
> employees could be immobilized by lack of portability of earned pension credits.

The President's Committee findings in effect revealed that defective private pension plans were failing to provide the elderly with adequate income to meet economic needs when their productivity had ended.

In a report to delegates attending the 1971 White House Conference on Aging, called by President Richard Nixon, the need for strengthening private pension plans was emphasized. The Employment and Retirement Section of that Conference reported that: "Legislation must be enacted as soon as possible requiring early vesting, adequate funding and portability of pensions and to provide for Federal insurance of pensions." They further state, "A National Pension Commission with a Governing Board of management, labor and public representatives should be established to encourage the expansion and the improvement of pension plans with particular reference to: flexible retirement ages, liberal (early) vesting and portability, adequate funding, more general coverage, and job redesign."

Moreover, in a report of a Special Task Force to the Secretary of Health, Education and Welfare, issued December, 1972 and entitled "Work in America" it was concluded that: "earlier vesting and portability would clearly reduce inequities in the existing private pension plans, and enhance the worker's ability to change occupations—to be freed from the job that keeps him only because it holds out the promise of economic security".

III. Major Issues

Although the need for legislative reform has been and continues to be widely acknowledged among all persons and sectors affected, governmental supervision of mandated and essential improvements has been resisted due to the belief that such legislation might impede plan growth. However, as the Committee has progressed in its inquiries and made public disclosures of its analysis and findings, it has been discerned that some resistance has become dissipated and various opponents have now acknowledged that such reforms will not deter the establishment or the improvement of pension plans.

The principal issues affecting the vital and basic needs for legislative reform involve consideration of the essential elements of pensions:

a. Vesting

One of the major private pension plan considerations centers around the concept of vesting. Vesting refers to the nonforfeitable right or interest which an employee participant acquires in the pension fund. The benefit credits may vest in the employee immediately, although in most cases participants do not become eligible for vesting of benefits until a stipulated age or period of service, or a combination of both, is attained.

Upon compliance with the basic requirements of age or service, many plans will grant their participants vested rights to those benefits earned to that time. However, should employment terminate prior to such time, the employee will recieve no benefits. Some pension plans, however, specify "graded" vesting formulas, whereby only a defined percentage of the accrued benefits earned will vest upon fulfillment of minimum requirements, and such percentage may increase periodically, as the employee continues in his employment and completes additional service.

Despite the recognized and acknowledged need for pension plans to provide for vesting of earned benefits, if pension promises are to be meaningful to workers, there is need for federal statutory requirements which will compel an employer to grant such vesting benefits. The difficulties and hardships resulting from nonexistent or inadequate plan provisions for vesting of benefits have been vividly established by the Subcommittee's studies and hearings.

It is noteworthy that in 1965, the President's Commission on Public Policy and Private Pensions, while acknowledging that there had been some improvement in private plans by increased adoption of vesting provisions, nonetheless found and recommended legislation to make minimum vesting provisions mandatory. That Commission concluded that ". . . the degree of retirement protection in private pension plans varies widely and in many cases remains quite inadequate." (President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, *Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans*, January, 1965, p. 39).

The vesting concept recommended by the Cabinet Committee suggested preference for deferred graded vesting. It specifically favored a vesting formula under which 50 percent of an accrued pension would be vested in a plan participant upon completion of 15 years of service, with rights to full vesting of accrued pension credits to occur after 20 years of service. In general, although there has been some discernible progress to permit early vesting of benefits to employees, some employers incline to defer such vesting until the employee reaches a normal or early retirement eligibility formula. This is essentially based upon the belief that it will discourage and deter such employee from leaving the job before reaching retirement age.

Despite claims by opponents that progress made in pension plan provisions to provide vesting manifest an eventual voluntary vesting system, plans involving substantial numbers of workers which contain no vesting are still not uncommon. The Senate Labor Subcommittee's statistical analysis of data furnished by 1,493 private pension plans has concluded that approximately 13 percent of private pension plans in the United States do not contain provisions which require vesting of benefits to employees prior to retirement. Opponents of mandatory vesting believe that compulsory vesting provisions will discourage development of new plans and impede flexibility and latitude in formulating employee benefits because of excessive costs that are certain to result. However, in face of Subcommittee findings relative to projected costs to plans for imposed vesting, indications are that the resistance of opponents to universal vesting is essentially structured upon extreme reluctance to submit to governmental regulatory measures concerning pension plan administration and operations. In its final analysis, the issue basically resolves itself into whether workers, after many years of labor, whose jobs terminate voluntarily or otherwise, should be denied benefits they have earned as deferred compensation and which have been placed for them in a fund for retirement purposes.

b. Funding

Another major issue in private pension plans relates to the adequacy of plan funding. "Funding" refers to the accumulation of sufficient assets in a pension plan to assure the availability of funds for payment of benefits due to the employees as such obligations arise. Today, funding of pension plans for the limited and specific purpose of qualifying for tax benefits permitted by law for contributions made is governed by statutory and regulatory requirements which are under the jurisdiction of the Internal Revenue Service (I.R.S. Code of 1954, Sections 401–404). The minimum funding rules (Treasury Regulations, Sections 1.401–404(c) (1963)) require an employer to make contributions to a pension fund, qualified by the Internal Revenue Service, of amounts at least equal to the pension liabilities being created currently, and the interest due upon those amounts of monies which reflect unfunded accrued liabilities. The inherent weakness of this required minimum funding is that the employer is not required under law to make payments toward the *principal* of the unfunded accrued liabilities. Without mandatory funding of past service liabilities, a pension plan may never be in financial posture to meet its pension obligations to its employees.

The pension plan which offers full protection to its employees is one which is funded with accumulated assets which at least are equal to the accrued liabilities, and with a contribution rate sufficient to maintain that status at all times. However, since plans are revised and amended to provide new benefits which create new and different liabilities for the plan, opponents of compulsory funding argue that it is unrealisitc to expect that plans maintain a full funding status at all times. The same opposition is voiced for new plans, which invariably assume a large unfunded liability at the outset of the plan, due to the granting of credit for past service by employees to the employer.

The ineffectiveness of funding requirements were acknowledged in the President's Cabinet Committee Report of 1965, when it concluded that ". . . the minimum standards for funding under present tax law do not assure adequate funding. The setting of standards for adequate funding therefore becomes an important public concern." (*Public Policy and Private Pension Programs*, 1965, pp. 50–51). The Promise and commitment of a pension can be fulfilled only when funds are available to pay the employee participant what is owed to him. Without adequate funding, a promise of a pension which may be illusory and empty.

c. Reinsurance

One of the more dramatic evidences of the deficiencies of pension plans, illustrated by the Studebaker case in 1964 and more recently in over 100 cases of pension plan termination uncovered by the Subcommittee during its inquiry into plan termination, is the failure of employees to receive all of the pension benefits to which they are entitled, when a company shuts down, relocates or merges with another corporate entity. Some critics have proposed that corporate assets be committed to guarantee any pension obligations which exist at termination.

Another suggestion is that a federal insurance program should be instituted to guarantee the payment of these obligations. Under this program, specified premiums would be paid by pension plan administrators, and, in the event that a plan is forced to terminate, with insufficient assets to pay vested employee benefits funds from the guaranty fund would become available for this purpose. The adverse impact upon workers of terminated underfunded plans was effectively shown in the Subcommittee report on plan terminations issued September 11, 1972.

In his message to Congress of December 8, 1971 on the subject of pension reform the President directed the Departments of Labor and Treasury to undertake a one-year study of pension plan terminations. To date, an interim report has been published. It reports 683 pension plan terminations during the first seven months of 1972 affecting approximately 20,700 pension participants.

d. Portability

Portability refers to the process by which an employee is permitted to transfer his earned vested pension rights from job to job and at the end of his career be able to convert all such credits into a final benefit amount reflecting all of his prior service. Such a process would require a centralized control or clearinghouse through which the earned credits could be channeled. The interchangeability of earned vested pension credits would require regulatory and administrative machinery in a federal agency to make it function properly. An effective system which permits the transferability of earned vested pension credits is certain to facilitate the mobility of labor.

e. Fiduciary responsibility and disclosure

Another area of concern of the Subcommittee has involved the conduct of administration and operations of pension plans. Of particular interest has been the course of conduct in fund transactions, the degree of responsibility required of the fiduciaries, the types of persons who should be deemed pension "fiduciaries," and the standards of accountability they shall be governed by in the management and disposition of pension funds. The only current federal requirement is that the Secretary of Labor require fiduciaries, trustees, etc., to make disclosure of the provisions and financial operations of the pension plan under the Welfare and Pension Plans Disclosure Act.

An important issue relates to the effectiveness of communication of plan contents to employees. Descriptions of plans furnished to employees should be presented in a manner that an average and reasonable worker participant can understand intelligently. It is grossly unfair to hold an employee accountable for acts which disqualify him from benefits, if he had no knowledge of these acts, or if these conditions were stated in a misleading or incomprehensible manner in plan booklets. Subcommittee findings were abundant in establishing that an average plan participant, even where he has been furnished an explanation of his plan provisions, often cannot comprehend them because of the technicalities and complexities of the language used.

IV. Committee Studies and Activities

The Subcommittee on Labor, pursuant to Senate Resolution 235, 92nd Congress, March 6, 1972, and prior resolutions from the 91st Congress, has conducted a comprehensive and exhaustive study of the private pension plan system in the United States, with particular emphasis upon the impact which such plans have upon the workers covered. The Subcommittee's implementation of the Senate resolutions has been a methodical collection and analysis of vital statistics and pertinent detailed data from individual and group cases reflecting the internal administration and operations of private pension and welfare plans. Invaluable data was furnished by 1,493 selected pension plans in response to a comprehensive questionnaire prepared by the Subcommittee in the spring of 1970. The data was analyzed in the Senate computer to extract information for evaluation by the Subcommittee staff to ascertain the weaknesses and effectiveness of the provisions of such plans. A preliminary staff report was issued on March 31, 1971, which contained findings by the Subcommittee relative to 87 pension plans covering approximately 10 million workers. Staff studies were also conducted of numerous individual pension plans in different industries and geographical locations in the United States. An additional study of 764 pension plans was made by the staff and its findings published on November 7, 1971, which, among other findings, determined that the median monthly income being received by retired pension plan participants in the United States was approximately $99.00.

In September 1972, the final statistical analysis of the 1,493 plans was prepared and a report issued. It focused on the several characteristics of private pension plans, eligibility requirements, retirement provisions, vesting, funding, disclosure and fiduciary standards. In general, it demonstrated that a substantial number of plans do not meet the obligation promised of retirement with dignity after many years of service.

In addition to the staff studies of plans, investigatory hearings were held in Washington, D.C. during July and October 1971, at which time workers, employers and affected sectors testified with respect to various inequities and hardships resulting to the plan participants from the non-existent or defective provisions of such plans with respect to vesting, funding, portability and insurance issues. During these hearings, 14 employer organizations and more than 25 individual plan participants were heard during a total of five days of hearings. Additionally, during 1972, the Subcommittee conducted field hearings on plan terminations in five major cities throughout the United States. These hearings, in St. Louis, Newark, Minneapolis, Cleveland and Philadelphia, publicly disclosed the adverse effects resulting to workers from the inadequate funding of pension plans which covered them. The problems surfaced were representative of those which exist in other cities throughout the country. These selective hearings in the five cities encompassed several different industry pension plans covering over 22,500 employees. Investigation preceding the hearings encompassed more than 115 other companies which had terminated their pension plans with similar disastrous effects upon their employees.

On May 11, 1972, S. 3598, the predecessor bill to S. 4, was introduced in the U.S. Senate. This legislative proposal, as its successor, S. 4, embodies remedies specifically designed to correct the deficiencies uncovered and would provide adequate protection to pension plan participants. In June 1972, the Subcommittee held six days of legislative hearings on S. 3598, at which time the Subcommittee heard testimony of not only experts in the pension field, but representatives and organizations vitally affected by the legislation.

After S. 4 was introduced in the Senate, similar legislative hearings were held on February 15 and 16 in the 93rd Congress, First Session, relative to S. 4 which incorporated all the provisions of its prececessor, S. 3598.

These hearings exemplified the purpose of underlying the Subcommittee's entire study, in that all affected sectors, within the limits of time available, were afforded ample opportunity to present their views with respect to proposed legislation. Additionally, those whose requests to testify could not be honored due to limitations of time, were encouraged to submit statements and views for consideration by the staff. Many of these resulted in subsequent conferences to discuss the merits of objections and suggestions. A number of suggestions were meritorious and constructive and were subsequently incorporated into the bill.

Because of the Subcommittee's concern with the effects which the projected costs of mandatory vesting might impose upon pension plans, the Subcommittee, through the actuarial firm of Grubbs & Company, Baltimore, Maryland, conducted its own actuarial study and evaluation of estimated increases in pension plan costs resulting from vesting provisions. This study, conducted by a recognized and qualified actuarial firm, permitted the Subcommittee to assess the range of increased costs to private pension plans which might be anticipated as a result of enactment of S. 3598. A summary of the Subcommittee cost study is attached as Appendix.

The Subcommittee's implementation of its study, as mandated by Senate resolution, was methodical and analytical. It undertook initially, through its inquiries and fact-finding, to define the specific problems of private pension plans in the United States. When the problems were sufficiently identified, a comprehensive analysis of each was made by the Subcommittee staff. The analysis was essential in order to determine the need and extent of reform essential to meet the deficiencies and problems surfaced.

In considering S. 4 and other legislation, the Subcommittee was of the opinion that, based upon its findings, it would be unwise and impractical to propose either revisions or new provisions of law in patchwork fashion. It was convinced that the nature and extent of the problems determined to exist required one omnibus legislative proposal which would embody essential and indispensable reforms.

V. Committee Action and Explanation of Amendments

The Committee enthusiastically endorses the concept of a comprehensive private pension reform program. It believes that expeditious enactment of S. 4 will institute a program which will achieve a stengthening of the role played by private retirement plans within the fabric of our economic and social structures. Its most important purpose will be to assure American workers that they may look forward with anticipation to a retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society. The enactment of progressive and effective pension legislation is also certain to increase stability within the framework of our nation's economy, since the tremendous resources and assets of the private pension plan system are an integral part of our economy. It will also serve to restore credibility and faith in the private pension plans designed for American working men and women, and this should serve to encourage rather than diminish efforts by management and industry to expand pension plan coverage and to improve benefits for workers.

The Committee believes that the legislative approach of establishing minimum standards and safeguards for private pensions is not only consistent with retention of the freedom of decision-making vital to pension plans, but in furtherance of the growth and development of the private pension system. At the same time, the Committee recognizes the absolute need that safeguards for plan participants be sufficiently adequate and effective to prevent the numerous inequities to workers under plans which have resulted in tragic hardship to so many. The Committee has vividly demonstrated this need in public hearings.

The Bill reported by the Committee represents an effort to strike an appropriate balance between the interests of employers and labor organizations in maintaining flexibility in the design and operation of their pension programs, and the need of the workers for a level of protection which will adequately protect their rights and just expectations. In adopting this approach, the Committee believes it has designed a bill, which, like the National Labor Relations Act, the wage-hour laws and other labor standards laws, brings the workers' interests up to parity with those of employers. This legislation strikes an appropriate and equitable balance between two opposing schools of thought—those who advocate complete and stringent control of private pensions and those who oppose any form of government supervisory or regulatory control.

The Subcommittee on Labor unanimously adopted and reported out S. 4, with several major changes from S. 4 as introduced on January 4, 1973. The Subcommittee Print also contained various changes which were technical or conforming in nature. These changes are explained in more detail in the section-by-section analysis which appears later.

Examples of major changes incorporated in the Subcommittee Print included:

1. Providing plan participants on the effective date of the vesting title with retrospective vesting credit for service performed prior to the effective date of the title regardless of the age of the plan participant. (Sec. 202)

2. Requiring the Secretary of Labor to undertake studies of vesting provisions with respect to high mobility workers and to develop recommendations for revision of government procurement regulations so as to provide more adequate protection against loss of benefits to professional, scientific, and technical personnel working on government contracts. (Secs. 101, 221–223)

3. Permitting the Secretary of Labor, upon appropriate application, to provide insurance to cover unfunded vested liabilities of a plan not otherwise covered by the Act, which conforms with vesting, funding and other standards required by the Act. (Sec. 401)

4. Requiring a plan to serve notice upon the Secretary of Labor of intent to terminate the plan; failure to provide such notice results in personal liability on persons who failed to give such notice of losses incurred by the Pension Benefit Insurance Fund. (Sec. 404)

5. Provision that persons who terminate plans with intent to circumvent the Act or WPPDA shall be personally liable for losses incurred by the Pension Benefit Insurance Fund. (Sec. 404)

6. Providing that upon termination an employer shall be liable for 100% of the plan's unfunded vested liabilities, but not to exceed 50% of such employer's net worth. (Sec. 405)

7. Where upon plan termination the plan has surplus assets attributable to employee contributions, they shall be equitably distributed in relation to employee contributions. (Sec. 510)

8. Fiduciaries cannot receive any consideration from any party dealing with such fund in connection with a transaction involving the fund. (Sec. 510)

9. No person can interfere with or discriminate against a participant with respect to rights and privileges which such person is entitled to under the plan, Act, or the WPPDA. (Sec. 610)

10. It shall be unlawful for any person to use force or threaten or otherwise interfere with a person's exercise of rights under the plan, Act, or WPPDA.

11. When considering the experience of multi-employer plans for insurance premium purposes the Secretary of Labor shall take into account the withdrawal of employers from the plan. (Sec. 217)

In its Executive meeting on March 20, 1973, the Committee adopted unanimously the following three amendments:

(1) An amendment offered by Chairman Williams and Senator Javits to assure participants that optional death benefits can only be waived in writing signed by the participant after the participant receives a written explanation of the terms and conditions of the options and the effect of such waiver. The amendment would prevent a participant from losing by default an optional death benefit. (Sec. 510)

(2) An amendment offered by Senator Javits to authorize the Secretary of Labor to bring civil litigation under the Act and the Welfare and Pension Plans Disclosure Act through attorneys appointed by the Secretary (except in the Supreme Court.) (Sec. 101)

(3) An amendment offered by Senator Javits extending coverage of the fiduciary and disclosure amendments to the WPPDA to all benefit arrangements described in or permitted by Section 302 of the Taft-Hartley Act. These benefit arrangements would include jointly administered vacation funds, apprenticeship training funds, day care centers, scholarship funds, etc. (Sec. 502)

In addition, there were several technical changes adopted by the Committee.

VI. Committee Views

Policy of the "Retirement Income Security for Employers Act"

The policy statement in Section 2 is most significant in that it recognizes that all of the problems in the private pension field surfaced by the Committee are so interrelated that they cannot be resolved without a comprehensive legislative program, dealing not only with malfeasance and maladministration in the plans, or the consequences of lack of adequate vesting, but also with the broad spectrum of questions such as adequacy of funding, plant shut-downs and plan terminations, transferability of vested credits, adequate communication to participants, and, in short, the establishment of certain minimum standards to which all private pension plans must conform if the private pension promise is to become a reality rather than an illusion.

Definitions

The Committee has the following technical notes concerning definitions:

The definition of "employee" is intended to encompass any person who has the status of an "employee" under a collective bargaining agreement.

The exclusion of assets of investment companies regulated under the Investment Company Act of 1940 from the definition of "fund" is not intended to exclude participating shares in an investment company held by the fund.

With respect to the term "profit-sharing retirement plan", it is intended that stock bonus, thrift and savings or similar plans with retirement features be treated as the equivalent of profit-sharing retirement plans for purposes of this Act unless expressly indicated otherwise.

With respect to the definition of "fully funded", it is intended that the assets of the plan be valued at fair market value at the time the funding status determination is made in order to ascertain whether plan assets are sufficient to cover all accrued liabilities. It is to be emphasized that "fully funded" is intended to refer to the sufficiency of assets with respect to all benefits which may be due and not just those benefits which are vested.

With respect to the term "experience deficiency", it is anticipated that the Secretary will devise rules to preclude a plan from suddenly revising actuarial standards in order to avoid or circumvent "experience deficiencies".

With respect to the term "normal service cost", it is intended that this definition be applied consistent with such cost methods recognized by the Internal Revenue Service unless there is an effort to avoid or evade the funding requirements of this Act.

With respect to the term "non-forfeitable right" or "vested right", it is not contemplated that vesting be required in benefits such as death benefits, disability benefits, or other forms of ancillary benefits provided by the plan. The plan may, of course, at its option, provide for vesting in such benefits.

With respect to the terms "normal retirement benefit" and "normal retirement age", it is intended that the participant not be compelled to await the receipt of his retirement or vested benefit beyond age 65. However, since the Act sets minimum standards, plans may provide retirement or vested benefits prior to age 65, or, on the basis of individual agreements made with participants, after age 65 if the participant so desires.

In formulating the definition of "multi-employer plan" the Committee was guided by the concept that such a plan, if sufficiently comprehensive in size or scope, would be unlikely to terminate because its existence did not depend on the economic fortunes of one employer or employer entity. The Committee recognized that certain single employer plans have characteristics similar to those of the multi-employer type described in the definition, but, on balance, it is believed that experience on plan terminations provides a reasonable basis for the distinction.

TITLE I.—ORGANIZATION

The Committee believes it is essential to concentrate in the Secretary of Labor sufficient powers to effectively implement the provisions of this Act with the minimum amount of duplication and overlapping o functions.

The Secretary's investigatory authority permits examination of plan books and records without the Secretary having reason to believe a violation of the Act (or Welfare and Pension Plans Disclosure Act) may exist. However, the Secretary is limited to one such examination annually. He may, of course, conduct an examination at any time when he has reasonable cause to believe a violation may exist. The Committee believes that monies in a pension or welfare fund should be as safe as money in a bank or insurance company. Periodic spot-check audits by governmental examiners is a time-tested method for assuring the security of funds. At the same time, the Committee recognizes a concern over possible "harassment" which may impede the effective implementation of the Act's requirements. Limiting the Secretary to one non-violation audit annually takes account of this concern and it is to be assumed that this authority shall be exercised in good faith and with no intent of capriciousness or harassment. In light of the large number of plans that will become subject to the Act, it is extremely doubtful, as a practical matter, that the Secretary could conduct more than one spot-check annually for any given plan.

The Secretary is also authorized to establish standards and qualifications for actuaries. This is a major innovation and indispensable to effective enforcement of the funding standards and operation of the plan termination insurance program. The Committee is unaware of any significant licensing procedures for actuaries at either the state of federal level and this may, to some extent, explain inadequate funding procedures which have been found to exist. Generally speaking, the American Academy of Actuaries is regarded as the umbrella organization with the most rigorous standards for admission to membership, and the Committee intends that the Secretary should give due weight to membership in this organization or its equivalent as a basis for certifying actuaries under the Act. Additionally, the Secretary may certify actuaries on the basis of objective standards, promulgated without regard to membership in any particular organization.

The Secretary is also required to establish and maintain reasonable limitations on actuarial assumptions. It should be noted that the Secretary is authorized not to prescribe what actuarial assumptions must be used, but rather to assure that those which are used are reasonable and reflect relevant experience.

The Secretary is authorized to undertake studies into the private pension and profit-sharing retirement plans covering a wide variety of subjects. Of particular interest to the Committee are those studies which would encompass methods of encouraging further growth of the private pension system and the advisability of additional coverage under the Act. With respect to the latter, the Committee intends that the Secretary pursue studies of those elements encompassed in this legislation to include but not be limited to vesting, funding, portability, reinsurance, and fiduciary and disclosure requirements. The Secretary is required to conduct appropriate studies of State, City and local government pension plans, exempt from S. 4, to ascertain any need for legislative actions with respect to these plans. He is further required to study the sufficiency of vesting provisions as applicable to workers who are engaged in high mobility services or professions such as scientists, engineers, teachers, architects and similar occupations. The innovative provisions of this bill require close observation to assure fulfillment of the legislative intent and accordingly, appropriate revisions or other necessary changes shall be incumbent upon the Secretary to initiate. The Secretary shall give high priority to recommendations regarding further legislation.

In order to avoid duplications and unnecessary expense, the Secretary is authorized to make arrangements with appropriate federal or state agencies for assistance in the performance of his functions. In addition, the Secretary is authorized to enter into arrangement with appropriate state agencies to assist him in implementing the Act's provisions. The states of Wisconsin and New York, for example, exercise supervision over certain pension and welfare funds in their respective jurisdictions, and the experience and technical know-how of these state agencies would be of valuable assistance to the Secretary. It is not intended, however, that the state agencies utilized would formulate or apply substantive standards to plans subject to this Act which differ from the standards in this Act. The Secretary may also enter into appropriate agreements with such Federal Banking agencies as the Comptroller of the Currency, the Federal Deposit Insurance Corporation, etc. to assist him in administering and enforcing the fiduciary standards in the Welfare and Pension Plans Disclosure Act.

Part B. Coverage and Exemptions

It is intended that coverage under the Act be construed liberally to provide the maximum degree of protection to working men and women covered by private retirement programs. Conversely, exemptions should be confined to their narrow purpose.

In the case of any plan which fluctuates in terms of participant coverage both above and below twenty-six participants, it shall continue to be subject to the Act's coverage once it has become initially subject to the Act's coverage.

Plans of all non-profit institutions, with the exception of religious organizations, shall be subject to the Act in order to provide the employees of these institutions with protection equal to the protection of employees of profitmaking organizations. In the case of plans established or maintained by religious organizations for the benefit of employees engaged in activities not substantially identified with the primary role of the religious organization, such employees should obtain the benefits of coverage under this Act.

The Committee notes that special exemptions have been provided to plans which are financed exclusively through the medium of union membership dues and for plans which, as indicated above, cover less than 26 participants. As to the first, it was the Committee's conclusion, after careful consideration, that it would be unwise to impose federally mandated standards of vesting and funding on plans where the participants themselves have the means through the democratic processes of their union (as protected under the LMRDA) to install these improvements themselves. To insist on the application of the standards in this Act to such plans would, in effect, result in requiring the union members to tax themselves at a higher rate for benefit improvements which they themselves have been unwilling to accomplish for themselves by the means at hand. Such an approach would be inconsistent with the basis of this legislation which is to provide welfare and pension plan improvements where the participants do not have the means to provide these improvements themselves through their collective actions.

The Committee also concluded that an exemption for plans of small size was necessary in order to prevent discouraging small employers from establishing pension plans. The Committee has abundant statistical evidence to demonstrate that the greatest need for extending pension plan programs occurs in connection with employees of small business. While reasonable men may differ in their judgment as to whether a small plan exemption would encourage greater expansion of private pension plans among small businessmen, it is the Committee's judgment that subjecting all plans, regardless of size, to the standards of this Act could have an inhibiting effect on future private pension expansion. In addition, the Committee recognized that small plans established for the self-employed and their employees meet adequate vesting standards under other laws. Finally, the bill does require the Secretary to study the need for expanding coverage of this Act to those plans which are not made subject to this Act. The Committee believes that this study will provide useful data which can serve as the basis for further policy in connection with expanding the Act's scope of coverage to smaller plans.

SECTION 108. CERTIFICATE OF RIGHTS

The Committee intends that the phrase "furnish or make available, whichever is most practicable" be construed to assure that plan participants obtain a copy of vested right certificates without imposing impractical burdens on plan administrators. In the case of large multiemployer plans, for example, arrangements made to delegate the certificate function to the participating employers or to require the participant to apply for his certificate upon his severance from employment may be necessary. Wherever possible, preference should be given to requiring the administrator to furnish the certificate to the participant.

Copies of vested right certificates are also required to be filed with the Secretary so that in the event a participant loses or misplaces his certificate or the certificate is accidentally destroyed, a record copy is availabe with the Secretary. It is the view of the Committee that the Secretary should explore the feasibility of coordinating his record keeping responsibilities in connection with this provision with the Social Security Administration so that the most efficient mechanism for maintaining records of vested interests can be developed.

TITLE II.—VESTING AND FUNDING REQUIREMENTS

PART A. VESTING

SECTION 201. ELIGIBILITY

Section 201 provides that no pension plan shall require, as a condition for eligibility to participate, a period of service longer than one year or an age greater than 25, whichever occurs later; however, a plan which provides 100% immediate vesting upon entry into plan, may restrict participation to those who are 30 years of age or have three years of service, whichever occurs later.

Earlier eligibility standards were considered and appeared to impose an unwarranted additional cost on plans. Additionally, the Committee believes on the basis of substantial evidence presented that until age 25 a large portion of the work force is still transient and accounting for such employees would impose unduly burdensome and costly record-keeping requirements on plan administrators. The Committee believes that an age 25 entry standard approaches the norm for the majority of plans today.

The exception for plans which provide 100% full vesting upon plan entry is based on the fact that such plans, like the TIAA-CREF plan for college teachers, provide earlier vesting in larger amounts than provided under the bill, and requiring such plans to install earlier membership requirements would impose burdens well beyond the minimum standards approach intended by the Committee, and might compel such plans to sacrifice immediate full vesting on plan entry.

SECTION 202. VESTING SCHEDULE

The Committee has endorsed a major innovation which provides for retrospective credit in accured benefits attributable to service rendered prior to the effective date of the vesting provisions. The prior version of S. 4 limited such retrospective vested benefit credit to workers age 45 or older on the effective date of the vesting provisions.

The prior version of S. 4 was predicated on the theory that older workers were most in need of retrospective vesting credit and that younger workers would have, in most instances, ample opportunity to attain adequate amounts of vested credits under the bill on the basis of their opportunity for service after the effective date of the vesting provisions.

Testimony in the February 15 and 16 hearings of the Labor Subcommittee indicated, however, that restricting retrospective vesting to workers age 45 tended to be arbitrary. In addition, actuarial cost data prepared for the Subcommittee in February, 1973, (See Appendix disclosed that the additional incremental cost associated with eliminating the age 45 cut-off was no more than .2 percent of payroll or an additional 9 percent of present plan cost. This additional increment of cost appears, therefore, to be tolerable by the vast majority of plans that would be subject to the vesting provisions of S. 4 and is greatly outweighed by the much larger number of workers who will be rewarded for their labors by retrospective vesting. Accordingly, in the interests of complete equity, as a means of strengthening worker's incentives based on private retirement arrangements, and to promote simplicity in the understanding and application of the vesting requirements of the bill, total retrospective vesting credit, regardless of age, was adopted.

It is to be understood that in the event the plan is provided a 5-year deferral from compliance with vesting in accordance with section 216, active participants at the time vesting compliance commences are to be provided credit for service performed during the 5-year period of deferral. It should also be made clear, that the vesting benefits provided by this title are applicable only to those active employees who are covered by the plan on the effective date of the title, or, in the event of a 5-year deferral, on the date statutory vesting compliance commences.

Section 202 requires that three of the eight years of service required to qualify for an initial vested right be continuous. In order to assist participants to know whether they have met this requirement, it is contemplated that the Secretary will prescribe appropriate notification procedures which avoid impractical burdens on plan administrators.

In addition, Section 202(b)(3) recognizes that while, in general, aggregate service rather than continuous service requirements will more nearly meet the needs of most employees in a mobile industrial society, such a standard if applied to an employee permanently separated from employment with 100% vested rights might militate against his subsequent rehire. Accordingly, Section 202(b)(3) permits an employer to ignore such an employee's prior service if he is rehired. This exception is not intended to apply to employees who are separated with less than 100% vested rights.

Under section 202(e), the Secretary is authorized to approve a vesting schedule, in lieu of that mandated by the bill, which provides a degree of vesting protection as equitable as that contained in the bill. For example, for most participants, vesting schedules in the so-called "pattern plans" negotiated in the auto industry, which provide 100 percent full vesting upon completion of 10 years of service, would appear to provide as equitable a degree of vesting protection as that in the bill. In no event, should the Secretary approve an alternate vesting schedule which provides for 100% vesting upon the completion of more than 15 years of service.

The Committee believes further that there is no reasonable justification for depriving employees in multiemployer plans of the vesting protection mandated by the Bill. Section 202 subjects such plans to its requirements.

PART B. FUNDING

SECTION 210.—FUNDING REQUIREMENTS

The Committee believes that actuarially sound funding procedures are indispensable to effective implementation of the purposes of the Act. If employers never went out of business or terminated pension plans before they were completely funded, there would, no doubt, be no persuasive justification for funding standards aside from whatever tax considerations might be applicable. Nevertheless, employers do experience financial or economic difficulties or they undergo varying degrees of corporate reorganization, all of which can lead to premature termination of underfunded plans. A plan termination insurance program provides the essential safeguard to the rights of workers who are trapped by these unforseen economic hazards but such a program cannot be made practical without being coupled to required standards of funding. To create a plan termination insurance program without appropriate funding standards would permit those who present the greatest risk in terms of exposure to benefit at the expense of employers who have developed conscientious funding programs. The funding standards contained in Section 210 are designed to lessen that unnecessary exposure by requiring every plan to be funded in a manner which will fully amortize unfunded liabilities in 30 years. 30 years was selected as representing more closely the funding period norm for most private plans. It is within the contemplation of the Committee that so-called "pay-as-you-go" or "terminal funded" plans are precluded under the requirements of this section.

It should be noted that the unfunded liabilities are to be amortized in no less than equal annual payments over a 30-year period. This will permit the unfunded liabilities to be funded faster in the earlier years of the plan and more slowly in the later years, as long as the cumulative funding status of the plan is always where it would have been if the unfunded liabilities had been amortized by precisely equal annual payments.

SECTION 211.—DISCONTINUANCE OF PLANS

One of the most unregulated features of the private pension plans is their bewildering array of inconsistent provisions governing the priority of distribution of plan assets in the event of plan termination. Section 211 is intended to rectify this matter and should be construed in an integral fashion with the plan termination insurance provisions. The Secretary has been given discretion to determine what constitutes "a substantial termination". In making his determination of a "substantial termination" the Secretary should be guided primarily by the interests of plan participants and beneficiaries and the capability of the insurance program to adequately and equitably underwrite plan termination losses.

PART C. VARIANCES

SECTION 216.—DEFERRED APPLICABILITY OF VESTING STANDARDS

The Committee recognizes that despite a three-year delayed effective date for compliance with vesting standards, there still may be some plans which will experience a cost burden that would result in substantial economic injury to the interests of employers and their employees.

As to these plans, provision is made that if they can demonstrate "substantial economic injury" as defined and intended by the Act, they may be eligible for an additional period not to exceed 5 years within which to commence compliance.

The requirement that in collectively-bargained plans both parties must join in requesting the variance is believed necessary since in such cases both parties involved have a vital and intrinsic interest. Both will serve as a check and balance on the other, and by virtue of this check and balance, a joint application from the parties is to be accorded due weight.

SECTION 217.—VARIANCES FROM FUNDING REQUIREMENTS

Under this section, the Secretary is directed to prescribe a period of time in excess of 30 years for multiemployer plans to fund their unfunded benefit liabilities. In prescribing such additional periods, it is the Committee's intention that the Secretary may proceed by promulgating specific periods for specific multiemployer plans or for specific classes of multiemployer plans where characteristics are substantially identical. In promulgating such additional periods the Secretary need not be bound by actuarial standards more appropriate in application to single employer plans, but should formulate a standard of funding adequacy which reflects the plan's experience and gives reasonable assurance that the plan's benefit commitments will be met. While no specific upper limit on the funding period is expressed in this section, no additional period should be prescribed which would be manifestly inconsistent with the underlying purposes of this Act.

In considering the experience of multi-employer plans for establishment of new premium rates, the Secretary shall take into account for prescribing lower rates, the withdrawal of employers from such plans, although the withdrawal did not result in significant reductions of contributions to the plan. The purpose of this provision is to direct the Secretary to assure that multi-employer plans are not inequitably treated by prescribing premium rates which do not take into account or are not consonant with the low incidents of termination experience of such plans.

In all proceedings under Part C, the Committee intends that the Secretary afford interested parties, including plan participants and beneficiaries, the opportunity to present their views.

Part D. Protection of Pension Rights

Because of rapid and frequent changes in Federal procurement objectives and policies, professional, teaching, scientific and technical personnel suffer a uniquely high rate of forfeiture under private pension plans. Last year, in connection with the National Science Policy and Priorities Act of 1972 (S. 32), the Committee adopted as a Title IV to that bill, requirements that would cause the Director of the National Science Foundation to investigate the matter and attempt to develop new procurement standards which would provide adequate protection of these mobile personnel who because of Federal procurement contract terminations and changes in procurement objectives rarely work long enough for a single employer so that the vesting standards contained in Title II of this bill would provide sufficient protection to them.

Upon review of this matter, the Committee concluded that it would be more appropriate to lodge this authority in the Secretary of Labor, who has overall supervisory authority of private pension plans under this bill, and to expand coverage of his authority to encompass other professional personnel, such as teachers, architects, medical technicians, etc., working on government contracts, in addition to engineers and scientists. This is accomplished in Part D of Title II.

Section 221 states that the Secretary of Labor shall develop his recommendations for changes in federal procurement regulations "in consultation with appropriate professional societies". The Committee considers this phrase to include unions of professional personnel. Section 221 also requires that changes in procurement contracts should be developed "to the extent feasible", and this element compels the Secretary of Labor to take account of the existing provisions of law affecting private pension plans, the circumstances surrounding the establishment and operation of such plans by government contractors, the impact of plan revisions on existing industrial relations in aerospace, defense, and similar industries, as well as the economic consequences of any specific approach or series of approaches to securing greater pension protection through governmentally-imposed standards.

TITLE III.—VOLUNTARY PORTABILITY PROGRAM FOR VESTED PENSIONS

It is the belief of the Committee that the voluntary portability program created by this Title will stimulate and lead to enhanced vested benefits under the Act and will pave the way for providing vested benefits more closely related to all of a worker's productive years. In addition, such a program will simplify and relieve many employers of recordkeeping problems which add administrative expense to their plans. The Committee is aware of the arguments of those who have opposed legislative efforts to initiate portability. However, the Committee is persuaded that such a program is feasible and that the successful implementation of a system of tax-free transfer of vested credits in Canada without the "clearinghouse" format created by this Section is proof of its feasibility. Obviously, if present tax laws could be modified to permit the tax-free transfer of vested credits by employees from job to job, then the "clearinghouse" system established by this Title might not be indispensable. However, in the absence of such far-reaching tax changes, the voluntary program established herein can prove to be of inestimable value to many participants.

There are a number of important elements of this voluntary program:

First, it is purely voluntary on the part of employers to enlist their plans in the portability system.

Second, it is purely voluntary on the part of the employee as to whether he wishes to transfer his vested credits from one member plan to another member plan through the clearinghouse mechanism.

Third, the Secretary is empowered to protect the employee's vested interest from his initial plan by assuring that the credits purchased from the new plan have equivalent actuarial value.

Fourth, amounts deposited in the "clearinghouse" fund may be channeled into socially desirable and productive investments, such as housing, since surplus amounts may be deposited in interest-bearing accounts of banks or savings and loan associations insured by the FDIC or the FSLIC.

Fifth, the Secretary is authorized to provide technical assistance to plans wishing to enter into reciprocal arrangements which will facilitate the free transfer of all pension credits, vested or not. In this connection, it is not intended that the Secretary actually establish such arrangements on behalf of the requesting parties but that he provide appropriate assistance.

The Committee does not believe that the portability program established by this Title is a substitute or replacement for adequate minimum vesting standards. It is, instead, an extension of the vesting concept which permits the employee to capture the value of his vested interest at a particular point in time and exchange that value for credits which will mature into an ultimately greater vested benefit than he might otherwise obtain.

TITLE IV.—PLAN TERMINATION INSURANCE

SECTION 401.—ESTABLISHMENT AND APPLICABILITY OF PROGRAM

The bill reported by the Committee requires plan termination insurance to cover unfunded vested liabilities incurred *prior to* as well as subsequent to enactment of the Act, in order to prevent employees from being deprived from insurance protection for retirement credits earned before enactment.

The Secretary may provide insurance to plans to cover unfunded vested liabilities of a plan not subject to the Act so long as there is compliance with the vesting, funding and other requirements of the

Act and the plan pays the requisite assessments and premiums. This is intended to make insurance coverage under the Act available on a voluntary basis to plans not subject to the Act.

SECTION 403.—ASSESSMENTS AND PREMIUMS

The Committee adopted a provision which requires initial three-year premium to be paid by plan, as follows:

(a) For funded vested liabilities incurred after enactment—0.2 percentum of unfunded vested liabilities;

(b) For unfunded vested liabilities incurred prior to enactment—0.2 percentum of unfunded vested liabilities provided plan was 75 percent funded during five-year period preceding Act, or if plan less than five years old on date of enactment, if it was reducing unfunded vested liabilities at rate of five percent each year;

(c) For unfunded vested liabilities incurred prior to Act, but funding tests above in (b) not met—not more than .4 percentum and not less than 0.2 percentum of such unfunded vested liabilities;

(d) As to multi-employer plans, both as to unfunded vested liabilities incurred before or after Act—not to exceed 0.2 percentum of all such unfunded vested liabilities.

In order to minimize the risk of shifting to the reinsurance program substantially unfunded liabilities created prior to enactment, it was believed essential to create two classes of risks for purposes of setting the premium rate. If the plan was being funded in an adequate fashion, i.e., was 75 percent funded or was amortizing unfunded vested liabilities at the rate of five percent each year, it was believed that such a plan was an acceptable risk and the .2 percentum premium rate was appropriate. In the event the plan did not meet the test of funding adequacy, as indicated, it falls in the category of being a higher risk, and therefore, can be charged up to twice the amount of normal premium, but no more. Since multi-employer plans, as defined in the bill, have a much lower risk of plan termination, it was believed appropriate to continue charging the .2 percent premium regardless of when the unfunded vested liabilities were incurred.

SECTION 404.—PAYMENT OF INSURANCE

There are a variety of circumstances under which pension plans terminate. In some cases, the termination proceeds by stages. In other cases, it may happen fairly rapidly. In order to carry out the purpose of the reinsurance program while at the same time protecting the program from undue exposure owing to delays, manipulation, or unforeseen economic hazards following plan termination, the Secretary is provided with sufficient flexibility to determine the most appropriate procedure for winding up terminated plans and assuring effective implementation of the insurance program.

It is also required that plans furnish to the Secretary adequate prior notice of intent to terminate the plan. Persons responsible for giving such notice who fail to do so, or who terminate plans in order to circumvent or avoid the Act or the WPPDA, are held personally liable for losses sustained by the insurance program. The Committee believes this approach to be more practical and less time-consuming than requiring a plan to obtain the approval of the Secretary before the plan can be terminated, which was the approach employed in the prior version of S. 4.

SECTION 405.—RECOVERY

The Committee recognizes that in order to provide adequate protection to employees against loss of vested benefits owing to premature plan termination, it is necessary for the insurance program to cover all forms of plan termination regardless of the circumstances giving rise to the termination. The Committee also recognzed that some degree of employer liability was essential where the employer was not insolvent at the point of plan termination in order to preclude abuse by shifting the financial burden to the plan termination insurance program despite the fact that the employer had avaiable funds to continue funding the plan.

One approach to this problem would be to require financially responsible employer to, in effect, act as self-insurers for the unfunded vested liabilities and those who are not financially responsible to obtain plan termination insurance. This approach, which is supported by precdent in the field of workmen's compensation, for example, was considered and rejected becuase of the potentially enormous liabilities invoved. To require the Secretary to evaluate the financial capabilities of particular employers to assume such potentially enormous liabilities might have an adverse effect on the employer's competitive position and on his continued healthy growth.

Having determined that participation in the plan termination insurance program was essential for all plans, and that some degree of employer liability was necessary, the question of the degree of such liability becomes important. The Committee had concern that if the degree of liability was absolute to the extent of the employer's assets, it might drive some employers to the brink of bankruptcy, impose substantial economic hardship, or discourage the establishment of plans or the reasonable liberalization of benefits.

Accordingly, the Committee endorsed a formula of employer liability which requires the employer to reimburse the plan termination insurance program for the total amount of insurance paid, but in no event greater than 50% of employer's net worth at time of plan termination.

In addition, as a result of plan termination field hearings held by the Labor Subcommittee, numerous instances were disclosed where acquiring companies that terminated pension plans failed to take over the liability for vested benefits owed to the employees of the predecessor company. Since this circumstance could also arise in connection with the reinsurance provision, it is necessary to strengthen the reinsurance provisions by requiring successors-in-interest to be liable for reimbursements owed by predecessor companies.

In order to make liability of employer for reimbursement of insurance paid meaningful, it was considered essential to provide a mechanism for enforcement of such liability through giving the government a lien on employer property for unpaid amounts due.

With respect to the Secretary's authority to treat portions of multiemployer plans as terminated for purposes of applying the plan termination insurance provisions, it should be noted that the contributing employers in such arrangements are free to arrange indemnification agreements among themselves in connection with the plan's application for insurance coverage under Title IV, so that employer liability for reimbursement of insurance paid under Title IV can be allocated under terms that the parties themselves have agreed to as equitable.

TITLE V.—DISCLOSURE AND FIDUCIARY STANDARDS

Title V amends the Welfare and Pension Plans Disclosure Act in two significant ways. First, by additions to and changes in the reporting requirements designed to disclose more significant information about plans and the transactions engaged in by those controlling plan operations and to provide specific data to participants and beneficiaries concerning the rights and benefits they are entitled to under the plans and the circumstances which may result in their not being entitled to benefits. Second, by the addition of a new section setting forth responsibilities and proscriptions applicable to persons occupying a fiduciary relationship to employee benefit plans, including a "prudent man" standard for evaluating the conduct of all fiduciaries, and by barring from responsible fiduciary positions in such plans for a period of five years all persons convicted of certain listed criminal offenses.

REPORTING AND DISCLOSURE

The underlying theory of the Welfare and Pension Plans Disclosure Act to date has been that reporting of generalized information concerning plan operations to plan participants and beneficiaries and to the public in general would, by subjecting the dealings of persons controlling employee benefit plans to the light of public scrutiny, insure that the plan would be operated according to instructions and in the best interests of participants and beneficiaries. The Secretary's role in this scheme was minimal. Disclosure has been seen as a device to impart to employees sufficient information and data to enable them to know whether the plan was financially sound and being administered as intended. It was expected that the information disclosed would enable employees to police their plans. But experience has shown that the limited data available under the present Act is insufficient. Changes are therefore required to increase the information and data required in the reports both in scope and detail. Experience has also demonstrated a need for a more particularized form of reporting so that the individual participant knows exactly where he stands with respect to the plan—what benefits he may be entitled to, what circumstances may preclude him from obtaining benefits, what procedures he must follow to obtain benefits, and who are the persons to whom the management and investment of his plan funds have been entrusted. At the same time, the safeguarding effect of the fiduciary responsibility section will operate efficiently only if fiduciaries are aware that the details of their dealings will be open to inspection, and that individual participants and beneficiaries will be armed with enough information to enforce their own rights as well as the obligations owed by the fiduciary to the plan in general.

The Committee regards the following changes in the reporting and disclosure provisions as most significant.

First, the general exemption in Section 4(b)(3) of the Act for plans of certain non-profit organizations such as hospitals, universities, foundations, etc. has been revised to exempt only plans of religious organizations. There is no substantial reason why employees covered by plans of non-profit organizations should be entitled to less protection or less disclosure than employees covered by plans of profit-making organizations.

Second, the annual report must include the opinion of an independent auditor based upon the results of a required annual audit. Such information will allow better assessment of the plan's financial soundness by administrators and participants alike (the exemption for the books of institutions providing investment, insurance, and related functions and subject to periodic examination by a government agency will prevent duplicative audit examinations of these institutions). In light of this change, the provision requiring the Secretary to obtain certification of the report by an independent accountant prior to making an investigation of plan books and records has been eliminated as superfluous.

Third, funded plans must include in their reports particularized information pertaining to leases, party-in-interest transactions, and investments in assets other than securities, in addition to information about securities, investments, and loans. With respect to transactions other than those involving parties-in-interest, particularized information is to be provided, in general, if the transaction exceeded three percent of fund value. Also, actuarial information is now required so that participants and beneficiaries and the Secretary can evaluate the funding of the plan.

Amendments to provide detailed information to individual participants are found in Section 8 of the Welfare and Pension Plans Disclosure Act. In addition to the current obligation to make available copies of the plan description and latest annnal report, the administrator will be required to furnish or make available, whichever is most practicable, to every participant upon enrollment in the plan a summary of the plan's important provisions, an explanation of the benefits, and the circumstances which may disqualify a participant from securing benefits, as well as the availability of the underlying plan documents, such as bargaining agreements, trust agreements. The participant may obtain from the administrator a copy of any or all underlying documents relating to the plan upon the payment of a reasonable charge (as determined by the Secretary).

Finally, in view of the significantly expanded functions, given to the Secretary under the Retirement Income Security for Employees Act and the Welfare and Pension Plans Disclosure Act, the membership of the Advisory Council to the Secretary found in Section 14 is amended to create new permanent categories of membership, including investment counselors, actuarial consultants, and accountants, and the composition of the Advisory Council is increased to 21 members to take account of these functions.

Fiduciary Responsibility

A fiduciary is one who occupies a position of confidence or trust. As defined by the amendments, a fiduciary is a person who exercises any power of control, management or disposition with respect to monies or other property of an employee benefit fund, or who has authority or responsibility to do so. It is not the intent of the Committee, however, that where the sole power of control, management or disposition with respect to plan funds rests with the participants themselves, as may be the case with respect to certain plans where the participant has the sole discretion over an individual account established in his name, that such participants shall be regarded as fiduciaries. The fiduciary responsibility section, in essence, codifies and makes applicable to these fiduciaries certain principles developed in the evolution of the law of trusts. The section was deemed necessary for several reasons.

First, a number of plans are structured in such a way that it is unclear whether the traditional law of trusts is applicable. Predominantly, these are plans, such as insured plans, which do not use the trust form as their mode of funding. Administrators and others exercising control functions in such plans under the present Act are subject only to minimal restrictions and the applicability of present State law to employee benefit plans is sometimes unclear. Second, even where the funding mechanism of the plan is in the form of a trust, reliance on conventional trust law often is insufficient to adequately protect the interests of plan participants and beneficiaries. This is because trust law had developed in the context of testamentary and inter vivos trusts (usually designed to pass designated property to an individual or small group of persons) with an attendant emphasis on carrying out the instructions of the settlor. Thus, if the settlor includes in the trust document an exculpatory clause under which the trustee is relieved from liability for certain actions which would otherwise constitute a breach of duty, or if the settlor specifies that the trustee shall be allowed to make investments which might otherwise be considered imprudent, the trust law in many states will be interpreted to allow the deviation. In the absence of a fiduciary responsibility section in the present Act, courts applying trust law to employee benefit plans have allowed the same kinds of deviations, even though the typical employee benefit plan, covering hundreds or even thousands of participants, is quite different from the testamentary trust both in purpose and in nature.

Third, even assuming that the law of trusts is applicable, without provisions (lacking in the present Act) allowing ready access to both detailed information about the plan and to the courts, and without standards by which a participant can measure the fiduciary's conduct (also lacking in the present Act) he is not equipped to safeguard either his own rights or the plan assets. Furthermore, a fiduciary standard embodied in Federal legislation is considered desirable because it will bring a measure of uniformity in an area where decisions under the same set of facts may differ from state to state. It is expected that courts will interpret the prudent man rule and other fiduciary standards bearing in mind the special nature and purposes of employee benefit plans intended to be effectuated by the Act.

Finally, it is evident that the operations of employee benefit plans are increasingly interstate. The uniformity of decision which the Act is designed to foster will help administrators, fiduciaries and participants to predict the legality of proposed actions without the necessity of reference to varying state laws.

Section 15(a) when read in connection with the definition of the term "employee benefit fund" makes it clear that the fiduciary provisions apply only to those funds which leave assets at risk. While the Retirement Income Security for Employees Act has the effect of requiring all retirement plans subject to that Act to be financed through the medium of a segregated fund, there may be welfare funds subject to the Welfare and Pension Plans Disclosure Act such as those providing sickness or disability benefits, which may not be funded. Thus, an unfunded plan in which the only assets from which benefits are paid are the general assets of the employer is not covered. However, if the plan does have assets at risk, the form in which these assets are held is deemed to be a trust, whether or not a trust agreement exists, except that every employee benefit fund is required to be established or maintained pursuant to a written document indicating the purpose and basis of the fund. In the case of insured plans, this would encompass the insurance contract or similar agreement. Fund assets are therefore deemed a trust and may only be used for the purposes of providing benefits for participants and defraying reasonable expenses.

It is to be noted that the definition of "employee benefit fund" excludes assets of an investment company regulated under the Investment Company Act of 1940 but any participating shares held by the employee benefit fund in an investment company are assets of the fund and subject to coverage under this section.

The Committee also has made provision for contributory plans to equitably distribute any surplus funds remaining on plan termination to the participants in accordance with their rate of contribution. This requirement is applicable only after plan assets have been used to satisfy all liabilities. The Committee believes it is unfair to permit the complete recapture by employers of surplus funds in terminated contributory plans, without regard to the fact that contributions by the workers helped to generate the surplus. The Committee wishes to emphasize that while it is not passing judgment on any particular case now pending, it has concluded that equitable principles require that this particular subject be governed by a specific rule which reflects what the Committee regards as essential protection for the interests of workers in such plans.

Subsection 15 (a) (b) and (c) incorporate the core principles of fiduciary conduct as adopted from existing trust law, but with modifications appropriate for employee benefit plans. These salient principles place a twofold duty on every fiduciary: to act in his relationship to the plan's fund as a prudent man in a similar situation and under like conditions would act, and to act consistently with the principles of administering the trust for the exclusive purposes previously enumerated, and in accordance with the documents and instruments governing the fund unless they are inconsistent with the fiduciary principles of the section.

There follows a list of proscriptions which represent the most serious type of fiduciary misconduct which in one way or another has occurred in connection with some welfare or pension plans. Some of these situations have been found in the administration of the WPPDA. Others have been discovered by congressional investigations, newspaper reporters, audits, and miscellaneous sources. While the magnitude of these improper practices is small in relation to the total number of plans in existence, the seriousness of the improper practices disclosed indicates the need for additional precautions to insure that these specific examples do not become general conditions. The list of proscriptions is intended to provide this essential protection.

With respect to the prohibition against transferring indicia of ownership of plan assets outside the United States, this is intended to preclude frustration of adequate fiduciary supervision and remedies for breach of trust. However, the Committee recognizes that it is not necessarily imprudent for plan funds to invest in securities of foreign companies, and the high cost of transferring securities back and forth overseas might result in impractical burdens to plan administrators. Accordingly, the Secretary is authorized to provide a specific exemption from this requirement where the participants' interests are safeguarded in an adequate fashion.

The exemption provision which follows the listed proscriptions has been included in recognition of established business practices, particularly of certain institutions such as commercial banks, trust companies, insurance companies, and investment counselors, which often perform fiduciary functions in connection with employee benefit plans. The Secretary may provide individual or class exemptions so that the established practices of these institutions and others are not unduly disrupted, so long as they serve the participants interests, and are not inconsistent with the purposes of this Act.

Next, there are listed transactions in which fiduciaries are expressly allowed to engage. This listing is necessary for reasons similar to those which required inclusion of the exemption provision. That is, the breadth of proscriptions, which was considered necessary for the reasons stated above, would operate in some cases to prohibit transactions which are deemed desirable to the sound, efficient functioning of employee benefit plans. It was, therefore, necessary to specify that certain transactions, likely to be engaged in by fiduciaries of virtually all plans, will be allowed notwithstanding the proscriptions.

It is emphasized, however, that even with respect to the transactions expressly allowed, the fiduciary's conduct must be consistent with the prudent man standards.

In this connection, the Subcommittee, after careful deliberation, deleted a prior provision, section 15(d), which expressly permitted a "party in interest" to provide multiple services to a plan, regardless of whether the "party in interest" was also serving in a fiduciary capacity and receiving fees or compensation for the performance of discretionary functions with respect to plan funds.

Section 15(d) had been predicated on the recognition that fiduciaries, subject to regulation and supervision under laws affecting banking, insurance and securities, performed a variety of services and functions, some customary and rooted in the historical development of the fiduciary's role, and some newly arisen as a means of strengthening the fiduciary's competitive position.

Many of these multiple services or functions are or could be rendered in connection with a variety of trusts or funds other than pension trusts or funds. Examples are widows' estates, mutual funds, college endowment funds, variable annuity funds, etc. Because the fiduciary's conduct relative to the performance of multiple functions was subject to regulation under laws affecting insurance, banking and securities, the Committee originally took the position that additional regulation in this field should proceed *sui generis* under these laws. The Committee believed that the bill provided ample remedy in the event, for example, the fiduciary breached his trust by "churning" pension fund accounts to generate profit for himself or ancillary activities under his control, or by channeling pension fund investments to shore up vulnerable investments made by a commercial adjunct.

Upon review by the Subcommittee of section 15(d), however, a competing school of thought emerged, which emphasized the difficulty of securing an adequate system of control over fiduciary-commercial relationships in the context of pension fund management. It was argued that these relationships tend to subordinate the strict professionalism expected of fund managers to business pressures and that, inevitably, certain fund managers are bound to yield to these pressures and cause trust fund abuse in a manner which is not always accessible to timely discovery. Because the interests of pension fund beneficiaries deserve the strongest protection, it was urged that the Subcommittee adopt a rule which would bar a fiduciary from performing multiple business services for the pension trust unless, after application by the fiduciary, the Secretary waives the proscription on grounds that it is consistent with the purposes of the Act and is in the interest of the fund or classes of funds and the participants and beneficiaries.

The Committee is aware that there exist various established and recognized practices which are accepted in commercial banking, trust and insurance companies, investment companies and other advisors in connection with employee benefit plans. However, notwithstanding current acceptance of such practices, the Subcommittee has found it difficult to establish definitive criteria concerning those practices which should be specifically proscribed. This difficulty was weighed by the Committee against the overriding need to protect workers' pension funds, and it concluded that the latter's interest out-weighed any current attempt to define all practices and relationships which constitute not only actual but real potential threats to the security and preservation of the pension funds. Accordingly, the Secretary of Labor, is authorized by the Act to waive any proscribed practice as long as it is consistent with the purposes of the Act and determined to be in the interests of pension plan participants. The Committee is not unaware of the possible impact of these prohibitions, and accordingly has made provision in the bill for an adequate transition period of 3 years, or longer, if warranted.

In the exercise of his exemption authority, the Secretary is expected to consult with other officials responsible for the administration of laws affecting insurance, banking, and securities, to ascertain their views. However, it is to be understood that in determining what is in the interest of participants and beneficiaries of pension plans, the judgment of the Secreatry of Labor shall be controlling.

The Secretary's exemption authority under section 15(b)(3) also extends to certain party-in-interest transactions which are proscribed under section 15(b). In exercising this authority, consideration should be given to developing criteria which, if met by the plan, would provide adequate safeguards to the interests of participants and beneficiaries, and thus, provide a basis for approving certain types or classes of party in interest transactions. The Committee believes, however, that such transactions should not be sanctioned solely on the basis that the transaction is for "adequate consideration" since it has sufficient evidence that the application of this standard has not, by itself, curbed conflict-of-interest abuse. Rather, the Committee intends that in developing criteria for adequate safeguards the Secretary should consider such matters as the nature and purpose of the plan, and the indispensability of the proscribed transaction to effectively carrying out the purposes of the plan, the extent to which participants under the plan possess alternative methods of investing or managing their accounts, the existence of independent safeguards or guarantees that provide adequate security to participant interests, etc.

Especially significant among the expressly allowed transactions is that which permits, in most type of plans, investment of up to ten percent of the fund assets in securities issued by the employer of employees who are participants in the plan. Since such an employer will often be an administrator of his plan, or will function as a trustee or in some other fiduciary capacity, this provision creates a limited exception to the listed proscription against self-dealing. The exception is made in recognition of the symbiotic relationship existing between the employer and the plan covering his employees. Such investments are commonly made under provisions in a trust agreement expressly allowing them.

The ten percent limitation applies to present holdings of plan funds as well as to prospective transactions. The Committee believes that where plan funds are presently heavily invested in securities of the employer, the participants are placed at jeopardy if the financial of the employer should deteriorate.

In recognition of the special purpose of profit-sharing and similar plans, the limitation does not apply to such plans if they explicitly provide for greater investment in the employer securities, nor should any diversification principle that may develop from application of the prudent man principle be deemed to restrict investment by profit-sharing plans in employer securities. On the other hand, diversification standards, whether based on percentage or amount of plan funds, may be appropriately applied to investments by profit-sharing plans in other than employer securities. An appropriate transitional period is provided for securing compliance with these requirements with discretion to the Secretary to provide additional time where needed.

The next two subsections (15(d) and (e)) are intended to codify, with respect to employee benefit fund fiduciaries, rules developed under the law of trusts. Thus a fiduciary is made personally liable for his breach of any responsibility, duty, or obligation owed to the fund, and must reimburse the fund for any loss resulting from such a breach. He must also pay over to the fund any personal profit realized through use of fund assets. Where two or more fiduciaries manage a fund, each must use care to prevent a co-fiduciary from committing a breach or to compel a co-fiduciary to redress a breach. Plan business is to be conducted by joint fiduciaries in accordance with the governing instruments of the plan, or in the absence of such provisions by a majority of fiduciaries and a fiduciary who objects in writing to a specific action and files a copy of his objections with the Secretary is not liable for the consequences of such action.

Exculpatory and similar clauses which purport to relieve a fiduciary from any responsibility, obligation, or duty which under the Act are expressly prohibited and made void as against public policy. Whatever the validity such provisions might have with respect to testamentary trust, they are inappropriate in the case of employee benefit plans.

The large numbers of people and enormous amounts of money involved in such plans coupled with the public interest in their financial soundness, as expressed in the Act, require that no such exculpatory provision be permitted.

In this connection, it should be noted that while co-fiduciaries are permitted to allocate responsibilities among themselves and, by so doing, generally limit their liability to the extent of their specified duties, a co-fiduciary who has specific knowledge of a breach of trust committed by a co-fiduciary or who could have reasonably been expected to realize that another co-fiduciary was breaching his trust, can be held personally liable for failure to compel redress of the breach or prevent the breach, unless he has filed in a timely fashion his objections with the Secretary.

Subsection 15(h) prohibits persons convicted of certain listed crime from serving, for a period of five years after conviction or the end of imprisonment for such conviction, in a responsible position in connection with an employee benefit plan. The prohibition is considered necessary because of the large funds involved and the attendant great risk of a loss affecting a large number of persons. Section 15 is modeled after Section 504 of the Labor-Management Reporting and Disclosure Act (LMRDA) which bars persons convicted of certain crimes from serving as union officers. The presence of the LMRDA prohibition is another reason for including a similar provision in the Protection Act. Without such a provision persons barred from serving as union officers might take positions with employee benefit plans. The danger inherent in such a transfer is especially great where elements of organized crime are involved.

The crimes listed have been chosen with care and have been specifically expanded from those listed in Section 504, LMRDA, to assure adequate protection to participants and beneficiaries.

It is to be noted, however, that the Secretary is empowered by the Act to waive the prohibition during the 5-year period where he determines that a person's services in such capacity would not be contrary to the purposes of the Act. It is intended that in the exercise of this discretionary power, the Secretary may not only inquire into the extent of rehabilitation of the convicted person, but also into the circumstances surrounding or attendant to the commission of the disqualifying offense in order to ascertain mitigating factors which would affect the gravity of such offense. Such mitigating circumstances would include technically disqualifying offenses committed in the context of, and related to, a genuine labor dispute, and should be considered by the Secretary in passing upon a waiver application.

In addition, the Committee has found that a substantial number of plans fail to provide adequate and fair procedures to participants and beneficiaries when their benefit claims or applications are denied. Subsection 15(1) is intended to rectify this inequity by requiring plans to provide adequate notice in writing to participants or beneficiaries whose benefits have been denied, setting forth the specific reasons in terms that can be readily grasped by the participant, and to afford a reasonable opportunity for a full and fair review by the plan administrator of any decision denying benefits.

Finally, the Committee has become aware of numerous instances in which the widows of deceased pension plan participants have failed to receive the survivorship or death benefits which they have relied on because the husband while alive had through inadvertance or misunderstanding, failed to exercise the survivorship or death benefit option in his retirement plan. In order to correct the loss of survivorship or death benefits which arise by reason of failure to comply with plan technicalities, the Committee adopted a provision which assures that survivorship or death benefit options cannot be lost by default on the part of the worker. The provision adopted by the Committee specifies that in order for the death benefit option to be waived by the participant, there must be a writing signed by the participant to such effect, after such participant has received a written explanation of the terms and conditions of the option and the effect of such waiver.

TITLE VI.—ENFORCEMENT

The enforcement provisions have been designed specifically to provide both the Secretary and participants and beneficiaries with broad remedies for redressing or preventing violations of the Retirement Income Security for Employees Act as well as the amendments made to the Welfare and Pension Plans Disclosure Act. The intent of the Committee is to provide the full range of legal and equitable remedies available in both state and federal courts and to remove jurisdictional and procedural obstacles which in the past appear to have hampered effective enforcement of fiduciary responsibilities under state law or recovery of benefits due to participants. For actions in federal courts, nationwide service of process is provided in order to remove a possible procedural obstacle to having all proper parties before the court.

Except where plans are not subject to the Retirement Income Security for Employees Act or the Welfare and Pension Plans Disclosure Act, and in certain other enumerated circumstances, state law is preempted. Because of the interstate character of employee benefit plans, the Committee believes it essential to provide for a uniform source of law in the areas of vesting, funding, insurance and portability standards, for evaluating fiduciary conduct, and for creating a single reporting and disclosure system in lieu of burdensome multiple reports. As indicated previously, however, the Act expressly authorizes cooperative arrangements with state agencies as well as other federal agencies, and provides that state laws regulating banking, insurance or securities remain unimpaired.

Section 610 makes it unlawful for any person to discharge, fine, suspend, expel, discipline or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of the plan or the Act or the Welfare and Pension Plans Disclosure Act or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan or the Act or the Welfare and Pension Plans Disclosure Act.

Section 611 makes it a criminal offense for any person to use fraud, force, or violence or threats thereof to restrain, coerce, intimidate or attempt to restrain, coerce, intimidate any participant or beneficiary for the purpose of interfering with or preventing the exercise of any right to which he is or may become entitled under the plan, the Act, or the WPPDA.

These provisions were added by the Committee in the face of evidence that in some plans a worker's pension rights or the expectations of those rights were interfered with by the use of economic sanctions or violent reprisals. Although the instances of these occurrences are relatively small in number, the Committee has concluded that safeguards are required to preclude this type of abuse from being carried out and in order to completely secure the rights and expectations brought into being by this landmark reform legislation.

TITLE VII.—EFFECTIVE DATES

In order to provide sufficient time for pension and profit-sharing retirement plans to adjust to the new vesting and funding standards, to make provision for additional costs which may be experienced, and to permit negotiated agreements to transpire, the Committee has provided a three-year delayed effective date for compliance with the vesting and funding standards. Since the portability program is voluntary, it is believed that a one-year delayed effective date is sufficient to permit the Secretary to set in motion the administrative apparatus appropriate for this program. In order to assure as expeditiously as possible, termination insurance coverage for unfunded vested liabilities incurred prior to enactment, a one-year delayed effective date is provided for plans to obtain termination insurance pursuant to the provisions of Title IV. All other provisions are to become effective upon enactment.

VII. Section-by-Section Analysis

TITLE 1.—ORGANIZATION, POWERS, AND DUTIES OF THE SECRETARY OF LABOR

Section 101.—This section requires the Secretary of Labor to promote programs and plans for the administration and operation of employee benefit plans in furtherance of the findings and policies set forth in the Act. He shall determine the eligibility for registration of such plans upon compliance with the requirements specified in the Act. Where plans are unqualified, he is authorized to cancel the registration. The Secretary is directed to administer and enforce the provisions of this Act and the Welfare and Pension Plans Disclosure Act. The Secretary is empowered to conduct inquiries reasonably necessary to ascertain violations of the Act or its regulations. He may not conduct an examination of books and records more than once annually unless he has reasonable cause to believe there has been a violation. He may exercise subpoena powers, if necessary, in the enforcement of the Act. The Secretary is authorized to institute civil actions to enforce the provisions of the Act with attorneys appointed by him except for proceedings in the Supreme Court.

The Secretary is authorized to prescribe rules and regulations to govern standards and qualifications and actuaries performing services under the Act, and to certify actuaries as qualified for purposes of the Act. He is authorized to establish and maintain reasonable limitations on actuarial assumptions. The Secretary is directed to conduct studies on the effects of and the subjects covered in the Act, including the sufficiency of vesting provisions for high-mobility employees.

Before promulgating regulations, the Secretary is directed to consult with appropriate government agencies to avoid duplication or conflicts. He may also make arrangements with federal or state agency facilities for the purposes of enforcing the Act on a reimbursable basis.

OFFICE OF ADMINISTRATION

Section 103.—This section establishes within the Department of Labor an Office of Pension and Welfare Plan Administration headed by an Assistant Secretary of Labor appointed by the President with Senate advice and consent. Under supervision of the Secretary of Labor, he shall exercise that power and authority delegated to him by the Secretary for the purpose of administration and enforcement of the Act.

The functions, records and personnel of the Office of Labor Management Services Administration necessary for the administration of the Welfare and Pension Plans Disclosure Act, are transferred to the new Office of Pension and Welfare Plan Administration.

Coverage and Exemptions

Section 104.—This section requires that, unless exempt, the provisions of the Act apply to any pension or profit-sharing-retirement plan established or maintained by an employer, a union, or both together in any industry or activity affecting interstate commerce. The fiduciary and disclosure provisions of the Act apply to all employee benefit plans unless exempt.

The Act does not apply to plans established by federal or state governments, plans, established by religious organizations, plans for the self-employed, plans covering not more than 25 participants, plans established outside the territorial jurisdiction of the United States for citizens of other countries unless they maintain funds in the United States, certain plans for key executives, and plans for members of labor organizations which are financed exclusively from the members' dues.

The funding and plan termination insurance requirements are not applicable to profit-sharing or money purchase plans, because of the nature of these plans.

Registration of Plans

Section 105.—This section requires administrators of pension and profit-sharing retirement plans to file applications with the Secretary of Labor for registration of such plans. The filing by the administrator shall be within six months after a plan has been established, or, if a plan was in effect at the time of enactment of this Act, such filing shall be within six months after the effective date of regulations promulgated by the Secretary of Labor, but in no event later than 12 months.

Upon finding by the Secretary that a plan is qualified, it shall be issued a certificate of registration by the Secretary. The criterion for the grant of such certificate shall be compliance with the requirements of the Act.

Where a plan is deficient, the administrator or other appropriate person shall be given an opportunity to remove the deficiency, and in the event that such deficiency is not removed, the Secretary may order cancellation or denial of such certificate.

Reports on Registered Plans

Section 106.—This section provides that the Secretary may, by regulation, provide for the filing of one single report which will satisfy the reporting requirements of this Act and the WPPDA.

Amendments of Registered Plans

Section 107.—This section provides that amendments to pension or profit-sharing-retirement plans shall be registered with the Secretary; that copies of such amendments shall be filed with the Secretary; and that the Secretary may require additional information in order that he may determine the initial unfunded liability which has been created by the amendment and to further determine special payments which may be required to remove such liability.

Certificate of Rights

Section 108.—This section requires the Secretary to promulgate regulations requiring each plan to furnish or make available to its participants (whichever is most practicable), upon termination of service with vested rights, with a certificate reciting the benefits due to such participants and the location of the entity responsible for the payments and pertinent data relating thereto. A copy of such certificate shall be filed with the Secretary.

TITLE II.—VESTING AND FUNDING REQUIREMENTS

Part A—Vesting

Section 201.—This section requires that no pension or profit-sharing-retirement plan may require as a condition of eligibility to participate in the plan, a period of service longer than one year or an age greater than 25, whichever occurs later, except that any plan which provides 100 percent immediate vesting upon entry into the plan may restrict participation to those who have attained age 30, or three years of service, whichever occurs later.

Section 202.—This section provides that all pension and profit-sharing-retirement plans are required to vest accrued benefits in participants with respect to service rendered both before, as well as after, the effective date of the title at the rate of a 30 percent vested interest, commencing with eight years of service, and increasing by 10 percent each year thereafter in order that 100 percent vesting is attained after 15 years of service. Vested plan benefits acquired under the Act may not be assigned or alienated, except that where a plan fails to make such provision, the Secretary shall be required to provide for final disposition of such benefits.

It further provides that no more than three of the eight years required to qualify for a 30 percent vested right need be continuous, but that service prior to age 25 may be ignored in determining eligibility for a vested right unless the participant or his employer has made contributions to the plan with respect to service prior to age 25.

In addition, in the event a participant has achieved 100 percent full vesting when permanently separated from the plan and subsequently returns to coverage under the same plan, he may be treated as a new participant for purposes of vesting schedule.

Any plan may allow more liberal vesting than required by the Act. If, upon application by a plan, the Secretary determines that a plan's vesting provisions assures a degree of vesting protection as equitable as the vesting schedules required by the Act, he may waive the Act's requirements and permit the plan's vesting schedule to remain unchanged.

Part B—Funding

Section 210.—This section requires that plans provide for compulsory funding of its obligations to its employees, Every employer is required to provide contributions for funding of his pension plan in a manner adequate to amortize all pension benefit liabilities which may accrue under the terms of the plan. Employers must fund all normal service costs annually and must fund initial unfunded liabilities existing on the effective date of this title (or in any plan established after the effective date of the title) within 30 years from the applicable date, in no less than equal amounts annually. If any amendment to the plan results in substantial increase to the plan's unfunded liabilities, the increase shall be funded separately as if it were a new plan and shall be regarded as a new plan for purposes of the plan termination insurance program established under this Act.

If a plan has an experience deficiency (resulting from actuarial error) for any particular year, the deficiency must be removed in no more than a five-year period, except that where such deficiency cannot be removed within such period without exceeding allowable limits for tax deductions under the Internal Revenue Code for a given year during such period, the Secretary may prescribe necessary additional time to permit removal of such deficiency within allowable tax deduction limitations.

Within six months after the effective date of rules promulgated by the Secretary to implement this title, but not later than 12 months after the effective date of the title or within six months after date of plan establishment, whichever is later, the plan is required to submit a report by an actuary who has been certified by the Secretary, stating information necessary to determine the appropriate application of the funding requirements to the plan. Plans are also required to be reviewed every five years by certified actuaries who are to report the funding obligations which must be met and any surplus or experience deficiencies. The Secretary is authorized to exempt certain plans from these filing requirements if consistent with the purpose of the Act.

Section 211.—This section provides that subject to the authority of the Secretary to provide exemptions in cases of hardship, and certain other circumstances all assets of terminated pension plans must be distributed according to the following priorities:

First, to refund to nonretired participants in the plan the amount of contributions made by them; second, to retirees; third, to persons eligible to retire on date of plan termination; fourth, to participants who have vested rights under the plan but who have not reached retirement age; and fifth, to other participants. In addition, employers are held liable for contributions (including amounts withheld from employees) owing to the plan which were required to be made by virtue of the funding requirements of the Act, but which were not made as of the date of plan termination. Upon either complete or substantial termination of a profit-sharing plan, the interests of all participants shall fully vest.

The Secretary may approve payment of benefits due to survivors in accordance with priorities which are equal to those of the employees whose service had acquired such benefits.

Part C.—Variances

Section 216.—This section authorizes the Secretary to defer, in whole or in part, applicability of the vesting provisions for a period not to exceed five years from the effective date of such requirements where a plan makes a showing that the vesting requirements would increase the employer's costs or contributions to the plan to an extent that "substantial economic injury" would result to the employer and to the interests of the participants.

The definition of "substantial economic injury" is defined to include, but not to be limited to, a substantial risk to plan continuance, inability to discharge benefit obligations, substantial curtailment of pension or other employee benefits, or the production of an adverse effect upon employment levels of the work force of the employer contributing to the plan.

In collectively-bargained plans, both employer and union are required to submit application for the variance, and where such a submission is made, the Secretary is required to give due weight to the experience, competence, and knowledge of the parties concerning the necessity for the variance.

Section 217.—This section provides that where an employer can make a showing to the Secretary of Labor that he cannot make the required annual contribution to the pension plan, the Secretary may waive such contributions and authorize that such deficiency be funded over a period not to exceed five years in no less than equal annual payments. However, to authorize such variance, the Secretary must be satisfied that such waiver will not have an adverse effect upon the interests of employees and will not impair the financial position of the Pension Benefit Insurance Fund. No waiver may be granted for more than five years, and when a plan has been granted five consecutive waivers, the Secretary has the authority to: (1) merge or consolidate a deficiently funded plan with another plan of the employer, if feasible; (2) order termination of a plan if necessary to protect the interests of the participants or the position of the plan termination insurance program; (3) or such other action as may be appropriate to carry out the purposes of the Act.

No amendments increasing plan benefits are permitted during any period that a funding waiver is in effect.

The Secretary is required to promulgate regulations governing funding of multi-employer plans that cover a substantial portion of the industry or employees in a specific geographic area to assure that such plans are provided with sufficient assets to cover benefits under the plan. In promulgating such regulations, the Secretary is required to set a funding period that will reflect an adequate basis for funding the plan's benefit commitments and which takes into account the particular situation pertaining to the plan, industry, and circumstances involved. In no event is the Secretary authorized to prescribe a funding period for such a multi-employer plan which is less than 30 years, and no such plan is permitted to increase benefits beyond a point for which the contribution rate would be inadequate unless such rate is increased commensurately.

The Secretary may determine also that an employer's withdrawal from a multi-employer plan will significantly reduce the rate of aggregate contributions to the plan. He may then require the fund to be allocated between the nonworking and working participants, and treat the nonworkers' share of the fund as terminated for insurance purposes, and the remaining portion of the fund as a new one for funding, variances, and insurance purposes.

In considering the experience of multi-employer plans for new premium rates for insurance, the Secretary shall take into account the withdrawal of employers from the plan.

TITLE III.—VOLUNTARY PORTABILITY PROGRAM FOR VESTED PENSIONS

Program Established

Section 301.—This section establishes a voluntary program for portability of vested pension credits. The program will be administered by and under the Secretary's direction, and will be designed to facilitate the voluntary transfer of vested credits between registered plans. Plans registered under the Act may voluntarily apply for membership in the program and upon approval be issued a certificate of membership by the Secretary.

Acceptance of Deposits

Section 302.—This section requires that, upon request of a plan participant, plans which are members of this program are required to pay, to a central portability fund administered by the Secretary, monies representing the value of the participant's vested rights when he is separated from the plan prior to retirement. The Secretary will prescribe the terms and circumstances of deposits to be made.

Special Fund

Section 303.—This section establishes a Voluntary Portability Program Fund under the supervision of the Secretary into which payments will be made in accordance with regulations prescribed by the Secretary under the portability program. The Secretary shall be the trustee of the fund and shall administer the fund and report to the Congress annually of the fund's operations and fiscal status. The Secretary is authorized to deposit the amounts received in financial institutions insured by the FDIC or FSLIC but not more than 10 percent in any one financial institution.

Individual Accounts

Section 304.—This section requires the Fund to establish individual accounts for each participant for whom it has received monies under the portability program.

Payments From Individual Accounts

Section 305.—This section provides that, at the request of a participant transferring into a new plan, the Secretary is required to pay out if his account the accumulated amounts to purchase pension credits from the new plan which are actuarially equivalent. Unless the monies in a participant's account have been transferred to another employer's plan at the participant's request, the Secretary is required to use the monies in the participant's account to purchase a single-premium life annuity from a qualified life insurance carrier when the participant reaches age 65, and in the event of the participant's death, to pay out monies in this account to his designated beneficiary.

Technical Assistance

Section 306.—This section authorizes the Secretary to furnish technical assistance to unions, administrators, and all others affected by this Act who wish to develop portability or reciprocity arrangements of their own.

TITLE IV.—PLAN TERMINATION INSURANCE PROGRAM ESTABLISHED

Section 401.—This section establishes a Private Pension Plan Termination Insurance Program administered by the Secretary, which requires plans to insure unfunded vested liabilities incurred prior to enactment of the Act, as well as after enactment of the Act. The Secretary may provide insurance to cover unfunded vested liabilities of a plan not subject to the Act where he determines that such plan conforms to the vesting, funding and all other standards required by the Act.

CONDITION OF INSURANCE

Section 402.—This section requires the insurance program to insure participants against loss of vested benefits arising from plan termination.

The amount of vested benefit insurance is limited to 50 percent of highest average monthly wage of participants earned over a five-year period, or $500 monthly, whichever is the lesser.

No insurance shall be paid if the plan is terminated less than three years from date of establishment or registration unless the Secretary determines that a registered plan was otherwise in substantial compliance with the Act and that the reserve position of the insurance program will not be adversely affected.

Insurance will not cover vested rights created by any plan amendment which took effect less than three years prior to plan termination.

No coverage is extended to participants who own 10 percent or more of employer voting stock.

ASSESSMENT AND PREMIUMS

Section 403.—This section requires plans to pay an initial uniform assessment to be prescribed by the Secretary to cover administrative costs of the program. The Secretary shall prescribe an annual premium rate based upon unfunded vested liabilities. For the first three years, the insurance premium shall not exceed 0.2 percent of unfunded vested liabilities incurred after enactment of the Act. With respect to those unfunded vested liabilities incurred prior to enactment, the premium shall be 0.2 percent, provided that the unfunded vested liabilities of the plan were funded at least 75% during the five-year period preceding enactment.

As to plans which on date of enactment were less than five years old, the premium shall be 0.2 percent, provided that the plan had been reducing its unfunded vested liabilities at a rate of no less than 5 percent annually. In the event plans do not meet the above funding standards, they can be charged a premium not to exceed 0.4 percent or less than 02. percent of pre-enactment unfunded vested liabilities.

Also, in the case of multi-employer plans (as defined in the Act), the premium rate for the initial three years shall not exceed 0.2 percent of unfunded vested liabilities, regardless of when such liabilities were incurred.

After the initial three-year period, the Secretary may prescribe an annual rate based upon experience, and unless Congress objects within 90 days, the new premium shall become effective.

The Secretary is required to consult with appropriate private and government agencies on matters relating to the assessment and premium rates before prescribing rates.

Payment of Insurance

Section 404.—This section requires that plans must notify the Secretary of intent to terminate, and failing to do so will make such persons personally liable for any losses incurred by the Pension Benefit Insurance Fund in connection with plan termination.

The insurance to be paid shall be the difference between the plan's assets and unfunded vested benefits owed at the time of plan termination.

In addition, the Secretary is required to prescribe procedures under which funds of terminated plans shall be liquidated and paid out to cover vested benefits of participants. In implementing this authority, the Secretary may transfer terminated funds under his supervision or purchase annuities from qualified insurance carriers for participants or take such other action as may be appropriate. Persons who terminate a plan with intent to circumvent the Act or the WPPDA shall be personally liable for losses.

Recovery

Section 405.—This section provides that, where employers in terminated plans are not insolvent, they or their successors-in-interest may be liable for reimbursement of a portion of insurance benefits paid. The liability of the employer is to pay 100% of the unfunded vested liabilities and in no event shall it exceed 50% of the employer's net worth.

The Secretary shall make arrangements with employers on equitable terms for the reimbursement of insurance paid.

The amount or amounts of any unpaid liability owed by an employer shall constitute a lien in favor of the government, but junior to any lien for unpaid taxes owed to the government.

Pension Benefit Insurance Fund

Section 406.—This section establishes within the Labor Department a fund for the deposit of premiums, assessments, etc., made under the Act and for payment of such claims thereunder.

TITLE V.—DISCLOSURE AND FIDUCIARY STANDARDS

The new Disclosure and Fiduciary Requirements of this Act are accomplished by amendment to the Welfare and Pension Plans Disclosure Act. (WPPDA).

Disclosure

Section 501.—This section requires that annual reports filed are required to be accompanied by a certificate designating the Secretary as agent for service of process in any action arising under this Act.

Section 502.—This section amends Section 3 of the Welfare and Pension Plans Disclosure Act by adding new paragraphs containing revised definitions of terms such as "relative," "administrator," "employee benefit plan," "employee benefit fund," "separate account," "adequate consideration," "nonforfeitable pension benefit," "covered service," and various other terms which are intended to reconcile definitions contained in the Act with the new amendments. The definition of "employee welfare benefit plan" is expanded to include all benefit arrangements described or permitted by Section 302 of the Taft-Hartley Act, such as vacation funds, scholarship, child care funds, etc.

Section 503.—This section amends Sec. 4(a) of the Welfare and Pension Plans Disclosure Act by making editorial changes required by the terms of the current Act in order that the definitions of the WPPDA will be reconciled with those of the current amendments.

Section 504.—This section amends Sec. 5(b) of the WPPDA by permitting the Secretary to require the filing of a special terminal report in the event that there are monies or other assets remaining in the plan. Additionally, it is amended to grant the Secretary the right to exempt from the reporting and disclosure requirements of the Act a certain class of employee benefit plans if the same does not serve the purposes of the Act.

Section 505.—This section amends Sec. 6 of the WPPDA and requires plan descriptions under this Act to be comprehensive and written in a language and manner calculated to be understood by the average participant. In addition, the prior filing requirements are revised to authorize plan amendments to be filed in accordance with regulations prescribed by the Secretary. Heretofore, plan amendments had to be filed within 60 days after they were effective.

Section 506.—This section provides for two significant changes to the WPPDA. The first is a new requirement that the annual financial report must include an opinion of the plan's financial condition by an independent accountant based upon the results of an annual audit. Second, plans must include in their reports more detailed financial information, particularly in connection with party-in-interest transactions, and more detailed actuarial information relating to the plan's funding method and its overall financial soundness.

Section 507.—This section broadens the WPPDA requirements by requiring administrators to furnish reports to employees or to make available (whichever is more practicable) to every participant upon his enrollment in the plan a summary of the plan's important provisions written in a manner calculated to be understood by the average participant. (This requirement covers major amendments as well). This summary should include an explanation of a participant's rights and obligations under the plan and the circumstances which may disqualify him from benefits, as well as the requirements of WPPDA. Administrators are also required to furnish or make available to participants every three years a revised, up-to-date summary of the plan's important provisions (including major amendments).

Additionally, the plan administrator must furnish to participants and beneficiaries, upon request, copies of the plan description, annual report, or bargaining agreement, trust agreement, contract, or instrument under which the plan is established and operated. The plan administrator may make a reasonable charge to cover the costs of such copies.

Plan administrators are also required to furnish participants with notices of any vesting or funding variance the plan has received under other provisions of the Act.

Section 508.—This section amends Section 9(d) of the WPPDA to permit the Secretary to make necessary inquiries to determine violations provided that plans cannot be investigated more than once annually without reasonable cause. This provision eliminates the requirement of certification previously required to examine reports and records of a plan. The annual audit required by the Act dispenses with the need for such certification.

Section 509.—This section amends Section 14 of the WPPDA to restructure the Advisory Council on Employee Welfare and Pension Benefit Plans so that it will serve as an advisory council for both the WPPDA and the Retirement Income Security for Employees Act. The Advisory Council is expanded from its present number of 13 members to 21 members. New permanent categories of membership are added to include the fields of actuarial counseling, investment counseling, and accounting. Five representatives of management have also been added. The period of advisory council meetings is changed from its requirement of twice a year to meetings of at least four times a year.

Fiduciary Standards

Section 510.—This section adds new Section 15 to the WPPDA which establishes fiduciary standards for employee pension and welfare plans.

In general, this section requires plans to be established pursuant to a written document and requires plan funds to be treated as a trust for the exclusive purpose of (1) providing benefits to participants and their beneficiaries and (2) paying reasonable administrative expenses, and (3) assets remaining after satisfaction of all rights, attributable to employee contributions, shall be distributed equitably on basis of the rate of employee contributions.

This section also requires a fiduciary (i.e., a person who is responsible for handling plan funds) to act as a prudent man in a similar situation and other like conditions would act. The fiduciary must adhere to trust principles established by the Act, and to trust terms which are consistent with the Act and is prohibited from receiving any consideration from any party dealing with such fund, in connection with fund transactions. However, transactions which are otherwise prohibited may be permitted by the Secretary if he finds that the participants' interests would be served by such action. A fiduciary is prohibited from investing, or maintaining investment of more than 10 percent of a pension fund's assets in securities of the employer.

In general, fiduciaries may be reasonably compensated and entitled to receive benefits which belong to them by reason of being participants in the plan and may also make certain loans to participants or beneficiaries or make reasonable arrangements with parties-in-interest for office space or other services, including providing more than one type of service to fiduciaries or other parties-in-interest which are customarily furnished.

Any fiduciary who breaches his trust is personally liable for losses resulting from such breach, and co-fiduciaries are jointly and severally liable except that a co-fiduciary may avoid liability by objecting promptly to any action which may constitute a breach of trust.

Exculpatory clauses in trust agreements are prohibited; however, fiduciaries are permitted to allocate specific responsibilities among themselves, and, thereby, subject to disapproval by the Secretary, delineate the responsibility of each fiduciary.

The bill further prohibits any individual who has been convicted of certain specified crimes from serving as an administrator, officer, trustee, employee, or consultant of, or with respect to a plan, for five years following his conviction or release from imprisonment, unless the Secretary determines that a waiver is justified.

The bill also requires all investments and deposits of plan funds to be made in the name of the fund or its nominee and prohibits employees of either the employer or an employee organization from receiving commissions, or brokerage fees with respect to plan investments; and provides for a transitional period as determined by the Secretary for a plan to dispose of conflict-in-interest investments.

Every plan, in accordance with regulations of the Secretary, is required to provide adequate notice in writing to a participant whose benefit claim has been denied, setting forth the specific reason for the denial in understandable language and providing reasonable review procedures with respect to any denial of benefits. The bill also requires that where a plan offers the option of survivorship benefits to a participant, he can only lose such option if he waives it in writing.

TITLE VI.—ENFORCEMENT

Sec. 601.—This section empowers the Secretary to petition the federal courts to compel a pension or profit-sharing-retirement plan to comply with the Act or effect recoveries of moneys which may be due under the Act.

Sections 602, 603, 604, and 605.—These sections provide that when the Secretary has reason to believe that a pension, profit-sharing, retirement plan, or other employee benefit plan is violating the Act or the plan's governing documents, he may seek relief in the federal courts to compel the return of assets to the fund, to require payments to be made, to require the removal of a fiduciary, and to obtain other appropriate relief. Plan participants also may seek relief in federal and state courts against violations committed by a fiduciary, including his removal from office. They may also seek relief to recover benefits required to be paid under the plan in the same courts. The Secretary has the right to remove an action pending in a state court to the federal courts for relief provided under this Act.

Sections 607 and 608.—These sections provide that administrators and fiduciaries have the right to obtain judicial review of the actions of the Secretary. The bill provides a statute of limitations of five years for actions arising under the Act.

Section 609.—This section provides that this Act supersedes state laws covering the same matters. However, the Act does not exempt or relieve any person from complying with any state law regulating insurance, banking, and related matters, and does not remove state jurisdiction over plans not subject to the Act. State courts are not prevented from asserting jurisdiction in compelling the accounting of a fiduciary or requiring clarification of the plan. The Secretary or a plan participant may remove such a case from the state to the federal court if it involves the applicability of the Act.

Section 610.—This section makes it unlawful for any person to discharge, fine, suspend, expel, discipline or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of the plan or the Act or the Welfare and Pensions Plans Disclosure Act or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan or the Act or the WPPDA.

Section 611.—This section makes it a criminal offense for any person to use fraud, force, or violence or threats thereof to restrain, coerce, intimidate or attempt to restrain, coerce, intimidate any participant or beneficiary for the purpose of interfering with or preventing the exercise of any right to which he is or may become entitled under the plan, the Act or the WPPDA.

TITLE VII.—EFFECTIVE DATES

Section 701.—This section provides that the registration, administration, disclosure, government procurement, fiduciary, and enforcement provisions of the Act become effective upon enactment.

The vesting and funding provisions of the Act shall become effective three years after enactment of the Act, and portability and insurance provisions one year after enactment.

VIII. Changes in Existing Law

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by sections 1 through 9 and titles I through VI of the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter printed in italic):

WELFARE PENSION PLANS DISCLOSURE ACT

Pub. L. No. 85–836, 85th Cong., 2d Sess., 1958, 72 Stat. 997, as amended by Pub. L. No. 87–420, 87th Cong., 2d Sess., 1962, 76 Stat. 35; 29 U.S.C. §§ 301–09; F.C.A. 29 §§ 301–09

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Welfare and Pension Plans Disclosure Act."

FINDINGS AND POLICY

SEC. 2. (a) The Congress finds that the growth in size, scope, and numbers of employee welfare and pension benefit plans in recent years has been rapid and substantial; that the continued well-being and security of millions of employees and their dependents are directly affected by these plans; that they are affected with a national public interest; that they have become an important factor affecting the stability of employment and the successful development of industrial relations; that they have become an important factor in commerce because of the interstate character of their activities, and of the activities of their participants, and the employers, employee organizations, and other entities by which they are established or maintained; that owing to the lack of employee information concerning their operation, it is desirable in the interests of employees and their beneficiaries, and to provide for the general welfare and the free flow of commerce, that disclosure be made with respect to the operation and administration of such plans.

(b) It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee welfare and pension benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto.

DEFINITIONS

SEC. 3. When used in this Act—

(1) The term "employee welfare benefit plan" means any plan, fund, or program which is communicated or its benefits described in writing to the employees, and which was heretofore or is hereafter established *or maintained* by an employer or by an employee organization, or by

both, for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident disability death or [unemployment.] *unemployment or benefits of the type described or permitted by section 302(c) of the Labor-Management Relations Act.*

(2) The term "employee pension benefit plan" means any plan, fund, or program which is communicated or its benefits described in writing to the employees, and which was heretofore or is hereafter established *or maintained* by an employer or by an employee organization, or by both, for the purpose of providing for its participants or their beneficiaries, by the purchase of insurance or annuity contracts or otherwise, retirement benefits, and includes any profit-sharing plan which provides benefits at or after retirement.

(3) The term "employee organization" means any labor union or any organization of any kind, or any agency or employee representation committee, association, group, or [plan,] *program* in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning an employee [welfare or pension] benefit plan, or other matters incidental to employment relationships; or any employees' beneficiary association organized for the purpose, in whole or in part, of establishing such a plan.

(4) The term "employer" means any person acting directly as an employer or indirectly in the interest of an employer in relation to an employee [welfare or pension] benefit plan, and includes a group or association of employers acting for an employer in such capacity.

(5) The term "employee" means any individual employed by an employer.

(6) The term "participant" means any employee or former employee of an employer or any member of an employee organization who is or may become leigible to receive a benefit of any type from an employee [welfare or pension] benefit plan, or whose beneficiaries may be eligible to receive any such benefit.

(7) The term "beneficiary" means a person designated by a participant or by the terms of an employee [welfare or pension] benefit plan who is or may become entitled to a benefit thereunder.

(8) The term "person" means an individual, partnership, corporation, mutual company, joint-stock company, trust, unincorporated organization, association, or employee organization.

(9) The term "State" includes any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake Island, the Canal Zone, and Outer Continental Shelf lands defined in the Outer Continental Shelf Lands Act (43 U.S.C. 1331–1343).

(10) The term "commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place outside thereof.

(11) The term "industry or activity affecting commerce" means any activity, business, or industry in commerce or in which a labor dispute would hinder or obstruct commerce or the free flow of commerce and includes any activity or industry "affecting commerce" within the meaning of the Labor-Management Relations Act, 1947, as amended, or the Railway Labor Act, as amended.

(12) The term "Secretary" means the Secretary of Labor.

(13) The term "party in interest" means *as to an employee benefit plan or fund,* any administrator, officer, *fiduciary,* trustee, custodian, counsel, or employee of any employee [welfare] benefit plan [or employee pension benefit plan,] or a person providing benefit plan services to any such plan, or an [employer] *employer,* any of whose employees are covered by such a plan *or any person controlling, controlled by, or under common control with such employer* or officer or employee or agent of such [employer, or an officer or agent or employee of] *employer or such person,* or an employee organization having members covered by such [plan.] *plan, or an officer or employee or agent of such an employee organization, or a relative, partner, or joint venturer or any of the above-described persons. Whenever the term "party in interest" is used in this Act, it shall mean a person known to be a party in interest. If any moneys or other property of an employee benefit fund are invested in shares of an investment company registered under the Investment Company Act of 1940, such investment shall not cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a "fiduciary" or a "party in interest" as those terms are defined in this Act, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit fund established or maintained pursuant to an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.*

Nothing contained herein shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other provision of law.

(14) The term "relative" means a spouse, ancestor, descendant, brother, sister, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

(15) The term "administrator" means—

(A) the person specifically so designated by the terms of the plan, collective bargaining agreement, trust agreement, contract, or other instrument, under which the plan is operated; or

(B) in the absence of such designation (i) the employer in the case of an employee benefit plan established or maintained by a single employer, (ii) the employee organization in the case of a plan established or maintained by an employee organization, or (iii) the association, committee, joint board of trustees, or other similar group of representatives of the parties who established or maintained the plan, in the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations.

(16) The term "employee benefit plan" or "plan" means an employee welfare benefit plan or an employee pension benefit plan or a plan providing both welfare and pension benefits.

(17) The term "employee benefit fund" or "fund" means a fund of money or other assets maintained pursuant to or in connection with an employee benefit plan and includes employee contributions withheld but not yet paid to the plan by the employer. The term does not include: (A) any assets of an investment company subject to regulation under the Investment Company Act of 1940; (B) premium, subscription charges, or deposits received and retained by an insurance carrier or service or other organiza-

tion, except for any separate account established or maintained by an insurance carrier.

(18) The term "separate account" means an account established or maintained by an insurance company under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(19) The term "adequate consideration" when used in section 15 means either (A) at no more than the price of the security prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (B) if the security is not traded on such a national securities exchange, at a price not less favorable to the fund than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer, or (C) if the price of the security is not quoted by persons independent of the issuer, a price determined to be the fair value of the security.

(20) The term "nonforfeitable pension benefit" means a legal claim obtained by a participant or his beneficiary to that part of an immediate or deferred pension benefit which, notwithstanding any conditions subsequent which would affect receipt of any benefit flowing from such right, arises from the participant's covered service under the plan and is no longer contingent on the participant remaining covered by the plan.

(21) The term "covered service" means that period of service performed by a participant for an employer or as a member of an employee organization which is recognized under the terms of the plan or the collective-bargaining agreement (subject to the requirements of the Retirement Income Security for Employees Act), for purposes of determining a participant's eligibility to receive pension benefits or for determining the amount of such benefits.

(22) The term "pension benefit" means the aggregate, annual, monthly, or other amounts to which a participant has or will become entitled upon retirement or to which any other person is entitled by virtue of such participant's death.

(23) The term "accrued portion of normal retirement benefit" means that amount of such benefit which, irrespective of whether the right to such benefit is nonforfeitable, is equal to—

(A) in the case of a profit-sharing-retirement plan or money purchase plan, the total amount credited to the account of a participant;

(B) in the case of a unit benefit-type pension plan, the benefit units credited to a participant; or

(C) in the case of other types of pension plans, that portion of the prospective normal retirement benefit of a participant that, pursuant to rule or regulation under the Retirement Income Security for Employees Act, is determined to constitute the participant's accrued portion of the normal retirement benefit under the terms of the appropriate plan.

(24) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in, or, in general, any interest or instrument commonly known as a

security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(25) The term "fiduciary" means any person who exercises any power of control, management, or disposition with respect to any moneys or other property of any employee benefit fund, or has authority or responsibility to do so.

(26) The term "market value" or "value" when used in this Act means fair market value where available, and otherwise the fair value as determined pursuant to rule or regulation under this Act.

COVERAGE

SEC. 4. (a) Except as provided in subsection (b), this Act shall apply to any employee [welfare or pension] benefit plan if it is established or maintained by any employer [or employers] engaged in commerce or in any industry or activity affecting commerce or by any employee organization [or organizations] representing employees engaged in commerce or in any industry or activity affecting commerce or by both.

(b) This Act shall not apply to an employee [welfare or pension] benefit plan if—

(1) such plan is administered by the Federal Government or by the government of a State, by a political subdivision of a State, or by an agency or instrumentality of any of the foregoing;

(2) such plan was established and is maintained solely for the purpose of complying with applicable workmen's compensation laws or unemployment compensation disability insurance laws; or

[(3) such plan is administered by an organization which is exempt from taxation under the provisions of section 501(a) of the Internal Revenue Code of 1954 and is administered as a corollary to membership in a fraternal benefit society described in section 501(c)(8) of such Code or by organizations described in sections 501(c)(3) and 501(c)(4) of such Code: *Provided*, That the provisions of this paragraph shall not exempt any plan administered by a fraternal benefit society or organization which represents its members for purposes of collective bargaining; or]

(3) Such plan is administered by a religious organization described under section 501(c) of the Internal Revenue Code of 1954 which is exempt from taxation under the provisions of section 501(a) of such Code;

(4) such plan covers not more than twenty-five [.] *participants, except that participants and beneficiaries of such plan shall be entitled to maintain an action to recover benefits or to clarify their rights to future benefits as provided in section 604 of the Retirement Income Security for Employees Act.*

(5) such plan is established or maintained outside the United States primarily for the benefit of employees who are not citizens of the United States and the situs of the employee benefit plan fund established or maintained pursuant to such plan is maintained outside the United States.

DUTY OF DISCLOSURE AND REPORTING

SEC. 5. (a) The administrator of an employee welfare benefit plan or an employee pension benefit plan shall publish in accordance with section 8 to each participant or beneficiary covered thereunder (1) a description of the plan and (2) an annual financial report. Such description and such report shall contain the information required by sections 6 and 7 of this Act in such form and detail as the Secretary shall by regulations prescribe and copies thereof shall be executed, published, and filed in accordance with the provisions of this Act and the Secretary's regulations thereunder. No regulation shall be issued under the preceding sentence which relieves any administrator of the obligation to include in such description or report any information relative to his plan which is required by section 6 or 7. Notwithstanding the foregoing, if the Secretary finds, on the record after giving interested persons an opportunity to be heard, that specific information on plans of certain kinds or on any class or classes of benefits described in section 3(1) and (2) which are provided by such plans cannot, in the normal method of operation of such plans, be practicably ascertained or made available for publication in the manner or for the period prescribed in any provision of this Act, or that the information if published in such manner or for such period would be duplicative or uninformative, the Secretary may by regulations prescribe such other manner or such other period for the publication of such information as he may determine to be necessary and appropriate to carry out the purposes of this Act.

⟦(b) The term "administrator" whenever used in this Act, refers to—

⟦(1) the person or persons designated by the terms of the plan or the collective bargaining agreement with responsibility for the ultimate control, disposition, or management of the money received or contributed; or

⟦(2) in the absence of such designation, the person or persons actually responsible for the control, disposition, or management of the money received, or contributed, irrespective of whether such control, disposition, or management is exercised directly or through an agent or trustee designated by such person or persons.⟧

(b) The Secretary may require the filing of special terminal reports on behalf of an employee benefit plan which is winding up its affairs, so long as moneys or other assets remain in the plan. Such reports may be required to be filed regardless of the number of participants remaining in the plan and shall be in such form and filed in such manner as the Secretary may prescribe.

(c) The Secretary may by regulation provide for the exemption from all or part of the reporting and disclosure requirements of this Act of any class or type of employee benefit plans if the Secretary finds that the application of such requirements to such plans is not required in order to implement the purposes of this Act.

DESCRIPTION OF THE PLAN

SEC. 6. (a) ⟦Except as provided in section 4, the⟧ *A* description of any employee ⟦welfare or pension⟧ benefit plan shall be published as required herein within ninety days [of the effective date of this Act or within ninety days] after the establishment of such [plan, whichever is later.] *plan or when such plan becomes subject to this Act.*

(b) The description of the plan shall be [published, signed and sworn to by the person or persons defined as the "administrator" in section 5, and shall include their names and addresses, their official positions with respect to the plan, and their relationship, if any, to the employer or to any employee organizations, and any other officer, positions, or employment held by them; the name, address, and description of the plan and the type of administration; the schedule of benefits; the names, titles, and addresses of any trustee or trustees (if such persons are different from those persons defined as the "administrator"); whether the plan is mentioned in a collective bargaining agreement; copies of the plan or of the bargaining agreement, trust agreement, contract, or other instrument, if any, under which the plan was established and is operated;] *comprehensive and shall include the name and type of administration of the plan; the name and address of the administrator; the names and addresses of any person or persons responsible for the management or investment of plan funds; the schedule of benefits; a description of the provisions providing for vested benefits written in a manner calculated to be understood by the average participant;* the source of the financing of the plan and [the] identity of any organization through which benefits are provided; whether [the] records of the plan are kept on a calendar year basis, or on a policy or other fiscal year basis, and if on the latter basis, the date of the end of such policy or fiscal year; the procedures to be followed in presenting claims for benefits under the plan and the remedies available under the plan for the redress of claims which are denied in whole or in part. Amendments to the plan reflecting changes in the data and information included in the original plan, other than data and information also required to be included in annual reports under section 7, shall be included in the description on and after the effective date of such amendments. Any change in the information required by this subsection shall be reported [to the Secretary within sixty days after the change has been effectuated.] *in accordance with regulations prescribed by the Secretary.*

Annual Reports

SEC. 7. (a) (*1*) [The administrator of any employee welfare or pension benefit plan, a description of which is required to be published under section 6, shall also publish an annual report with respect to such plan]. *An annual report shall be published with respect to any employee benefit plan if the plan provides for an employee benefit fund subject to section 15 of this Act or* if it covers one hundred or more participants. However, the Secretary, after [investigation,] *notice and opportunity to be heard,* may require the administrator of any plan otherwise *not* covered by the Act to publish such report when necessary and appropriate to carry out the purposes of the Act. Such report shall be published as required under section 8, within one hundred and fifty days after the end of the calendar [year (or, if] *policy or fiscal year on which* the records of the plan are [kept on a policy or other fiscal year basis, within one hundred and fifty days after the end of such policy or fiscal year).] *kept.*

(2) If some or all of the benefits under the plan are provided by an insurance carrier or service or other organization, such carrier or organization shall certify to, the administrator of such plan, within one hundred and twenty days after the end of each calendar, policy, or other fiscal year, as the case may be, such information as determined by the Secretary to be necessary to enable such administrator to comply with the requirements of this Act.

(3) The administrator of an employee benefit plan shall cause an audit to be made annually of the employee benefit fund established in connection with or pursuant to the provisions of the plan. Such audit shall be conducted in accordance with generally accepted standards of auditing by an independent certified or licensed public accountant, but nothing herein shall be construed to require such an audit of the books or records of any bank, insurance company, or other institution providing insurance, investment, or related function for the plan, if such books or records are subject to periodic examination by any agency of the Federal Government or the government of any State. The auditor's opinion and comments with respect to the financial information required to be furnished in the annual report by the plan administrator shall form a part of such report.

(b) A report under this section shall [be signed by the administrator and such report shall include the following:] *include—*

(1) The amount contributed by each employer: the amount contributed by the employees; the amount of benefits paid or otherwise furnished; the number of employees covered; a statement of [assets specifying the total amount in each of the following types of assets: cash, Government bonds, non-Government bonds and debentures, common stocks, preferred stocks, common trust funds, real estate loans and mortgages, operated real estate, other real estate, and other assets; a statement of liabilities, receipts, and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amount, and for what purposes. The Secretary, when he has determined that an investigation is necessary in accordance with section 9(d) of this Act, may require the filing of supporting schedules of assets and liabilities. The information required by this section shall be sworn to by the administrator, or certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing, but nothing herein shall be construed to require such an audit of the books or records of any bank, insurance company, or other institution providing an insurance, investment, or related function for the plan, if such books or records are subject to examination by an agency of the Federal Government or the government of any State. In the case of reports sworn to, but not certified. the Secretary, when he determines that it may be necessary to investigate the plan in accordance with section 9(d) of this Act, shall, prior to investigation by the Department of Labor, require certification of the report by an independent certified or licensed public accountant.] *assets, liabilities, receipts, and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amount, and for what purpose; the name and address of each fiduciary, his official position with respect to the plan, his relationship to the employer of the employees covered by the plan, or the employee organization, and any*

other office, position, or employment he holds with any party in interest;

(2) a schedule of all investments of the fund showing as of the end of the fiscal year:

(A) the aggregate cost and aggregate value of each security, by issuer,

(B) the aggregate cost and aggregate value, by type or category, of all other investments, and separately identifying (i) each investment, the value of which exceeds 3 per centum of the value of the fund and (ii) each investment in securities or properties of any person known to be a party in interest;

(3) a schedule showing the aggregate amount, by type of security, of all purchases, sales, redemptions, and exchanges of securities made during the reporting period; a list of the issuers of such securities; and in addition, a schedule showing, as to each separate transaction with or without respect to securities issued by any person known to be a party in interest, the issuer, the type and class of security, the quantity involved in the transaction, the gross purchase price, and in the case of a sale, redemption, or exchange, the gross and net proceeds (including a description and the value of any consideration other than money) and the net gain or loss, except that such schedule shall not include distribution of stock or other distributions in kind from profit-sharing or similar plans to participants separated from the plan;

(4) a schedule of purchases, sales, or exchanges during the year covered by the report of investment assets other than securities—

(A) by type or category of asset the aggregate amount of purchases, sales, and exchanges; the aggregate expenses incurred in connection therewith; and the aggregate net gain (or loss) on sales, and

(B) for each transaction involving a person known to be a party in interest and for each transaction involving over 3 per centum of the fund, and indication of each asset purchased, sold, or exchanged (and, in the case of fixed assets such as land, buildings, and leaseholds, the location of the asset); the purchase or selling price; expenses incurred in connection with the purchase, sale, or exchange; the cost of the asset and the net gain (or loss) on each sale; the identity of the seller in the case of a purchase, or the identity of the purchaser in the case of a sale, and his relationship to the plan, the employer, or any employee organization;

(5) a schedule of all loans made from the fund during the reporting year or outstanding at the end of the year, and a schedule of principal and interest payments received by the fund during the reporting year, aggregated in each case by type of loan, and in addition, a separate schedule showing as to each loan which—

(A) was made to a party in interest, or

(B) was in default, or

(C) was written off during the year as uncollectable, or

(D) exceeded 3 per centum of the value of the fund

the original principal amount of the loan, the amount of principal and interest received during the reporting year, the unpaid balance, the identity and address of the loan obligor, a detailed description of the loan (including date of making and maturity, interest rate, the type and value of collateral, and the material terms), the amount of principal and interest overdue (if any) and as to loans written off as uncollectable an explanation thereof;

(6) a list of all leases with—

(A) persons other than parties in interest who are in default, and

(B) any party in interest,

including information as to the type of property leased (and, in the case of fixed assets such as land, buildings, leaseholds, and so forth, the location of the property), the identity of the lessor or lessee from or to whom the plan is leasing, the relationship of such lessors and lessees, if any, to the plan, the employer, employee organization, or any other party in interest, the terms of the lease regarding rent, taxes, insurance, repairs, expenses, and renewal options; if property is leased from persons described in (B) the amount of rental and other expenses paid during the reporting year; and if property is leased to persons described in (A) or (B), the date the leased property was purchased and its cost, the date the property was leased and its approximate value at such date, the gross rental receipts during the reporting period, the expenses paid for the leased property during the reporting period, the net receipt from the lease, and with respect to any such leases in default, their identity, the amounts in arrears, and a statement as to what steps have been taken to collect amounts due or otherwise remedy the default;

(7) a detailed list of purchases, sales, exchanges, or any other transactions with any party in interest made during the year, including information as to the asset involved, the price, any expenses connected with the transaction, the cost of the asset, the proceeds, the net gain or loss, the identity of the other party to the transaction and his relationship to the plan;

(8) subject to rules of the Secretary designed to preclude the filing of duplicate or unnecessary statements if, some or all of the assets of a plan or plans are held in a common or collective trust maintained by a bank or similar institution or in a separate account maintained by an insurance carrier, the report shall include a statement of assets and liabilities and a statement of receipts and disbursements of such common or collective trust or separate account and such of the information required under paragraphs (2), (3), (4), (5), (6), and (7) of section 7(h) with respect to such common or collective trust or separate account as the Secretary may determine appropriate by regulation. In such case the bank or similar institution or insurance carrier shall certify to the administrator of such plan or plans, within one hundred and twenty days after the end of each calendar, policy, or other fiscal year, as the case may be, the information determined by the Secretary to be necessary to enable the plan administrator to comply with the requirements of this Act, and

(9) in addition to reporting the information called for by this subsection the administrator may elect to furnish other information as to investment or reinvestment of the fund as additional disclosures to the Secretary.

[(c) If the plan is unfunded, the report shall include only the total benefits paid and the average number of employees eligible for participation, during the past five years, broken down by year; and a statement, if applicable, that the only assets from which claims against the plan may be paid are the general assets of the employer.]

(c) If the only assets from which claims against an employee benefit plan may be paid are the general assets of the employer or the employee organization, the report shall include (for each of the past five years) the benefits paid and the average number of employees eligible for participation.

(d) If some or all of the benefits under the plan are provided by an insurance carrier or service or other organization such report shall include with respect to such plan (in addition to the information required by subsection (b)) the following:

(1) [The] *the* premium rate or subscription charge and the total premium or subscription charges paid to each such carrier or organization and the approximate number of persons covered by each class of such benefits.

(2) [The] *the* total amount of premiums received, the approximate number of persons covered by each class of benefits, and the total claims paid by such carrier or other organization: dividends or retroactive rate adjustments, commissions, and administrative service or other fees or other specific acquisition costs, paid by such carrier or other organization; any amounts held to provide benefits after retirement; the remainder of such premiums; and the names and addresses of the brokers, agents, or other persons to whom commissions or fees were paid, the amount paid to each, and for what purpose: *Provided,* That if any such carrier or other organization does not maintain separate experience records covering the specific groups it serves, the report shall include in lieu of the information required by the foregoing provisions of this paragraph (A) a statement as to the basis of its premium rate or subscription charge, the total amount of premiums or subscription charges received from the plan, and a copy of the financial report of the carrier or other organization and (B), if such carrier or organization incurs specific costs in connection with the acquisition or retention of any particular plan or plans, a detailed statement of such costs.

[(e) Details relative to the manner in which any funds held by an employee welfare benefit plan are held or invested shall be reported as provided under paragraphs (B), (C), and (D) of subsection (f)(1).]

(e) Every employee pension benefit plan shall include with its annual report (to the extent applicable) the following information:

(1) the type and basis of funding,

(2) the number of participants, both retired and nonretired, covered by the plan,

(3) the amount of all reserves or net assets accumulated under the plan,

(4) the present value of all liabilities for all nonforfeitable pension benefits and the present value of all other accrued liabilities,

(5) the ratios of the market value of the reserves and assets described in (3) above to the liabilities described in (4) above,

(6) a copy of the most recent actuarial report, and

(A)(i) the actuarial assumptions used in computing the contributions to a trust or payments under an insurance contract, (ii) the actuarial assumptions used in determining the level of benefits, and (iii) the actuarial assumptions used in connection with the other information required to be furnished under this subsection, insofar as any such actuarial assumptions are not included in the most recent actuarial report,

(B)(i) if there is no such report, or (ii) if any of the actuarial assumptions employed in the annual report differ from those in the most recent actuarial report, or (iii) if different actuarial assumptions are used for computing contributions or payments

than are used for any other purpose, a statement explaining same; and

(7) such other reasonable information pertinent to disclosure under this subsection as the Secretary may by regulation prescribe.

[(f) Reports on employee pension benefit plans shall include, in addition to the applicable information required by the foregoing provisions of this section, the following:

[(1) If the plan is funded through the medium of a trust, the report shall include—

[(A) the type and basis of funding, actuarial assumptions used, the amount of current and past service liabilities, and the number of employees, both retired and nonretired covered by the plan;

[(B) a statement showing the assets of the fund as required by section 7(b). Such assets shall be valued on the basis regularly used in valuing investments held in the fund and reported to the United States Treasury Department, or shall be valued at their aggregate cost or present value, whichever is lower, if such a statement is not so required to be filed with the United States Treasury Department;

[(C) a detailed list, including information as to cost, present value, and percentage of total funds, of all investments in securities or properities of the employer or employee organization, or any other party in interest, but the identity of all securities and the detail of brokerage fees and commissions incidental to the purchase or sale of such securities need not be revealed if such securities are listed and traded on an exchange subject to regulation by the Securities and Exchange Commission or securities in an investment company registered under the Investment Company Act of 1940, or securities of a public utility holding company registered under the Public Utility Holding Company Act of 1935, and the statement of assets contains a statement of the total investments in common stock, preferred stock, bonds and debentures, respectively, valued as provided in subparagraph (B);

[(D) a detailed list of all loans made to the employer, employee organization, or other party in interest, including the terms and conditions of the loan and the name and address of the borrower: *Provided,* That if the plan is funded through the medium of a trust invested, in whole or in part, in one or more insurance or annuity contracts with an insurance carrier, the report shall include, as to the portion of the funds so invested, only the information required by paragraph (2) below.

[(2) If the plan is funded through the medium of a contract with an insurance carrier, the report shall include—

[(A) the type and basis of funding, actuarial assumptions used in determining the payments under the contract, and the number of employees, both retired and nonretired, covered by the contract; and

[(B) except for benefits completely guaranteed by the carrier, the amount of current and past service liabilities, based on those assumptions, and the amount of all reserves accumulated under the plan.

[(3) If the plan is unfunded, the report shall include the total benefits paid to retired employees for the past five years, broken down by year.

[(g) If some or all of the benefits under the plan are provided by an insurance carrier or service or other organization, such carrier or organization shall certify to the administrator of such plan, within one hundred and twenty days after the end of each calendar, policy, or other fiscal year, as the case may be, such reasonable information determined by the Secretary to be necessary to enable such administrator to comply with the requirements of this Act.

[(h) The Secretary shall prescribe by general rule simplified reports for plans which he finds that by virtue of their size or otherwise a detailed report would be unduly burdensome, but the Secretary may revoke such provisions for simplified forms for any plan if the purposes of the Act would be served thereby.]

PUBLICATION

SEC. 8. [(a) Publication of the description of the plan and the latest annual report required under this Act shall be made to the participants and to the beneficiaries covered by the particular plan as follows:

[(1) The administrator shall make copies of such description of the plan (including all amendments or modifications thereto upon their effective date) and of the latest annual report available for examination by any participant or beneficiary in the principal office of the plan.

[(2) The administrator shall deliver upon written request to such participant or beneficiary a copy of the description of the plan (including all amendments or modifications thereto upon their effective date) and an adequate summary of the latest annual report, by mailing such documents to the last known address of the participant or beneficiary making such request.

[(b) The administrator of any plan subject to the provisions of this Act shall file with the Secretary two copies of the description of the plan and each annual report thereon. The Secretary shall make available for examination in the public document room of the Department of Labor copies of descriptions of plans and annual reports filed under this subsection.]

[(c)] (*a*) The Secretary shall prepare forms for the descriptions of plans and the annual reports required by the provisions of this Act, and shall make such forms available to the administrators of such plans on request.

(*b*) *The administrator of any employee benefit plan subject to this Act shall file with the Secretary a copy of the plan description and each annual report. The administrator shall also furnish to the Secretary, upon request, any documents relating to the employee benefit plan, including but not limited to the bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated, and any document so furnished shall be available for public inspection. The Secretary shall make copies of such descriptions and annual reports available for public inspection.*

(*c*) *Publication of the plan descriptions and annual reports required by this Act shall be made to participants and beneficiaries of the particular plan as follows:*

(*1*) *the administrator shall make copies of the plan description (including all amendments or modifications thereto) and the latest annual report and the bargaining agreement, trust agreement, con-*

tract, or other instrument under which the plan was established or is operated available for examination by any plan participant or beneficiary in the principal office of the administrator;

(2) the administrator shall furnish to any plan participant or beneficiary so requesting in writing a fair summary of the latest annual report;

(3) the administrator shall furnish or make available, whichever is most practicable: (i) to every participant upon his enrollment in the plan and within one hundred and twenty days after each major amendment to the plan, a summary of the plan's important provisions, including the names and addresses of any person or persons responsible for the management or investment of plan funds, and requirements of the amendment, whichever is applicable, written in a manner calculated to be understood by the average participant; such explanation shall include a description of the benefits available to the participant under the plan and circumstances which may result in disqualification or ineligibility, and the requirements of the Welfare and Pension Plans Disclosure Act with respect to the availability of copies of the plan, bargaining agreement, trust agreement, contract or other instrument under which the plan is established or operated; and (ii) to every participant every three years (commencing January 1, 1975), a revised up-to-date summary of the plan's important provisions and major amendments thereto, written in a manner calculated to be understood by the average participant; and (iii) to each plan participant or beneficiary so requesting in writing a complete copy of the plan description (including all amendments or modifications thereto) or a complete copy of the latest annual report, or both. He shall in the same way furnish a complete copy of any bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated. In accordance with regulations of the Secretary, an administrator may make a reasonable charge to cover the cost of furnishing such complete copies.

(d) In the event a plan is provided a variance with respect to standards of vesting, funding, or both, pursuant to title II of the Retirement Income Security for Employees Act, the administrator shall furnish or make available, whichever is most practicable, notice of such action to each participant in a manner calculated to be understood by the average participant, and in such form and detail and for such periods as may be prescribed by the Secretary.

ENFORCEMENT

SEC. 9. (a) Any person who willfully violates any provision of this Act shall be fined not more than $1,000, or imprisoned not more than six months, or both.

(b) Any administrator of a plan who fails or refuses, upon the written request of a participant or beneficiary covered by such plan, to make publication to him within thirty days of such request, in accordance with the provisions of section 8, of a description of the plan or an annual report containing the information required by sections 6 and 7, may in the court's discretion become liable to any such participant or beneficiary making such request in the amount of $50 a day from the date of such failure or refusal.

(c) Action to recover such liability may be maintained in any court of competent jurisdiction by any participant or beneficiary. The court in such action may in its discretion, in addition to any judgment awarded to the plaintiff or plaintiffs, allow a reasonable attorney's fee to be paid by the defendant, and costs of the action.

[(d) The Secretary may, after first requiring certification in accordance with section 7(b), upon complaint of violation not satisfied by such certification, or on his own motion, when he continues to have reasonable cause to believe investigation may disclose violations of this Act, make such investigations as he deems necessary, and may require or permit any person to file with him a statement in writing, under oath or otherwise, as to all the facts and circumstances concerning the matter to be investigated.]

(d) The Secretary may make appropriate and necessary inquiries to determine violations of the provisions of this Act, or any rule or regulation issued thereunder: Provided, however, That no periodic examination of the books and records of any plan or fund shall be conducted more than once annually unless the Secretary has reasonable cause to believe there may exist a violation of this Act or any rule or regulation issued thereunder.

(e) For the purposes of any investigation provided for in this Act, the provisions of sections 9 and 10 (relating to the attendance of witnesses and the production of books, records, and documents) of the Federal Trade Commission Act of September 16, 1914, as amended (15 U.S.C. 49, 50), are hereby made applicable to the jurisdiction, powers, and duties of the Secretary or any officers designated by him.

(f) Whenever it shall appear to the Secretary that any person is engaged in any violation of the provisions of this Act, he may in his discretion bring an action in the proper district court of the United States or United States court of any place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted.

(g) The United States district courts and the United States courts of any place subject to the jurisdiction of the United States shall have jurisdiction, for cause shown, to restrain violations of this Act.

[(h) Nothing contained in this Act shall be so construed or applied as to authorize the Secretary to regulate, or interfere in the management of, any employee welfare or pension benefit plan, except that the Secretary may inquire into the existence and amount of investments, actuarial assumptions, or accounting practices only when it has been determined that investigation is required in accordance with section 9(d) of this Act.]

[(i)]*(h)* The Secretary shall immediately forward to the Attorney General or his representative any information coming to his attention in the course of the administration of this Act which may warrant consideration for criminal prosecution under the provisions of this Act or other Federal law.

Reports Made Public Information

Sec. 10. The contents of the descriptions and regular annual reports filed with the Secretary pursuant to this Act shall be public information, and the Secretary, where to do so would protect the interests of participants or beneficiaries of a plan, may publish any such inofrmation and data. The Secretary may use the information and data for statistical and research purposes, and compile and publish such studies, analyses, reports, and surveys based thereon as he may deem appropriate.

RETENTION OF RECORDS

SEC. 11. Every person required to file any description or report or to certify any information therefor under this Act shall maintain records on the matters of which disclosure is required which will provide in sufficient detail the necessary basic information and data from which the documents thus required may be verified, explained, or clarified, and checked for accuracy and completeness, and shall include vouchers, worksheets, receipts, and applicable resolution, and shall keep such records available for examination for a period of not less than five years after the filing of the documents based on the information which they contain.

RELIANCE ON ADMINISTRATIVE INTERPRETATIONS AND FORMS

SEC. 12. In any action or proceeding based on any act or omission in alleged violation of this Act, no person shall be subject to any liability or punishment for or on account of the failure of such person to (1) comply with any provision of this Act if he pleads and proves that the act or omission complained of was in good faith, in conformity with, and in reliance on any written interpretation or opinion of the Secretary, or (2) publish and file any information required by any provision of this Act if he pleads and proves that he published and filed such information in good faith, on the description and annual report forms prepared by the Secretary and in conformity with the instructions of the Secretary issued under this Act regarding the filing of such forms. Such a defense, if established, shall be a bar to the action or proceeding, notwithstanding that (A) after such act or omission, such interpretation or opinion is modified or rescinded or is determined by judicial authority to be invalid or of no legal effect, or (B) after publishing or filing the description and annual reports, such publication or filing is determined by judicial authority not to be in conformity with the requirements of this Act.

BONDING

SEC. 13. (a) Every administrator, officer, and employee of any employee welfare benefit plan or of any employee pension benefit plan subject to this Act who handles funds or other property of such plan shall be bonded as herein provided; except that, where such plan is one under which the only assets from which benefits are paid are the general assets of a union or of an employer, the administrator, officers and employees of such plan shall be exempt from the bonding requirements of this section. The amount of such bond shall be fixed at the beginning of each calendar, policy, or other fiscal year, as the case may be, which constitutes the reporting year of such plan. Such amount shall be not less than 10 per centum of the amount of funds handled, determined as herein provided, except that any such bond shall be in at least the amount of $1,000 and no such bond shall be required in an amount in excess of $500,000: *Provided,* That the Secretary, after due notice and opportunity for hearing to all interested parties, and after consideration of the record, may prescribe an amount in excess of $500,000, which in no event shall exceed 10 per centum of the funds handled. For purposes of fixing the amount of such bond, the amount of funds handled shall be determined by the funds handled by the person, group, or class to be covered by such bond and by their predecessor or predecessors, if any, during the preceding reporting year, or if the plan has no preceding reporting year, the amount of funds to be handled during the current reporting year by such person, group, or class, estimated as provided in regulations of the Secretary. Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of such administrator, officer, or employee, directly or through connivance with others. Any bond shall have as surety thereon a corporate surety company which is an acceptable surety on Federal bonds under authority granted by the Secretary of the Treasury pursuant to the Act of July 30, 1947 (6 U.S.C. 6–13). Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule or blanket forms of bonds which cover a group or class.

(b) It shall be unlawful for any administrator, officer, or employee to whom subsection (a) applies, to receive, handle, disburse, or otherwise exercise custody or control of any of the funds or other property of any employee welfare benefit plan or employee pension benefit plan, without being bonded as required by subsection (a) and it shall be unlawful for any administrator, officer, or employee of such plan, or any other person having authority to direct the performance of such functions, to permit such functions, or any of them, to be performed by any such person, with respect to whom the requirements of subsection (a) have not been met.

(c) It shall be unlawful for any person to procure any bond required by subsection (a) from any surety or other company or through any agent or broker in whose business operations such plan or any party in interest in such plan has any significant control or financial interest, direct or indirect.

(d) Nothing in any other provision of law shall require any person, required to be bonded as provided in subsection (a) because he handles funds or other property of an employee welfare benefit plan or of an employee pension benefit plan, to be bonded insofar as the handling by such person of the funds or other property of such plan is concerned.

(e) The Secretary shall from time to time issue such regulations as may be necessary to carry out the provisions of this section. When, in the opinion of the Secretary, the administrator of a plan offers adequate evidence of the financial responsibility of the plan, or that other bonding arrangements would provide adequate protection of the beneficiaries and participants, he may exempt such plan from the requirements of this section.

ADVISORY COUNCIL

SEC. 14. (a)(*1*) There is hereby established an Advisory Council on Employee Welfare and Pension Benefit Plans (hereinafter referred to as the "Council") [which shall consist of thirteen members to be appointed in the following manner: One from the insurance field, one from the corporate trust field, two from management, four from labor, and two from other interested groups, all appointed by the Secretary from among persons recommended by organizations in the respective groups; and three representatives of the general public appointed by the Secretary.] *consisting of twenty-one members appointed by the Secretary. Not more than eleven members of the Council shall be members of the same political party.*

(2) Members shall be appointed from among persons recommended by groups or organizations which they shall represent and shall be persons qualified to appraise the programs instituted under this Act and the Retirement Income Security for Employees Act.

(3) Of the members appointed, five shall be representatives of labor organizations; five shall be representatives of management; one representative each from the fields of insurance, corporate trust, actuarial counseling, investment counseling, and the accounting field; and six representatives shall be appointed from the general public.

(4) Members shall serve for terms of three years, except that of those first appointed, six shall be appointed for terms of one year, seven shall be appointed for terms of two years, and eight shall be appointed for terms of three years. A member may be reappointed, and a member appointed to fill a vacancy shall be appointed only for the remainder of such term. A majority of members shall constitute a quorum and action shall be taken only by a majority vote of those present.

(5) Members shall be paid compensation at the rate of $150 per day when engaged in the actual performance of their duties except that any such member who holds another office or position under the Federal Government shall serve without additional compensation. Any member shall receive travel expenses, including per diem in lieu of subsistence as authorized by section 5703 of title 5, United States Code, for persons in the Government service employed intermittently.

(b) It shall be the duty of the Council to advise the Secretary with respect to the carrying out of his functions under this Act, *and the Retirement Income Security for Employees Act* and to submit to the Secretary recommendations with respect thereto. The Council shall meet at least [twice] *four times* each year and at such other times as the Secretary requests. At the beginning of each regular session of the Congress, the Secretary shall transmit to the Senate and House of Representatives each recommendation which he has received from the Council during the preceding calendar year and a report covering his activities under the Act *and the Retirement Income Security for Employees Act* for [such] *the* preceding [calendar] *fiscal* year, including full information as to the number of plans and their size, the results of any studies he may have made of such plans and the [Act's] operation *of this Act and the Retirement Income Security for Employees Act* and such other information and data as he may deem desirable in connection with employee welfare and pension benefit plans.

(c) The Secretary shall furnish to the Council an executive secretary and such secretarial, clerical, and other services as are deemed necessary to [the] conduct [of] its business. The Secretary may call upon other agencies of the Government for statistical data, reports, and other information which will assist the Council in the performance of its duties.

(d) Appointed members of the Council shall be paid compensation at the rate of $50 per diem when engaged in the work of the Council, including travel time, and shall be allowed travel expenses and per diem in lieu of subsistence as authorized by law (5 U.S.C. 73b–2) for persons in the Government service employed intermittently and receiving compensation on a per diem, when actually employed, basis.

(e)(1) Any member of the Council is hereby exempted, with respect to such appointment, from the operation of sections 281, 283, and 1914 of title 18 of the United State Code, and section 190 of the Revised Statues (5 U.S.C. 99), except as otherwise specified in paragraph (2) of this subsection.

(2) The exemption granted by paragraph (1) of this subsection shall not extend—

(A) to the receipt or payment of salary in connection with the appointee's Government service from any source other than the private employer of the appointee at the time of his appointment, or

(B) during the period of such appointment, to the prosecution or participation in the prosecution, by any person so appointed, of any claim against the Government involving any matter with which such person, during such period, is or was directly connected by reason of such appointment.

"Fiduciary Standards

Sec. 15. (a) Every employee benefit fund established to provide for the payment of benefits under an employee's benefit plan shall be established or maintained pursuant to a duly executed written document which shall set forth the purpose or purposes for which such fund is established and the detailed basis on which payments are to be made into and out of such fund. Such fund shall be deemed to be a trust and shall be held for the exclusive purpose of (1) providing benefits to participants in the plan and their beneficiaries and (2) defraying reasonable expenses of administering the plan.

(b)(1) A fiduciary shall discharge his duties with respect to the fund—

(A) with the care under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; and

(B) subject to the standards in subsection (a) and in accordance with the documents and instruments governing the fund insofar as is consistent with this Act, except that (i) any assets of the fund remaining upon dissolution or termination of the fund shall, after complete satisfaction of the rights of all beneficiaries to benefits accrued to the date of dissolution or termination, be distributed ratably to the beneficiaries thereof, or if the trust agreement so provides, to the contributors thereto; (ii) that in the case of a registered pension or profit-sharing-retirement plan, such distribution shall be subject to the requirements of the Retirement Income Security for Employees Act and (iii) any assets of the fund, attributable to employee contributions, remaining after complete satisfaction of the rights of all beneficiaries accrued to the date of dissolution or termination shall be equitably distributed to the employee contributors according to their rate of contribution.

(2) Except as permitted hereunder, a fiduciary shall not—

(A) rent or sell property of the fund to any person known to be a party in interest of the fund;

(B) rent or purchase on behalf of the fund any property known to be owned by a party in interest of the fund;

(C) deal with such fund in his own interest or for his own account;

(D) represent any other party with such fund, or in any way act on behalf of a party adverse to the fund or adverse to the interests of its participants or beneficiaries;

(E) receive any consideration from any party dealing with such fund in connection with a transaction involving the fund;

(F) loan money or other assets of the fund to any party in interest of the fund;

(G) furnish goods, services, or facilities of the fund to any party in interest of the fund;

(H) permit the transfer of any assets or property of the fund to, or its use by or for the benefit of, any party in interest of the fund; or

(I) permit any of the assets of the fund to be held, deposited, or invested outside the United States unless the indicia of ownership remain within the jurisdiction of a United States District Court, except as authorized by the Secretary by rule or regulation.

(3) The Secretary, by rules or regulations or upon application of any fiduiciary or party in interest, by order, shall provide for the exemption conditionally or unconditionally of any fiduciary or class of fiduciaries or transactions or class or transactions from all or part of the proscriptions contained in this subsection 15(b)(2) when the Secretary finds that to do so is consistent with the purposes of this Act and is in the interest of the fund or class of funds and the participants and beneficiaries: Provided, however, That any such exemption shall not relieve a fiduciary from any other applicable provisions of this Act.

(c) Nothing in this section shall be construed to prohibit the fiduciary from—

(1) receiving any benefit to which he may be entitled as a participant or beneficiary in the plan under which the fund was established;

(2) receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the fund, or receiving in a fiduciary capacity proceeds from any transaction involving plan funds, except that no person so serving who already receives full-time pay from an employer or an association of employers whose employees are participants in the plan under which the fund was established, or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred and not otherwise reimbursed;

(3) serving in such position in addition to being an officer, employee, agent, or other representative of a party in interest;

(4) engaging in the following transactions:

(A) holding or purchasing on behalf of the fund any security which has been issued by an employer whose employees are participants in the plan, under which the fund was established or a

corporation controlling, controlled by, or under common control with such employer, except that (i) the purchase of any security is for no more than adequate consideration in money or money's worth, and (ii) that if an employee benefit fund is one which provides primarily for benefits of a stated amount, or an amount determined by an employee's compensation, an employee's period of service, or a combination of both, or money purchase type benefits based on fixed contributions which are not geared to the employer's profits, no investment shall be held or made by a fiduciary of such a fund in securities of such employer or of a corporation controlling, controlled by, or under common control with such employer, if such investment, when added to such securities already held, exceeds 10 per centum of the fair market value of the assets of the fund. Notwithstanding the foregoing, such 10 per centum limitation shall not apply to profit sharing, stock bonus, thrift and savings or other similar plans which explicitly provide that some or all of the plan funds may be invested in securities of such employer or a corporation controlling, controlled by, or under common control with such employer, nor shall said plans be deemed to be limited by any diversification rule which may be invested in such securities. Profit-sharing, stock bonus, thrift, or other similar plans, which are in existence on the date of enactment and which allow investment in such securities without explicit provision in the plan, shall remain exempt from the 10 per centum limitation until the expiration of one year from the date of enactment of Retirement Income Security for Employees Act. Nothing contained in this subparagraph shall be construed to relieve profit-sharing, stock bonus thrift and savings or other similar plans from any other applicable requirements of this section;

(B) purchasing on behalf of the fund any security or selling on behalf of the fund any security which is acquired or held by the fund, to or from a party in interest, if (i) at the time of such purchase or sale the security is of a class of securities which is listed on a national securities exchange registered under the Securities Exchange Act of 1934 or which has been listed for more than one month (at the time of such sale or purchase) on an electronic quotation system administered by a national securities association registered under the Securities Exchange Act of 1934, (ii) no brokerage commission, fee (except for customary transfer fees), or other remuneration is paid in connection with such transaction, (iii) adequate consideration is paid, and (iv) that in the event the security is one described in subparagraph (A), the transaction has received the prior approval of the Secretary;

(5) making any loan to participants or beneficiaries of the plan under which the fund was established where such loans are available to all participants or beneficiaries on a nondiscriminatory basis and are made in accordance with specific provisions regarding such loans set forth in the plan and are not otherwise inconsistent with the purposes of this Act;

(6) contracting or making reasonable arrangements with a party in interest for office space and other services necessary for the operation of the plan and paying reasonable compensation therefor;

(7) following the specific instructions in the trust instrument or other document governing the fund insofar as consistent with the specific prohibitions listed in subsection (b)(2);

(8) taking action pursuant to an authorization in the trust instrument or other document governing the fund, provided such action is consistent with the provisions of subsection (b).

(d) Any fiduciary who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this Act shall be personally liable to such fund for any losses to the fund resulting from such breach, and to pay to such fund any profits which have inured to such fiduciary through use of assets of the fund.

(e) When two or more fiduciaries undertake jointly the performance of a duty or the exercise of a power, or where two or more fiduciaries are required by an instrument governing the fund to undertake jointly the performance of a duty or the exercise of power, but not otherwise, each of such fiduciaries shall have the duty to prevent any other such cofiduciary from committing a breach of responsibility, obligation, or duty of a fiduciary or to compel such other cofiduciary to redress such a breach, except that no fiduciary shall be liable for any consequence of any act or failure to act as a cofiduciary who is undertaking or is required to undertake jointly any duty or power if he shall object in writing to the specific action and promptly file a copy of his objection with the Secretary.

(f) No fiduciary may be relieved from any responsibility, obligation, or duty imposed by law, agreement, or otherwise. Nothing herein shall preclude any agreement allocating specific duties or responsibilities among fiduciaries, or bar any agreement of insurance coverage or indemnification affecting fiduciaries, unless specifically disapproved by the Secretary.

(g) A fiduciary shall not be liable for a violation of this Act committed before he became a fiduciary or after he ceased to be a fiduciary.

(h) No individual who has been convicted of, or has been imprisoned as a result of his conviction of: robbery, bribery, extortion, embezzlement, grand larceny, burglary, arson, violation of narcotics laws, murder, rape, kidnaping, perjury, assault with intent to kill, assault which inflicts grievous bodily injury, any crime described in section 9(a) (1) of the Investment Company Act of 1940, or a violation of any provision of the Welfare and Pension Plans Disclosure Act, or a violation of section 302 of the Labor-Management Relations Act of 1947 (61 Stat. 157, as amended), or a violation of chapter 63 of title 18, United States Code, or a violation of section 874, 1027, 1503, 1505, 1506, 1510, 1951, or 1954 of title 18, United States Code, or a violation of the Labor-Management Reporting and Disclosure Act of 1959 (73 Stat. 519, as amended), or conspiracy to commit any such crimes or attempt to commit any such crimes or a crime in which any of the foregoing crimes is an element, shall serve—

(1) as an administrator, officer, trustee, custodian, counsel, agent, employee (other than as an employee performing exclusive clerical or janitorial duties) or other fiduciary position of any employee benefit plan; or

(2) as a consultant to any employee benefit plan, during or for five years after such conviction or after the end of such imprisonment, unless prior to the end of such five-year period, in the case of a person so convicted or imprisoned, (A) his citizenship rights having been revoked as a result of such conviction, have been fully

restored, or (B) the Secretary determines that such person's service in any capacity referred to in clause (1) or (2) would not be contrary to the purposes of this Act. No person shall knowingly permit any other person to serve in any capacity referred to in clause (1) or (2) in violation of this subsection. Any person who willfully violates this subsection shall be fined not more than $10,000 or imprisoned for not more than one year, or both. For the purposes of this subsection, any person shall be deemed to have been "convicted" and under the disability of "conviction" from the date of the judgment of the trial court or the date of the final sustaining of such judgment on appeal, whichever is the later event, regardless of whether such conviction occurred before or after the date of enactment of this section. For the purposes of this subsection, the term "consultant" means any person who, for compensation, advises or represents an employee benefit plan or who provides other assistance to such plan, concerning the establishment or operation of such plan.

(i) All investments and deposits of the funds of an employee benefit fund and all loans made out of any such fund shall be made in the name of the fund or its nominee, and no employer or officer or employee hereof, and no labor organization, or officer or employee thereof, shall either directly or indirectly accept or be the beneficiary of any fee, brokerage, commission, gift, or other consideration for or on account of any loan, deposit, purchase, sale, payment, or exchange made by or on behalf of the fund.

(j) In order to provide for an orderly disposition of any investment, or termination of any service, the retention or continuation of which would be deemed to be prohibited by this Act, and in order to protect the interest of the fund and its participants and its beneficiaries, the fiduciary may in his discretion effect the disposition of such investment or termination of such service within three years after the date of enactment of this Act, or within such additional time as the Secretary may by rule or regulation allow, and such action shall be deemed to be in compliance with this Act.

(k) In accordance with regulations of the Secretary, every employee benefit plan subject to this Act shall—

(1) provide adequate notice in writing to any participant or beneficiary whose claim for benefits from the plan has been denied, setting forth the specific reasons for such denial, written in a manner calculated to be understood by the participant, and

(2) afford a reasonable opportunity to any participant whose claim for benefits has been denied for a full and fair review by the plan administrator of the decision denying the claim.

(l) An employee benefit plan subject to this Act or the Retirement Income Security for Employees Act, which provides an optional death benefit or any kind, or in any form, shall not provide that such option may be waived by default or in any manner other than in a writing signed by the participant, after such participant receives an explanation of their terms and conditions of the option and the effect of such waiver.

ADMINISTRATION

SEC. [15.] *16.* (a) The provisions of the Administrative Procedure Act shall be applicable to this Act.

(b) No employee of the Department of Labor shall administer or enforce this Act with respect to any employee organization of which he is a member or employer organization in which he has an interest.

(c) No more than 260 employees shall be employed by the Department of Labor to administer or enforce this Act for the first two years after the enactment of the Welfare and Pension Plans Disclosure Act Amendments of 1962.

(d) Not more than two million two hundred thousand dollars per year is authorized to be appropriated for the administration and enforcement of this Act, for the first two years after the enactment of the Welfare and Pension Plans Disclosure Act Amendments of 1962.

EFFECT OF OTHER LAWS

SEC. [16.] *17.* (a) In the case of an employee welfare or pension benefit plan providing benefits to employees employed in two or more States, no person shall be required by reason of any law of any such State to file with any State agency (other than an agency of the State in which such plan has its principal office) any information included within a description of the plan or an annual report published and filed pursuant to the provisions of this Act if copies of such description of the plan and of such annual report are filed with the State agency, and if copies of such portion of the description of the plan and annual report, as may be required by the State agency, are distributed to participants and beneficiaries in accordance with the requirements of such State law with respect to scope of distribution. Nothing contained in this subsection shall be construed to prevent any State from obtaining such additional information relating to any such plan as it may desire, or from otherwise regulating such plan.

(b) The provisions of this Act, except subsection (a) of this section and section 13, and any action taken thereunder, shall not be held to exempt or relieve any person from any liability, duty, penalty, or punishment provided by any present or future law of the United States or of any State affecting the operation or administration of employee welfare or pension benefit plans, or in any manner to authorize the operation or administration of any such plan contrary to any such law.

SEPARABILITY OF PROVISIONS

SEC. [17.] *18.* If any provision of this Act or the application of such provision to any person or circumstance is held invalid, the remainder of this Act and the application of such provision to other persons or circumstances shall not be affected.

APPENDIX

GRUBBS & COMPANY

DONALD S. GRUBBS, JR.
Fellow of the Society of Actuaries
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SUMMARY OF REPORT

STUDY OF THE COST OF MANDATORY VESTING PROVISIONS

PREPARED FOR

SENATE SUBCOMMITTEE ON LABOR

BY

DONALD S. GRUBBS, JR.
Fellow of the Society of Actuaries
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September 11, 1972

1. Basis for Study

The Senate Subcommittee on Labor was authorized by Senate Resolution 235, 92nd Congress, 2nd Session, to continue its study of private pension plans, with particular attention to the various cost factors which affect employers and plans. As part of this study, the Subcommittee contracted to obtain certain pension plan cost estimates from the actuarial firm of Grubbs and Company, Baltimore, Maryland. The study was made to determine the range of estimated costs to private pension plans resulting from compliance with minimum vesting requirements under several proposed minimum vesting standards.

2. Summary of Methods and Assumptions

Data was collected from actual pension plans and used to construct seven model plans distributions of employees. The distribution of employees by sex, age, years of service and rates of compensation were based directly on those for seven actual pension plans. The actual rates of termination of employment for each plan were used in the study. Assumptions were made about the plan provisions, rates of disablement, mortality,retirement age, investment return and increases in compensation. The various assumptions used are described in detail in the report and were carefully selected to be representative of actual experience under pension plans in the United States.

For each model distribution costs were calculated under four different benefit formulas. For each model and benefit formula costs were determined for plans which currently have (a) no vesting provisions, (b) a liberal vesting provision and (c) a moderate vesting provision. For each combination costs were calculated for (a) present employees under fully funded plans,

(b) present employees under unfunded plans, and (c) new employees. And for each of these various combinations the increase in pension plan costs was determined under four alternative minimum vesting standards.

3. Summary of Findings

Private pension plans contain endless variety. They contain variety in their plan provisions, including existing vesting provisions, in the extent of their funding, in the distributions of employees they cover by age, sex and years of service, in their rates of termination of employment of plan participants, in rates of investment return on their funds, and in many other factors. Each of these variations results in differences of costs. Thus the cost of private pension plans covers a wide range. And the increase in cost to comply with the vesting provisions of the proposed legislation also covers a wide range. The report endeavors to determine the range of those costs for the large majority of plans. There will still exist a small percentage of plans with characteristics such that they do not fall within the range of costs presented in this study.

Costs were determined under four different schedules of vesting requirements. Under the first schedule an employee would be 30% vested in his accrued pension after 8 years of service, and the vesting would increase 10% per year until 100% vesting was reached after 15 years of service. Service prior to the effective date would be counted in determining eligibility for vesting, but benefits accrued based on such past service would not be required to be vested. If such past service were not counted for eligibility, the increase in pension plan costs would initially be slightly less than those shown in the report.

The second vesting schedule is like the first, except that all past service benefits would also be subject to the vesting requirements.

The third vesting schedule is like the first, except that, for employees age 45 or over on the effective date, all past service benefits would also be subject to the vesting requirements.

The fourth vesting schedule is the "Rule of 50" under which an employee's accrued benefit is 50% vested when his age plus service equals 50 years, but not prior to 3 years of service, and the vesting percentage increases 10% for each of the following 5 years. The Rule of 50 does not apply to past service benefits based on service prior to the effective date.

The range of increase in pension plan costs under each of the four vesting schedules is summarized in the table on page 5. The table shows costs separately for plans with no present vesting provisions, plans with moderate present vesting provisions, and plans with liberal present vesting provisions, as well as all plans combined.

23% of pension plan members are now covered under plans with no vesting prior to eligibility for early or normal retirement. The annual long term cost for most of these plans, before being amended to conform with the proposed legislation, ranges from 1.8% to 10.4% of pay. The increase in long term cost to amend these plans to conform with each of the proposed vesting schedules is shown in the top portion of the table as a percentage of payroll, and is shown in the bottom portion of the table as a percentage of the pension plan cost before amendment.

21% of pension plan members are now covered under pension plans with full vesting after 10 years service or less, with no age requirement. The annual long term cost for most of these more liberal plans, before being amended to conform with the proposed legislation, ranges from 2.2% to 11.9%

of pay.

The remaining 56% of pension plan members are covered under plans with some moderate vesting provision, but less liberal than full vesting after 10 years service. The annual long term cost for most of these plans, before being amended to conform with the proposed legislation, ranges from 2.2% to 11.8% of pay.

Plans with liberal vesting at present have the highest present costs, but would have only a negligible increase. Plans with no vesting at present have the lowest present costs and would have the highest increase, bringing their costs up toward comparable plans with liberal vesting provisions at present.

Of those plans which do have an increase in cost, those with low turnover presently have the highest cost and would have the smallest increase. Those with high turnover have the lowest present cost and would have the largest increase, bringing them up toward the cost of comparable plans with low turnover.

Termination rates used in this study reflect a wide range of experience, but do not reflect the results of layoffs of large numbers of employees. While such layoffs increase the cost of vested pensions, the total cost of the pension plan as a percentage of pay is usually reduced by such an event.

This report presents pension plan costs as a percentage of total compensation for all plan members, and this is common practice. But it would be a mistake to think that a pension plan actually has costs for all members. Ultimately a pension plan only has costs for members who receive benefits. If a particular pension plan has indicated costs of 4.0% of total payroll, it may really have a cost averaging 6% of pay for those members who ultimately receive a benefit and 0% of pay for employees who terminate their employment with no vested benefit. If addition of a vesting provision increases the cost of that plan from 4.0% to 4.4% of total payroll, it has done so by increasing the number of members for whom there is a cost averaging 6% (perhaps more or less for these additional members), and decreasing the number of members for whom there is a 0% cost. Thus the addition of vesting does not increase the cost for plan members for whom there is already a cost, but rather it adds a cost for members who had no cost previously.

The full findings of the study and the basis on which it was conducted are described in the report.

RANGE OF INCREASE IN PENSION PLAN COSTS

FOR MANDATORY VESTING PROVISIONS

	PRESENT VESTING: NONE	PRESENT VESTING: MODERATE	PRESENT VESTING: LIBERAL	ALL PLANS
Percentage of Pension Plan Members Covered Under Such Plans	23%	56%	21%	100%
Range of Present Plan Cost as a Percent of Payroll	1.8%-10.4%	2.2%-11.8%	2.2%-11.9%	1.8%-11.9%
Range of Increase in Cost as a Percent of Payroll				
1. 30% at 8 years, graded, no past service vested	0.2%-0.6%	0.0%-0.2%	0.0%-0.0%	0.0%-0.6%
2. 30% at 8 years, graded, all past service vested	0.2%-1.4%	0.1%-0.3%	0.0%-0.0%	0.0%-1.4%
3. 30% at 8 years graded, past service vested for members age 45 and over	0.2%-1.2%	0.1%-0.2%	0.0%-0.0%	0.0%-1.2%
4. Rule of 50, no past service vested	0.2%-0.7%	0.0%-0.3%	0.0%-0.2%	0.0%-0.7%
Range of Increase in Cost as a Percent of Present Plan Cost				
1. 30% at 8 years, graded, no past service vested	3%-25%	0%-6%	0%-1%	0%-25%
2. 30% at 8 years, graded, all past service vested	5%-53%	1%-8%	0%-1%	0%-53%
3. 30% at 8 years, graded, past service vested for members age 45 and over	5%-44%	1%-6%	0%-1%	0%-44%
4. Rule of 50, no past service vested	3%-28%	0%-12%	0%-5%	0%-28%

Senate Report No. 93-383

1st Session

[Bracketed numerals indicate official report page numbers.]

PRIVATE PENSION PLAN REFORM

AUGUST 21, 1973.—Ordered to be printed
Filed under authority of the order of the Senate of August 1, 1973

Mr. LONG, from the Committee on Finance,
submitted the following

REPORT

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

[To accompany S. 1179]

The Committee on Finance, to which was referred the bill (S. 1179), having considered the same, reports favorably thereon with amendments and recommends that the bill (as amended) do pass.

I. SUMMARY

The Comprehensive Private Pension Security Act of 1973 as reported by the committee is designed to make pension profit-sharing, and stock bonus plans more effective in providing retirement income for employees who have spent their careers in useful and socially productive work. It encourages provision for the retirement needs of many millions of individuals. At the same time, the committee recognized that private retirement plans are voluntary on the part of the employer, and, therefore, it has carefully weighed the additional costs to the employer and minimized them to the extent consistent with minimum standards for retirement benefits.

In broad outline, the bill is designed—

(1) to increase the number of individuals participating in retirement plans;

(2) to make sure that those who do participate in such plans do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the plan to accumulate and retain sufficient funds to meet its obligations; and

[2] (3) to make the tax laws relating to such plans fairer by providing greater equality of treatment under such plans for the different taxpaying groups involved.

This bill also goes a long way toward equalizing the tax treatment of those in different lines of work. In the case of the self-employed, it makes a threefold increase in the deductible amount which can be set aside for retirement. At the same time, and closely related to this, it provides similar maximum set-asides for those in corporate organizations who are similarly situated to the self-employed. The bill also provides deductions for a modest retirement savings set-aside for those who are not covered by any existing plans.

The bill continues to rely primarily on the tax laws to secure needed improvements in pension and related plans. In general, it retains the tax incentives granted under present law for the purpose of encouraging the establishment of plans which contain socially desirable provisions. However, it also improves the effectiveness of these tax incentives by extending or increasing them in certain cases where this is warranted and by pruning them where they have given rise to problems. In addition, the bill provides that plans, in order to qualify for the favorable tax treatment, must meet certain new rules designed to bring about needed improvements. The committee has taken this approach because it believes that properly designed tax provisions are the most effective way of inducing plans to make the improvements that are so urgently needed. At the same time, however, the bill sets up in the Department of Labor a procedure for reviewing employee claims with respect to pension, profit-sharing and other similar plans. The Department of Labor is given the authority to require by court action that pension and similar plans maintain adequate fiduciary standards and that the assets and income of the plans are safeguarded.

Present tax treatment of qualified plans

Present law encourages employers to establish retirement plans for their employees by granting favorable tax treatment where plans qualify by meeting nondiscrimination and other rules set forth in the Internal Revenue Code. Such qualified plans must cover a specified percentage of employees or cover employees under a classification found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees. Similarly, the contributions to such plans or the benefits paid out by them cannot discriminate in favor of such employees.

The favorable tax treatment granted qualified plans is substantial. Employers, within certain limits, are permitted to deduct contributions made to these plans for covered employees whether or not their interests are vested; earnings on the plan's assets are exempt from tax; and covered employees defer payment of tax on employer contributions made on their behalf until they actually receive the benefits, generally after retirement when their incomes and hence applicable tax rates tend to be lower.

The private pension system has shown substantial development under the present tax rules. Private pension plans covered about 30

[3] million employees in 1970 and are expected to cover 42 million employees by 1980 without any change in law. Similarly, in 1970 about $14 billion was contributed to pension plans by employees and employers and 4.7 million beneficiaries received $7.4 billion in pension payments. Moreover, pension plan assets amounted to $150 billion (book value) in 1972 and are expected to reach $225 billion by 1980.

Problem areas

While the achievements of private retirement plans are substantial, a number of serious problems have become apparent.

Inadequate coverage.—Despite the rapid growth in pension coverage, one-half of all employees in private nonagricultural employment are still not covered. Pension plans are still relatively rare among small business firms and in agriculture. Moreover, many plans have overly restrictive age and service requirements for participation, resulting in the exclusion of many employees.

Inadequate vesting.—Present law generally does not require an employee plan to give a covered employee vested rights to benefits—that is, the right to receive benefits if he leaves or loses his job before retirement age. Many private pension plans do provide vested rights to benefits before retirement, but a general rule, employees do not acquire vested rights until they have served a fairly long time with the firm and/or are relatively mature. As a result, even employees with substantial periods of service may lose pension benefits upon separation from employment.

Inadequate funding.—A significant number of pension plans are not adequately funded—that is, they are not accumulating sufficient assets to pay benefits in the future to covered employees. Under the present minimum funding requirements, contributions to qualified plans must be at least large enough to pay the normal costs (the pension liabilities created in the current year) plus the interest on unfunded accrued liabilities attributable to the past service of the covered employees. However, this minimum funding requirement is not adequate because it does not require the unfunded accrued liabilities for past service to be amortized.

Loss of pension benefits due to plan terminations.—Even if employees acquire vested rights to pension benefits under a plan which is being funded on what appears to be an adequate contribution schedule, there is no assurance that they will actually receive their benefits when they retire. If, for example, the employer terminates the plan as a result of going out of business, moving, closure of a particular plant, or merger, there may not be sufficient funds accumulated in the plan to pay the full amount of the pension benefits. As a result, employees who have worked for the firm for a long time may be deprived of their pensions with resulting hardship.

Misuse of pension funds.—While most pension funds appear to be well managed, there have been instances in which such funds have not been used to the best interest of covered employees. Cases have been noted of extreme misuse of pension funds. In addition, present law permits pension funds to be invested heavily in employers' securities. This frequently is not in the best interest of employees which would be better served by diversifying plan investments. The Internal Revenue Code seeks to prevent abuses in the use of qualified pension funds

[4] by prohibiting certain types of transactions which are likely to result in abuse. However, this prohibited transaction provision is not effective both because the present prohibited transactions are limited in nature and because the penalty for noncompliance is the disqualification of the pension plan from tax benefits for a period of time. This penalizes the covered employees who have had no part in any wrongdoing.

Discrimination against individuals not covered by pension plans.—Individuals who are outside of qualified pension plans have no opportunity to set aside income for their own retirement under the favorable tax treatment accorded to individuals covered by such plans. These individuals must save for their retirement from income after tax and must pay tax currently on the income earned by their retirement savings.

Unjustifiable differences in tax treatment of corporate owner-employees and self-employed individuals under qualified plans.—At present, in practice there is almost no practical limit on the amount of pension contributions that closely held corporations can make to qualified plans on behalf of owner-employees. This has resulted in abuse situations in which extremely large pension benefits have been financed for corporate owner-managers in part at the expense of the general taxpaying public, as a result of the favorable tax treatment that is accorded.

The fact that pension contributions on behalf of owner-managers of closely held corporations are in practice not subject to control has also given rise to claims of discrimination on the part of self-employed persons. Pension contributions made by self-employed persons on their own behalf are limited to 10 percent of earned income up to $2,500 a year under present law. It has also had the undesirable effect of inducing many individuals, including professional people, who would normally carry on their activities as sole proprietors or partners, to convert their activities to the corporate form almost entirely to secure the greater tax advantage associated with corporate plans.

Provisions of the bill

The bill deals with these problems in many different ways. The principal provisions of the bill are summarized below.

1. *Participation requirements.*—To extend coverage more widely, the bill provides that a qualified plan cannot require an employee to serve longer than one year or attain an age greater than 30 (whichever occurs later) as a condition of eligibility to participate in the plan. This provision is effective immediately for plans adopted after the date of enactment and January 1, 1976, for plans in existence on the date of enactment. However, existing plans which have been determined on the basis of collective bargaining agreements are not subject to the new provision until the expiration of the collective bargaining agreement or January 1, 1981, whichever is sooner.

2. *Vesting.*—Qualified plans must provide a participant with vested rights to at least 25 percent of his accrued benefits derived from his employer's contributions after 5 years of service. The minimum vesting percentage is required to be increased by 5 percentage points for each of the next 5 years, and by 10 percentage points for each of the

[5] following 5 years after that. As a result, 50 percent vesting is required after 10 years of participation, and 100 percent vesting after 15 years of participation. In addition, an individual who becomes a participant in a qualified plan is permitted to count up to 5 years of preparticipation service for purposes of determining his vesting percentage.

The vesting percentages required under the committee bill are applied to all benefits accrued during the period of participation in the plan, regardless of whether such benefits accrued prior to the effective date of the provision or on or after this date.

To give plans time to adjust to the new minimum vesting requirement, the effective date of the minimum vesting standard is deferred to January 1, 1976, for plans in existence on the date of enactment of the legislation. However, in the case of plans adopted after enactment of the legislation (which will have been adopted with knowledge of the new requirement), the provision is effective for plan years beginning after the date of enactment. Also, where existing qualified plans were the subject of collective bargaining, the minimum vesting standard will not apply until the present collective bargaining agreement terminates—or 1981, whichever is sooner.

Existing plans which provide for full 100 percent vesting no later than at the end of 10 years of covered service will be exempt from compliance with the new vesting standard until 1981.

3. *Minimum funding standards.*—The new funding standard not only requires the contributions to qualified plans which provide defined benefits to be sufficient to pay costs attributable to the current operations of the plan (as does present law), but also requires the contributions to be sufficient to amortize the initial unfunded past service liabilities in level payments over a period of 30 years or less, instead of merely providing that the contributions be sufficient to meet the interest payments on such unfunded liabilities, as under present law. Past service costs arising as a result of plan amendments, which increase unfunded past service costs by at least 5 percent, are to be funded in the same way as past service costs under new plans—namely, in level amounts over a period of 30 years or less.

The new funding standard requires amortization of all accrued past service liabilities (i.e., both vested past service liabilities and those past service liabilities which are expected to vest in the future).

Experience deficiencies (which arise when the actual plan costs turn out to be greater than were previously estimated on the basis of the actuarial assumptions—for instance, when the value of the plan assets is less than was expected) are to be funded over a period of 15 years or the average remaining working life of the covered employees whichever is the shorter period. Similarly, experience gains (i.e., gains which are attributable to a favorable variation in actual experience compared to the actuarial assumptions) are to be taken into account over the same period as actuarial deficiencies—that is, over the shorter of 15 years or the average remaining working life of the employees. Also, to minimize the creation of experience gains or experience deficiencies the assets of pension plans are to be valued on the basis of a moving average of 5 or fewer years.

[6] Employers are required to contribute to profit-sharing, stock bonus, and money purchase pension plans any amounts that they have agreed to contribute. However, with this exception, such plans are not required to comply with any specific funding standard.

The Service is given the authority to waive the minimum funding requirement in cases involving financial hardship to the employer, but the waived contribution must be made up in level payments over the next 10 years. To avoid the indefinite postponement of the fulfillment of the funding standards, not more than 5 such waivers may be granted in a 10-year period.

Where the minimum funding standards result in an increase in annual cost of 10 percent or more for collectively bargained multiemployer plans and would cause substantial hardship, the Service can allow already existing past service costs to be funded over a period longer than 30 years (up to 45 years).

Qualified Federal, State, and local pension plans continue to be subject to present funding requirements instead of to the new funding requirements under the bill.

If an employer fails to contribute sufficient amounts to meet the new funding requirements, he will be subject to a nondeductible 5 percent excise tax per year on the amount of the underfunding for any year. If the employer fails to make up the underfunding by 90 days after original notification by the Internal Revenue Service, then unless the Service has granted an extension of time, the employer is subject to a second level excise tax amounting to 100 percent of the underfunding.

In the case of plans adopted after the legislation is adopted, the new funding requirements are effective for plan years beginning after the date of enactment. However, these funding standards do not apply until January 1, 1976, for plans in existence on the date of enactment in order to give such plans time to adjust. Existing plans which have been subject to collective bargaining agreements are not subject to the new standard until the expiration of the collective bargaining agreement or 1981, whichever is sooner.

4. *Portability.*—The Pension Benefit Guaranty Corporation, established to administer the termination insurance program, is also authorized to establish a central portability fund to receive deposits of sums representing an employee's vested rights when he is separated from a firm prior to reaching retirement age. The employee's interest in the portability fund can then either be transferred to his next employer's qualified plan or retained in the portability fund until he retires, when it would either be paid out to him or used to purchase an annuity from an insurance company for him.

The portability fund is authorized to receive transfers of amounts representing the interest of employees under qualified plans where they have terminated their employment with the firm. (However amounts accumulated in H.R. 10 plans by self-employed persons, in corporate plans by proprietary employers, and in individual retirement plans are not eligible for transfer to the portability fund.)

The payments made out of this central portability fund to the employee or his beneficiaries will generally be taxed in the same manner as payments made by qualified plans. However, the bill specifically

[7] provides that the transfer of amounts representing the employee's interest in a pension plan to the central portability fund and transfers from the central portability fund to the plan of a new employer are not to give rise to tax liability.

The transfer of amounts representing vested rights to benefits to or from the central portability fund is entirely voluntary. In order for such transfers to take place, both the employee and the private pension plans concerned with the transfer will have to give their agreement.

Moreover, the bill generally permits the voluntary transfer of sums of money representing an employee's vested rights from one qualified plan to another directly without the use of the central portability fund. The tax laws are amended to make it clear that such voluntary transfers are to be nontaxable, subject to specified conditions designed to prevent abuses.

Finally, to insure that employees will actually receive the plan benefits to which they are entitled when they retire, the Social Security Administration will keep records regarding the vested rights of employees which will be reported by employers at the time that employees terminate their employment. The Social Security Administration will then furnish this information regarding vested rights to individuals both on request and at the same time that official information is supplied regarding social security benefits.

5. *Plan termination insurance.*—A corporation (The Pension Benefit Guaranty Corporation, with the Secretaries of Labor, Commerce, and Treasury as trustees and the Secretary of Treasury as managing trustee) is established to insure employees against the loss of pension benefits resulting from defined benefit plan terminations.

The insurance under the program is limited to the vested benefit provided under the plan, up to 50 percent of the average monthly wage in the highest 5 years but not more than $750 a month. The $750 figure will be adusted upward as the social security wage base is increased. The insurance applies to vested benefits earned prior to as well as on and subsequent to the effective date of the Act.

In the event of plan termination, the assets of the plan must be used to pay the plan liabilities. Employers are generally made liable for 10 percent of the losses due to plan termination (i.e., amounts which the plan cannot pay out of its assets) up to 50 percent of their net worth. However, this liability is subordinated to amounts owed general creditors. In addition, employers are given the option of eliminating employer liability in certain circumstances under the plan termination insurance by paying an increased annual premium tax for the plan. During the first 3 years after the effective date of the provision (January 1, 1975), if there is employer liability, the employer pays an annual premium tax of 50 cents for each participant in the pension plan who is covered by the insurance in order to finance the plan. However, if the employer agrees to pay an annual premium tax of 70 cents per covered employee, employer liability is eliminated except where the employer remains in business after the plan is terminated or when the plan termination involves a merger or reorganization.

[8] The premium taxes will be paid for a minimum of 3 years before any benefits are paid out. This will give the insurance program time to accumulate funds with which to make payments and also to gain experience as to the level and types of premiums that can best fund the insurance program. After the initial 3-year period, the Pension Benefit Guaranty Corporation may recommend different premium tax levels for individual employer and multiemployer plans to reflect the different risk of termination under these two different kinds of plans. Any premium tax changes made must be approved by Congress.

6. *Fiduciary responsibility.*—Fiduciaries are required to discharge their duties solely in the interest of participants and their beneficiaries and in a manner which will not jeopardize the income or assets of the fund. They are also specifically prohibited from engaging in actions where there would be a conflict of interest with the fund, such as representing any other party dealing with the fund. Any fiduciary who breaches any of the responsibilities imposed on him by the committee provision is personally liable to make good to the plan any losses resulting from his failure to comply with the fiduciary standards. To enforce these obligations, the Secretary of Labor or a participant or beneficiary of a plan is authorized to bring a civil action in the courts for appropriate relief to redress or restrain any violation of the fiduciary standards.

In addition, parties in interest and fiduciaries who engage in specified prohibited transactions involving self-dealing are to be subject to a two-level excise tax on the amount involved in the prohibited transaction. The first level tax generally will be 5 percent (per year) of the amount involved; if the transaction is not corrected to make the trust whole, a second level tax of 100 percent will be imposed. (In the case of a fiduciary, the first level tax is 2.5 percent and the second level tax is 50 percent of the amount involved, up to a maximum of $10,000 at each level.) None of these taxes is deductible.

To protect the rights of covered employees, qualified pension plans are prohibited from investing in the securities of the employer after August 21, 1973. However, pension plans are permitted to retain indefinitely employer securities purchased before this date.

The bill generally places no restriction on the purchase of employer securities by profit-sharing and stock bonus plans. However, where the employer securities are not readily tradable on an established securities market, the bill limits the investment in employer securities by profit-sharing plans to 10 percent of their assets.

7. *Enforcement.*—To aid in enforcement, the committee bill provides for the establishment by the Internal Revenue Service of a separate office headed by an Assistant Commissioner of Internal Revenue to deal primarily with employee benefit plans and organizations exempt from tax under section 501(a) of the Internal Revenue Code, including religious, charitable, and educational organizations. In order to fund this new office, the bill authorizes appropriations equal to the sum of (1) a new tax of $1 per participant per year in a qualified plan and (2) one-half of the revenue raised by the present 4 percent excise tax on private foundations.

[9] In addition, to provide additional opportunities for redress in case of disagreement with the decisions of the Internal Revenue Service on pension matters, both employees and employers will be allowed to appeal determination letters issued by the Internal Revenue Service to the Tax Court after exhausting their remedies under the Internal Revenue Service administrative procedures. Employees are also given the right to submit disputes with pension plan administrators to the Labor Department for decision.

8. *Equal tax treatment under qualified plans.*—To provide more equitable tax treatment under qualified plans, the committee has provided the following three changes which should be regarded as one package in the sense that all three changes must be adopted to achieve the desired equity objectives.

A. Any individual (including an employee or a self-employed individual) who is not a participant in a qualified retirement plan or governmental plan may take tax deductions of up to $1,000 a year for amounts of earned income set aside for his own retirement. Alternatively, the employer of any individual who establishes such a personal retirement plan is allowed to make tax deductible contributions to the individual retirement account on behalf of the employee (which will not be currently taxable to the employee) so long as the sum of the employee's own contribution and the employer's contribution do not exceed $1,000. The contributions to the individual retirement plans can be invested in a wide range of investments, including special government savings bonds which would be issued for this purpose, annuity contracts sold by insurance companies, mutual funds, stocks, and savings accounts under custodial arrangements.

B. The maximum deductible contributions a self-employed individual is allowed to make on his own behalf to a qualified plan (H.R. 10 plan) are increased to 15 percent of earned income up to $7,500 a year (or the equivalent in benefit levels, in the case of fixed benefit plans). In addition, the bill limits to no more than $100,000 the portion of a self-employed person's income which may be taken into account for this purpose. This gives assurance that a self-employed individual will provide a set-aside of at least 7.5 percent for his employees if he is to take the maximum deduction of $7,500 for himself.

C. After careful consideration, the committee has concluded that the basic situation of certain proprietary-employees of closely-held corporations is so similar to that of self-employed people that they should generally be treated like self-employed people for pension purposes. The fact that there is no specific limit on the plan contributions for corporate proprietary-employees has led to abuses and charges of discrimination against the self-employed. To remedy this, contributions on behalf of corporate proprietary-employees who (1) own at least 2 percent of the stock and (2) together account for at least 25 percent of the accrued benefits of all employees under the plan are limited to exactly the same deduction limitations as apply to self-employed people—namely, 15 percent of earned income with a maximum annual ceiling of $7,500 (or the equivalent in benefit levels, in the case of fixed benefit plans). As in the case of self-employed people, the

[10] base for computing deductible plan contributions on behalf of such proprietary-employees is limited to the first $100,000 of their earned income.

9. *Lump-sum distributions.*—The committee bill provides a new method of taxing lump-sum distributions from employee plans which is equitable and relatively simpler than the 7-year averaging procedure provided by the 1969 Act. Under the new provision, that portion of the distribution (other than the employees' own contributions) representing pre-1974 value receives capital gains treatment; the balance of this lump-sum distribution is to be taxed as ordinary income under a separate tax schedule (the tax schedule applicable to single people) generally without reductions, exclusions, or consideration of the taxpayer's other income. However, to insure that the tax paid by lower income individuals on their lump-sum distributions will generally not be more than under present law, a special minimum distribution allowance is provided under the separate tax rate schedule. In addition, averaging relief is provided for the portion of the lump-sum distribution which is taxed as ordinary income under the separate tax rate schedule by providing 15-year averaging for such income (i.e., the tax is generally computed on one-fifteenth of such income and the result is then multiplied by 15).

II. REASONS FOR THE BILL

One of the most important matters of public policy facing the nation today is how to assure that individuals who have spent their careers in useful and socially productive work will have adequate incomes to meet their needs when they retire. This legislation—The Comprehensive Private Pension Security Act of 1973—is concerned with improving the effectiveness of qualified retirement plans in their vital role of providing retirement income. In broad outline, the objective is to increase the number of individuals participating in employer-financed plans; to make sure to the greatest extent possible that those who do participate in such plans actually receive benefits and do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the pension plan to accumulate and retain sufficient funds to meet its obligations; and to make the tax laws relating to qualified retirement plans fairer by providing greater equality of treatment under such plans for the different taxpayer groups concerned.

Essentially, the committee bill represents a significant improvement in the tax treatment now applicable with respect to qualified retirement plans. The committee regards the present legislation as part of an evolutionary process which keeps this basic framework but which builds on it new provisions which experience indicates are necessary for the proper functioning of these plans.

A fundamental aspect of present law, which the committee bill continues, is reliance on voluntary action by employers (and employees under contributory plans) for the establishment of qualified retirement plans. The committee bill also continues the approach in

[11] present law of encouraging the establishment of retirement plans which contain socially desirable provisions through the granting of tax inducements. In other words, under the new legislation as under the present law, no one is compelled to establish a retirement plan. However, if a retirement plan is to qualify for the favorable tax treatment, it will be required to comply with specified new requirements which are designed to improve the retirement system. Since the favorable tax treatment is quite substantial, presently involving a revenue loss of over $4 billion a year, it is anticipated that plans will have a strong inducement to comply with the new qualification rules and thereby become more effective in fulfilling their objective of providing retirement income.

The tax advantages associated with qualification under the Internal Revenue Code are substantial. Employers, within certain limits, are permitted to deduct contributions made to such plans on behalf of covered employees, whether or not the interests of covered employees are vested; earnings on the plan's assets are exempt from tax; and covered employees defer payment of tax on employer contributions made on their behalf until they actually receive the benefits, generally after retirement when their incomes and hence applicable tax rates tend to be lower.

THE ENCOURAGEMENT OF NONDISCRIMINATORY PLANS UNDER PRESENT LAW

As already indicated, our tax laws now provide substantial tax incentives for the establishment of nondiscriminatory retirement plans. In order to qualify as nondiscriminatory, a retirement plan must cover a specified percentage of employees [1] or cover employees under a classification found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees. Similarly, either the contributions to the plan or the benefits paid out by the plan must not discriminate in favor of officers, etc.

In adopting this legislation, the Finance Committee is aware of the achievements of the private pension system under the 1942 legislation. The private retirement system has grown rapidly over the past three decades. About 30 million employees were covered by private retirement plans in 1970 compared to 4 million in 1940 and 9.8 million in 1950. (See Table 1.) By 1980, these retirement plans are expected to cover 42 million employees.[2]

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[1] To qualify on this basis, the plan must cover 70 percent or more of all the employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are so eligible, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not ore than 20 hours in any 1 week, and employees whose customary employment is for not more than 5 months in any calendar year (sec. 401(a)(3)(A)).

[2] See Public Policy and Private Pension Programs. A Report to the President on Private Employee Retirement Plans by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, January 1965, p. vi.

TABLE 1.—PRIVATE PENSION AND DEFERRED PROFIT-SHARING PLANS:[1] ESTIMATED COVERAGE, CONTRIBUTIONS, BENEFICIARIES, BENEFIT PAYMENTS, AND RESERVES, 1950, 1955, 1960–70

Year	Coverage[1] end of year (in thousands)			Employer contributions (in millions)			Employee contributions (in millions)			Number of beneficiaries, end of year (in thousands)[2]			Amount of benefit payments (in millions)			Reserves, end of year (in billions)		
	Total	Insured	Non-insured	Total	Insured	Non-insured	Total	Insured	Non-insured	Total	Insured	Non-insured	Total[3]	Insured	Non-insured	Total	Insured	Non-insured
1950	9, 800	2, 600	7, 200	$1, 750	$720	$1, 030	$330	$200	$130	450	150	300	$370	$80	$290	$12. 1	$5. 6	$6. 5
1955	15, 400	3, 800	11, 600	3, 280	1, 100	2, 180	560	280	280	980	290	690	850	180	670	27. 5	11. 3	16. 1
1960	21, 200	4, 900	16, 300	4, 710	1, 190	3, 520	780	300	480	1, 780	540	1, 240	1, 720	390	1, 330	52. 0	18. 8	33. 1
1961	22, 200	5, 100	17, 100	4, 830	1, 180	3, 650	780	290	490	1, 910	570	1, 340	1, 970	450	1, 520	57. 8	20. 2	37. 5
1962	23, 100	5, 200	17, 900	5, 200	1, 240	3, 960	830	310	520	2, 100	630	1, 470	2, 330	510	1, 820	63. 5	21. 6	41. 9
1963	23, 800	5, 400	18, 400	5, 560	1, 390	4, 170	860	300	560	2, 280	690	1, 590	2, 590	570	2, 020	69. 9	23. 3	46. 6
1964	24, 600	6, 000	18, 600	6, 370	1, 520	4, 850	910	310	600	2, 490	740	1, 750	2, 990	640	2, 350	77. 7	25. 2	52. 4
1965	25, 300	6, 200	19, 100	7, 370	1, 770	5, 600	990	320	670	2, 750	790	1, 960	3, 520	720	2, 800	86. 5	27. 3	59. 2
1966	26, 300	6, 900	19, 400	8, 210	1, 850	6, 360	1, 040	330	710	3, 110	870	2, 240	4, 190	810	3, 380	95. 5	29. 3	66. 2
1967	27, 500	7, 700	19, 800	9, 050	2, 010	7, 040	1, 130	340	790	3, 410	930	2, 480	4, 790	910	3, 880	106. 2	31. 9	74. 2
1968	28, 000	7, 900	20, 100	9, 940	2, 240	7, 700	1, 230	340	890	3, 770	1, 010	2, 760	5, 530	1, 030	4, 500	117. 8	34. 8	83. 1
1969	29, 000	8, 700	20, 300	11, 420	3, 030	8, 490	1, 360	350	1, 010	4, 180	1, 070	3, 110	6, 450	1, 160	5, 290	127. 8	37. 2	90. 6
1970	29, 700	9, 300	20, 400	12, 580	2, 860	9, 720	1, 420	350	1, 070	4, 720	1, 220	3, 500	7, 360	1, 330	6, 030	137. 1	40. 1	97. 0

[1] Includes pay-as-you-go, multi-employer, and union-administered plans, those of nonprofit organizations, and railroad plans supplementing the Federal railroad retirement program. Excludes pension plans for Federal, State, and local government employees as well as pension plans for the self-employed. Insured plans are underwritten by insurance companies; noninsured plans are, in general, funded through trustees.

[2] Excludes annuitants; employees under both insured and noninsured plans are included only once—under the insured plans.

[3] Includes refunds to employees and their survivors and lump-sums paid under deferred profit-sharing plans.

Source: Compiled by the Office of the Actuary, Social Security Administration, from data furnished primarily by the Institute of Life Insurance and the Securities and Exchange Commission.

[13] The growth which has occurred is also evidenced in other ways. Between 1950 and 1970, total annual contributions made to retirement plans by employees and employers rose from about $2.1 billion to about $14 billion. In 1950, 450,000 beneficiaries received $370 million from retirement plans; in 1970, 4.7 million beneficiaries received $7.4 billion in pension payments. Moreover, retirement plan assets soared from $12.1 billion in 1940 to $150 billion in 1972 (book value) and are expected to reach $225 billion by 1980.[4]

PROBLEM AREAS

Despite the substantial achievements of retirement plans, it has become apparent that a number of problems have arisen which prevent many of these plans from achieving their full potential as a source for retirement income. These problem areas are outlined below.

Inadequate coverage.—Despite the rapid growth in retirement plan coverage in recent years to its 1970 level of about 30 million employees, one-half of all employees in private, nonagricultural employment are still not covered by retirement plans. Retirement plans are still relatively rare among small business firms and in agriculture. Moreover, even where employees work for a firm with a retirement plan, the age and service requirements for participation in the plan may be overly restrictive, excluding many employees.

Discrimination against the self-employed and employees not covered by retirement plans.—Another problem area is that present law discriminates against employees not covered by retirement plans and against the self-employed. This is primarily because the personal retirement savings of individuals not covered by pension plans must be made out of after-tax income, while those covered by retirement plans are permitted to defer tax on their employer's retirement contributions. In addition, the earnings on the retirement savings of noncovered persons are subject to tax as earned, while the tax on earnings of pension funds is deferred until paid out as a retirement benefit.

Self-employed people also frequently maintain that they are discriminated against as compared with corporate executives and owner-managers of corporations in regard to the tax treatment of retirement savings. At present, there is no comprehensive limit on the amounts the employer can contribute on behalf of corporate executives and owner-managers of corporations; similarly, there is no statutory limit on the amount of pension benefits that the latter can receive—so long as those contributions or benefits do not discriminate in favor of employees who are shareholders, officers, supervisors, or highly paid and do not constitute unreasonable compensation. As a result of legislation enacted in 1962 and amended in subsequent years, self-employed people can establish retirement plans for themselves and their employees but their deductible contributions to such plans on their own behalf are limited to 10 percent of earned income up to $2,500 a year.

Some self-employed people, including professional people, have been successful in securing the tax advantages associated with corporate

[4] Table 1 and Securities and Exchange Commission, Private Noninsured Pension Funds, 1972 (Preliminary).

[14] retirement plans by forming professional corporations. In many cases these are one-man corporations. Although the Service for a long time refused to recognize the validity of such corporations for Federal tax purposes, the courts sided with the taxpayers, and the Internal Revenue Service has agreed to generally recognize such corporations.[5]

Inadequate vesting.—Present law generally does not require a retirement plan to give a covered employee vested rights to benefits—that is, the right to receive benefits even if he leaves or loses his job before retirement age.[6] Over two-thirds of the private retirement plans provide vested rights to retirement benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have accumulated a fairly long period of service with the firm and/or are relatively mature.

At present, only one of every three employees participating in employer-financed plans has a 50 percent or greater vested right to his accrued retirement benefits. Moreover, 58 percent of covered employees between the ages of fifty and sixty and 54 percent of covered employees 60 years of age and over do not have a qualified vested right to even 50 percent of their accrued retirement benefits.[7] As a result, even employees with substantial periods of service may lose retirement benefits on separation from employment. Extreme cases have been noted in which employees have lost retirement rights at advanced ages as a result of being discharged shortly before they would be eligible to retire. In addition, failure to vest more rapidly is charged with interfering with the mobility of labor, to the detriment of the economy.

Inadequate funding.—Another problem area is that a significant portion of present pension plans are not adequately funded—that is they are not accumulating sufficient assets to pay benefits in the future to covered employees. As a result, there is concern that many employees now covered by pension plans may not actually receive pensions when they retire because the funds will not be available to pay for those pensions.

In general, pension plans that are qualified under the Internal Revenue Code must meet certain minimum funding requirements by

[5] However, the 1969 Tax Reform Act made contributions on behalf of shareholder-employees who own more than 5 percent of an electing small business (subchapter S) corporation's stock subject to the same 10 percent-$2,500 limitations as apply to retirement contribution deductions on behalf of self-employed people.

[6] However, as noted below, vesting is required for employees under so-called H.R. 10 plans for owner-employees and may also be required in other cases to prevent the plan from having a discriminatory effect in operation, or upon plan termination or complete discontinuance of contributions.

[7] U.S. Treasury Department—Fact Sheet. Pension Reform Program, as reprinted in Material Relating to Administration Proposal Entitled the "Retirement Benefits Tax Act", Committee on Ways and Means, 93d Cong., 1st sess., p. 37, Table B.

[15] irrevocably setting aside funds in a trust or through the purchase of insurance contracts. Contributions to such plans must generally be at least large enough to pay the normal pension costs plus the interest on unfunded accrued liabilities which generally are attributable to the past service of the covered employees. However, this minimum funding requirement is not adequate because it is designed only to prevent the unfunded liabilities from growing larger and does not require any payment to reduce the amount of the outstanding unfunded liabilities, which may be substantial.

The available evidence suggests that many pension plans are adequately funded—but that a significant proportion of the plans have not been adequately funded. This is indicated, for example, by a survey made by the Senate Labor Subcommittee of 469 trustee-administered pension plans covering 7.1 million employees. In 1970, about one-third of the plans in the study covering one-third of the participants reported a ratio of assets to total accrued liabilities of 50 percent or less; while 7 percent of the plans covering 8 percent of the participants reported a ratio of assets to accrued liabilities of 25 percent or less. (See Table 2.)

In general, the older plans are better funded than the newer ones. Over one-half of the plans covered by the study which were 6 years old or less had an assets-liabilities ratio of 50 percent or less, while 35 percent of the plans in existence for 17 years to 21 years had such an assets-liabilities ratio. (See Table 3.)

TABLE 2.—FUNDING OF PRIVATE PENSION PLANS: ASSETS AT MARKET VALUE, AS PERCENT OF PRESENT VALUE[1] OF TOTAL ACCRUED RETIREMENT BENEFITS, BY PLAN AND BY PARTICIPANT: AS OF 1970

	By plan		By participant	
	Number [2]	Percent	Number	Percent
Assets as percent of accrued benefits:				
25 percent or less	33	7	541, 801	8
26 through 50	118	25	1, 798, 945	25
51 through 75	104	22	2, 134, 601	30
76 through 100	117	25	1, 211, 298	17
101 through 125	55	12	949, 975	13
126 through 150	20	4	134, 252	2
151 through 175	8	2	52, 498	1
Over 175	14	3	276, 835	4
Total	469	100	7, 100, 205	100

[1] Present value of accrued benefits is actuarially determined.
[2] Sample consists of 469 trustee-administered plans. Comparable data were not available for insured plans.

Note: The sum of individual items may not equal totals because of rounding.

Source: Senate Committee on Labor and Public Welfare Report on S. 3598, The Retirement Income Security for Employees Act of 1972, 92d Cong., 2d sess., p. 97.

TABLE 3.—FUNDING OF PRIVATE PENSION PLANS: ASSETS AT MARKET VALUE AS PERCENT OF PRESENT VALUE[1] OF TOTAL ACCRUED RETIREMENT BENEFITS, BY AGE OF PLAN: AS OF 1970

	Age of plans[2]													
	6 years or less		7 to 11 years		12 to 16 years		17 to 21 years		22 to 26 years		27 to 31 years		Over 31 years	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Assets as percent of accrued benefits:														
25 percent or less	9	21	7	9	10	8	2	2	4	8	----	----	1	5
26 through 50	13	31	24	30	36	29	34	33	4	8	6	13	1	5
51 through 75	9	21	18	22	31	25	24	23	8	15	9	20	5	24
76 percent and over	11	26	32	39	48	38	43	42	36	69	30	66	14	68
Total	42	100	81	100	25	100	103	100	52	100	45	100	21	100

Present value of accrued benefits is actuarially determined.
[2] Sample consists of 469 trustee-administered plans.

Note: The sum of individual items may not equal totals because of rounding.

Source: Senate Committee on Labor and Public Welfare report on S. 3598. The Retirement Income Security for Employees Act of 1972, 92d Cong., 2d sess., p. 98.

[17] *Loss of pension benefits due to plan terminations.*—Concern has also been expressed over the possible loss of pension benefits as a result of termination of pension plans. The Studebaker case, which has been widely publicized, illustrates how pension benefits can be lost as a result of termination of a plan. When Studebaker closed its South Bend, Indiana, plant in 1964, the employees were separated and the pension plan was terminated. The plan provided fairly generous vested rights and the funding apparently would have been adequate had the firm remained in business and the plan continued in operation. However, at termination, the plan had not yet accumulated sufficient assets to meet all its obligations. As a result, full pension benefits were paid only to employees already retired and to employees age 60 or over with 10 years or more of service. Little or no benefits were paid to large numbers of other employees, many of whom had vested rights.

A joint study of the Treasury Department and the Department of Labor indicates that there were 1,227 plan terminations in 1972.[8] These terminations resulted in the loss of $49 million of benefits (present value) by 19,400 pension participants in 546 of the terminated plans. The average loss of benefits for participants amounted to $2,500. Participants losing benefits represented about eight one-hundredths of one percent of workers covered by pension plans. The data, of course, cover terminations occurring over a relatively short period of time.

Misuse of pension funds and disclosure of pension operations.—There also has been concern about the administration of pension plans. It has been charged that all too frequently pension funds have not been used in the best interest of covered employees. There have been cases of extreme misuse of pension funds.

Also, questions have been raised as to whether a pension plan should be permitted to invest heavily in the employer's securities instead of diversifying investments. Present law permits such investments in the employers' securities, subject to certain restrictions.

The Welfare and Pension Plans Disclosure Act, which is administered by the Labor Department, was adopted in 1958 to protect the interests of welfare and pension plan participants and beneficiaries by requiring disclosure of information regarding such plans. This Act requires the plan administrators to file with the Secretary of Labor and to send to participants upon written request a description and annual report of the plan. The Act was amended in 1962 to make theft, embezzlement, bribery, and kickbacks Federal crimes where these occur in connection with welfare and pension plans. The 1962 amendment also conferred limited investigatory and regulatory powers upon the Secretary of Labor. However, abuses in the administration of pension plans and in the handling of pension funds have continued.

The Internal Revenue Code (sec. 503(b)) seeks to prevent abuses in the use of funds held under qualified retirement plans by prohibiting qualified trusteed plans from engaging in certain specified prohibited transactions such as lending funds without adequate security and a reasonable rate of interest to the creator of the plan, his family, or corporations controlled by him. Other prohibited transactions include

[8] Department of the Treasury and the Department of Labor Study of Pension Plan Terminations, 1972—Final Report, August 1973.

[18] payment of excessive salaries, purchase of property for more than an adequate consideration, sale of property for less than an adequate consideration, or any other transactions which result in a substantial diversion of funds to such individuals. Special additional rules apply to trusts benefiting owner-employees. However, this prohibited transaction provision is not effective because the penalty for noncompliance is the disqualification of the pension plan from tax benefits for a period of time, which is unfavorable to the covered employees who have had no part in any wrongdoing. There is need, therefore, for more effective remedies to prevent misuse of pension funds to the detriment of the interests of participating employees.

OBJECTIVES OF THE MAIN PROVISIONS OF THE BILL

Although there have been significant legislative changes since the present basic framework of the tax laws relating to pensions was first adopted—principally in allowing self-employed people to establish retirement plans for themselves and their employees and in requiring the disclosure of information regarding welfare and pension plans—it has been more than 30 years since these basic pension provisions were first adopted. It is time for new legislation to conform the pension provisions to the present day situation and to provide remedial action for the various problems that have arisen in the retirement plan area during the past three decades.

As indicated above, the present provisions of the Internal Revenue Code provide tax inducements for the adoption of nondiscriminatory plans and to a limited extent other objectives. These nondiscrimination provisions are retained, but the new legislation also requires retirement plans to conform to additional requirements in order to qualify for the favorable tax treatment under the Internal Revenue Code. In taking this action, the committee has been mindful of the need to construct the new requirements so that they will provide meaningful improvement in the various problem areas noted under the present law. At the same time, the committee is aware that under our voluntary pension system, the cost of financing pension plans is an important factor in determining whether any particular retirement plan will be adopted and in determining the benefit levels if a plan is adopted, and that unduly large increases in costs could impede the growth and improvement of the private retirement system. For this reason, in the case of those requirements which add to the cost of financing retirement plans, the committee has sought to adopt provisions which strike a balance between providing meaningful reform and keeping costs within reasonable limits.

Generally, it would appear that the wider or more comprehensive the coverage, vesting, and funding, the more desirable it is from the standpoint of national policy. However, since these plans are voluntary on the part of the employer and both the institution of new pension plans and increases in benefits depend upon employer willingness to participate or expand a plan, it is necessary to take into account additional costs from the standpoint of the employer. If employers respond to more comprehensive coverage, vesting and funding rules by decreasing benefits under existing plans or slowing the rate of for-

[19] mation of new plans, little if anything would be gained from the standpoint of securing broader use of employee pensions and related plans. At the same time, there are advantages in setting minimum standards in these areas both to serve as a guideline for employers in establishing or improving plans and also to prevent the promise of more in the form of pensions or related benefits than eventually is available.

Coverage.—One of the major objectives of the new legislation is to extend coverage under pension plans more widely. For this reason, the committee bill sets limits on the age and service requirements which can be used to exclude employees from participation in pension plans. Under the new rules, a qualified plan cannot require an employee to serve longer than one year or attain an age greater than 30 (whichever occurs later) as a condition of eligibility to participate in the plan. Thus, an employee who reaches age 30 and has at least a year of service would be eligible to participate. The Committee believes that this rule is a reasonable one. It provides a balance between the need to grant employees the right to participate in pension plans at a relatively early age so that they can begin to acquire pension rights and at the same time avoids the administrative drawbacks that would be involved in granting coverage to transient short-term employees whose pension benefits would in any event be small. The participation rule also prevents potential avoidance of the vesting rule in the committee bill.

Vesting.—Coverage under a pension plan does not aid an individual if he later forfeits his right to his pension benefits upon voluntary or involuntary termination of employment. This is an important consideration in view of the fact that ours is a fairly mobile economy where employees tend to change jobs rather frequently, especially in their younger years. Moreover, the cyclical and technological nature of certain industries results in frequent layoffs over a work career for employees in those industries, as in aerospace and defense. The committee bill deals with this problem by requiring qualified pension plans to grant covered employees minimum vested rights to their pensions after serving a specified number of years.

In considering a minimum vesting provision, it is especially important to balance the protection offered by the provision against the additional cost involved in financing the plan. Employees, of course, would be accorded the maximum protection in this regard if they were granted immediate and full vested rights to employer contributions. However, it is generally recognized that such a requirement for immediate and full vesting would not be feasible because it would involve such substantial additional costs for the financing of pension plans that it would tend to impede the adoption of new plans and the liberalization of existing ones.

After careful consideration, the committee came to the conclusion that any adequate and feasible minimum vesting provision should be gradual—that is, the employee should be given a vested right to a specified percentage of his accrued pension benefits after serving for a specified period of time. This required vesting percentage should then be increased gradually as the period of service increases until all pension benefits would be 100 percent vested. Such gradual vesting

[20] avoids the abrupt increase in pension plan costs that would generally be involved in a requirement for full and immediate vesting and brings down the cost of the vesting requirement to manageable levels. In addition, gradual vesting over a number of years is less likely to have a detrimental effect on the continued employment of the individual concerned than a requirement to grant full vesting at one point in time—say, after the completion of a specified period of covered service. The committee is, of course, aware that most employers would not discharge employees merely to avoid the expense involved in granting them vested rights, particularly since this additional expense is generally relatively small in relation to payroll. Nonetheless, the committee believes that it would be undesirable to adopt a vesting provision that would have this effect even on the small minority of employers who would be disposed to discharge employees because of pension cost considerations. Graduated vesting, while on the one hand providing more mobility to employees, on the other hand provides an incentive to stay to earn more vested benefits. This affords the employer the opportunity to retain experienced workers.

The committee also came to the conclusion that the minimum vesting requirement should be "age neutral"—that is, the vesting requirement should apply equally to all pension plan participants regardless of their age. Specifically, the committee does not believe that it would be wise to grant older people vested rights to their accrued pension benefits more quickly than younger people. Such age-related vesting requirements generally have the socially desirable objective of according vested rights to mature employees who are most in need of the protection offered by the vesting. However, there is serious question whether such proposals would actually be in the best interest of mature workers. For one thing, the committee believes that such age-related minimum vesting requirements would hamper older workers in their search for new employment because it would involve higher pension costs for them as compared with younger employees. At present, older employees face sufficient obstacles in seeking new employment without adding still another.

Moreover, there would appear to be persuasive grounds to start to provide employees with vested pension rights at relatively early ages. This helps them to accumulate adequate pensions over their entire working careers and tends to spread the cost of providing such pensions more equitably over the various employers for whom they have worked during these careers instead of concentrating these costs on the firms that employ them in their mature years.

In view of the considerations outlined above, the committee adopted a provision which requires qualified plans to provide an employee with vested rights to 100 percent of his accrued benefits from employee contributions and at least 25 percent of his accrued benefits from employer contributions after 5 years of service plus 5 percentage points for each of the next 5 years, and by 10 percentage points for each of the next following 5 years. As a result, at least 50 percent vesting is required after 10 years of participation, and 100 percent vesting in the employer-provided benefit after 15 years of participation. In addition, an individual who becomes a participant in a pension plan is permitted to count up to 5 pre-participation years of service for purposes of determining his vesting percentage.

[21] The committee further decided to apply the minimum vesting requirements to benefits accrued prior to the effective date of the provision, as well as to benefits accrued after this date, on the ground that employees merit equal protection with regard to their pension benefits regardless of when these benefits accrued.

It is anticipated that the minimum vesting provision in the committee bill will result in a substantial increase in the number of employees with vested rights. According to estimates furnished to the committee, about 83 percent of the employees covered by plans will have at least a 25 percent vested right to their accrued benefits under the vesting provision, even if the plans merely comply with the minimum vesting requirement, while 55 percent of all covered employees will have at least a 50 percent vested right to their accrued benefits. Under present law, only about 28 percent of all covered employees have vested rights to their benefits.[9]

TABLE 4.—ESTIMATED RANGE OF INCREASE IN PENSION PLAN COSTS UNDER REQUIREMENT FOR MINIMUM VESTING ADOPTED BY THE COMMITTEE

	Present vesting: None	Present vesting: Moderate [1]	Present vesting: Liberal [2]	All plans
Percentage of pension plan members covered under such plans	23	56	21	100
Range of present plan cost as a percent of payroll	1.8–11.2	2.2–12.5	2.2–12.7	1.8–12.7
Range of increase in cost under committee vesting requirement:				
As a percent of payroll	.2–1.5	.1–.2	0–.1	0–1.5
As a percent of present plan cost	5–58	1–8	0–3	0–58

[1] Plan provides some vesting, but less liberal than full vesting after 10 years of service.
[2] Plan provides full vesting after 10 years service or less, with no age requirement.

Source: "Summary of Report, Study of the Cost of Mandatory Vesting Provisions Prepared for the Joint Committee on Internal Revenue Taxation," by Donald S. Grubbs, Jr., July 30, 1973.

Table 4 shows the additional costs of financing pension plans involved in the minimum vesting requirement adopted by the committee is expected to be moderate.

The additional costs will, of course, be zero or smallest for those plans which now have liberal vesting provisions and greatest for those plans which now provide no vesting prior to retirement. This reflects the fact that the committee's minimum vesting provision will generally bring the costs of the latter plans up to the level of those plans which now have liberal vesting provisions. Overall, for all plans, the cost increases resulting from the new minimum vesting requirement will range from 0 to 1.5 percent of payroll.

The committee bill provides ample opportunity to plans to adjust to the new minimum vesting requirement. For plans in existence on the date of enactment of the legislation, the effective date of the minimum vesting standard is deferred to January 1, 1976. However, in the case of plans adopted after enactment of the legislation, which will have been adopted with knowledge of the new requirement, the effective date is the first plan year beginning after the date of enactment. For existing plans which were the subject of collective bargaining, the minimum vesting standard will not apply until the present collective

[9] Estimates supplied by Professor Howard Winklevoss of the Wharton School of Finance, University of Pennsylvania.

[22] bargaining agreement terminates—or until 5 years after the effective date whichever is sooner. Finally, plans which now provide for full 100 percent vesting no later than at the end of 10 years of covered service will be exempt from compliance with the new vesting standard until 1981.

Minimum funding standards.—The committee believes that it is essential for pension plans to be adequately funded in accordance with a contributions schedule which will produce sufficient pension funds to meet the obligations of the plan when they fall due. Such an adequate contributions schedule for funding pension plans not only protects the pension rights of employees but also provides an orderly and systematic way for employers to pay their pension costs.

The committee believes that the minimum funding requirements under present law are inadequate. To remedy this, the committee has provided a new minimum funding requirement for qualified plans. This new funding standard is similar to the present standard in that it requires the contributions to qualified plans to be sufficient to pay normal pension costs (the costs attributable to the current operations of the plan); however, it also requires the contributions to be sufficient to amortize all unfunded past service liabilities in level payments over no more than a 30-year period, instead of merely providing that the contributions be sufficient to prevent an increase in such unfunded liabilities as under present law.

The new funding standard requires amortization of all accrued past service liabilities (i.e., both vested and nonvested unfunded past service liabilities). In making this decision, the committee is aware that proposals have been made to base the minimum funding requirement entirely on presently vested past service liabilities on the ground that such liabilities represent the nonforfeitable rights of the employees. However, the committee decided to use total accrued liabilities as the base for funding past service costs because this approach constitutes the most orderly and comprehensive method of funding past service costs since it makes financial provision not only for vested liabilities but also for accrued liabilities which are expected to be vested and paid in the future.

The level payment method of funding adopted by the committee is analogous to the payment of a home mortgage in that each specified payment includes a payment for both interest and principal. It has the advantage of spreading the payments out evenly over the payment period which generally makes it easier for the employer to plan for meeting the payments. Another factor in the committee's decision is that the level payment method, while providing for adequate amortization of past service costs, initially adds only relatively moderate amounts to an employer's existing funding costs. This is because interest on unfunded accrued past service costs, which accounts for the bulk of the payments under the level payment method in the early years, is already required to be contributed to a defined benefit plan under present law.

In addition, the committee bill allows plans to amortize past service costs arising as a result of plan amendments in the same way as past service costs under new plans—namely, in level premiums over no more than a 30-year period—if the amendments increase unfunded past service costs by at least 5 percent.

[23] Provision is also made for the equitable funding of experience deficiencies which arise when the actual plan costs turn out to be greater than were previously estimated on the basis of the actuarial assumptions. For example, when the value of the plan assets is less than was expected. In establishing a minimum funding standard for such experience deficiencies, the committee sought to avoid two problems. If it allowed the experience deficiencies to be funded over a very long period of time, an incentive would be provided for the use of actuarial assumptions which understate the costs since any resulting deficiencies could then be made up over a long period of time without penalty. On the other hand, if the experience deficiencies were required to be amortized over too short a period, employers would encounter hardship in meeting the annual payments. This is especially pertinent in view of the fact that most actuarial or experience deficiencies are inadvertent.

The committee's bill seeks to avoid both these problems by allowing experience deficiencies to be funded over a period of 15 years or the average remaining working life of the covered employees, whichever is the shorter period. Symmetrical treatment is provided for experience gains which are attributable to a favorable variation between actual experience and the actuarial assumptions entering into the determination of the employer's cost and contributions.

Moreover, in order to minimize the creation of experience gains or experience deficiencies because of sharp fluctuations in the value of plan assets, such as stock, the committee provided that the assets of pension plans should be valued on the basis of a moving average over 5 or fewer years.

The committee is aware that the actuarial assumptions made by actuaries in estimating future pension costs are crucial to the application of minimum funding standards for pension plans. This is because in estimating such pension costs, actuaries must necessarily make actuarial assumptions about a number of future events, such as the rate of return on investments (interest), employee future earnings, and employee mortality and turnover. In addition, actuaries must also choose from a number of funding methods to calculate future plan liabilities. As a result, the amounts required to fund any given pension plan can vary significantly according to the mix of these actuarial assumptions and methods.

Conceivably an attempt might be made to secure uniform application of the minimum funding standards by authorizing the Secretary of the Treasury or some other authority to establish the specific actuarial assumptions and methods that could be used by pension plans. This would involve, for example, setting a specific rate of interest that could be used by certain pension plans or by specifying certain turnover rates for specified types of firms. However, the committee does not believe that this would be an appropriate procedure, since the proper actuarial assumptions may differ substantially between industries, among firms, geographically, and over time. Further, in estimating plan costs each actuarial assumption may be reasonable over a significant range and it would appear that the proper test would be whether all actuarial assumptions used together are reasonable. These considerations strongly indicate that any attempt to specify actuarial

[24] assumptions and funding methods for pension plans would in effect place these plans in a straitjacket so far as estimating costs is concerned, and would be likely to result in cost estimates that are not reasonable.

However, the committee bill requires the actuarial assumptions of each plan to be certified by an actuary every three years (or more frequently if required by the Internal Revenue Service). These certifications will be reported to the Service. Moreover, in order to insure that such certification will be made by competent actuaries, the bill provides that the Secretary of the Treasury is to establish qualifications for actuaries and is to certify for practice before the Internal Revenue Service the persons who meet these standards. For purposes of such certification, examination may not be needed for individuals who have demonstrated sufficient pension experience or satisfactory performance in a rigorous examination system maintained by professional societies. The Secretary of the Treasury is also to review the actuarial assumptions used by particular plans and an advisory board of actuaries is to be established to assist him in setting up general standards as to reasonableness of assumptions.

Profit-sharing and money purchase plans do not specify that the participants are to receive any designated amount of benefits but rather provide whatever benefits the funds in the plan will purchase at the date such benefits are to begin. For this reason, the committee bill does not impose on such plans any requirement that contributions be sufficient to fund a specified level of benefits. However, the bill requires employer contributions to qualified money purchase pension plans and profit-sharing plans to conform to the provisions of the plan. In other words, the employer is required to contribute to such plans any amounts that he has agreed to contribute.

The committee bill also provides new and more effective penalties where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employees' rights, to the extent funded, under plans which do not meet these standards. This procedure, however, has proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the committee bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs—namely, the employer.

This is achieved by imposing an excise tax where the employer fails to meet the funding standards, which starts out at a relatively modest level and increases sharply where there is continued failure to make the indicated contributions. More specifically, if an employer fails to contribute sufficient amounts to meet the new funding requirements, he will be subject to a nondeductible excise tax of 5 percent per year on the amount of the underfunding for any year. If the employer fails to make up the underfunding by 90 days after original notification by the Internal Revenue Service (but with the Service in a position to grant extensions of time), then the employer is subject to a second level excise tax amounting to 100 percent of the underfunding. This determination by the Service is appealable to the Tax Court and no assessment may be made until after the end of the litigation. Since the employer remains liable for the contribu-

[25] tions necessary to meet the funding standards even after the payment of the excise taxes, it is anticipated that few, if any, employers will willfully violate these standards.

The new funding standards do not apply to existing plans until January 1, 1976, in order to give such plans the opportunity to adjust to these standards. For plans established after the date of enactment, the standards become effective in plan years beginning after the date of enactment.

In addition, relief measures are provided to mitigate the impact of the funding requirement in cases where it would otherwise result in hardship. The bill gives the Secretary of the Treasury the authority to waive the minimum funding requirement in cases involving financial hardship to the employer, but the waived contribution must be made up in level payments over a maximum of 10 years. To avoid the indefinite postponement of the fulfillment of the funding standards, however, the committee bill further provides that not more than 5 such waivers may be made in a 10-year period.

The committee also recognizes that multi-employer plans which are negotiated as a result of collective bargaining agreements may involve different considerations in regard to funding than individual employer plans. While it is the objective of the committee's bill to require adequate funding for multi-employer plans as well as for individual employer plans, the committee is aware that a number of multiemployer plans are not as well funded as they might be at the present time and that the application of the new funding standards to such plans without an adequate transition period might cause hardship and be detrimental to the interests of the employees covered by such plans.

For this reason, the committee bill provides that where the new minimum standards result in an increase in annual cost of 10 percent or more for multi-employer plans, and funding past service costs over 30 years would cause substantial hardship, the Service can allow past service costs existing on the effective date of the legislation to be funded over a period longer than 30 years (up to 45 years). This relief provision does not apply to past service costs created after the effective date of the legislation. This is because the committee believes that it is entirely appropriate to apply the new funding standards to cases in the future where past service liabilities are created with the knowledge that the law requires past service costs to be funded over a 30-year period. In other words, while the committee is desirous of granting relief for situations which arose in the past where hardship was created, it believes firmly that sound funding practices should be encouraged and required in the future.

Plan termination insurance.—It is anticipated that the new minimum vesting and funding requirements adopted by this legislation will make pension plans more effective in achieving their objective of providing retirement income and will increase the aggregate benefits paid out by such plans to retired employees. But these provisions are not sufficient in themselves to provide complete assurance that employees will actually receive their promised benefits. This is because the termination of a pension plan which grants vested rights and which is being funded regularly on what appears to be an adequate funding schedule for a going concern can result in the loss of sub-

[26] stantial benefits by plan participants if the termination occurs before full funding is achieved. In fact, what probably has been the most publicized loss of benefits as a result of plan termination—namely, the loss of benefits resulting when Studebaker closed its Indiana plant—illustrates how termination of a plan can result in a substantial loss of vested benefits even when a plan is being funded on what appears to be an adequate schedule.

The committee bill, therefore, establishes a plan for insuring employees against the loss of benefits resulting from plan termination. This is achieved by establishing a corporation (Pension Benefit Guaranty Corporation) with the Secretaries of Labor, Treasury and Commerce as directors to insure such benefits. Qualified pension plans which provide defined benefits (i.e., which state that the participant is to receive a determinable amount of pension) are required to participate in the insurance arrangement. Such termination insurance does not apply to employees under money purchase, stock bonus, or profitsharing plans since in view of the fact that such plans do not provide specific previously determined benefits, there is no defined benefit to insure.

The program adopted by the committee is designed to insure significant amounts of pension benefits, and yet at the same time to exclude large benefits. Specifically, the insurance will be limited to the vested benefit provided under the plan up to 50 percent of the average monthly wage in the highest 5-year period but not more than $750 a month (with the latter limit adjusted upward as the social security wage base is increased). The insurance will apply to vested benefits earned prior to as well as subsequent to the effective date of the Act.

The termination insurance program is intended to work hand-in-hand with the minimum funding standards imposed by the bill, since the latter will limit the losses due to plan termination by requiring more adequate funding of pension plans. In addition, the employer is made liable for 10 percent of the losses due to plan termination up to 50 percent of his net worth. It is anticipated that such employer liability will contribute to responsibility in the funding of plan liabilities and in the establishment of benefit levels.

However, the employer is given the option of eliminating employer liability in certain circumstances under the termination insurance program. Where employer liability is eliminated, the employer pays an increased annual premium type tax. Thus, where the employer liability applies, the employer pays an annual premium tax of 50 cents for each participant in the pension plan who is covered by the insurance. However, if the employer elects to eliminate employer liability except where the plan termination involves a merger or where the employer remains in business he pays a 70 cent per participant premium tax. The bill provides special rules for employers who chose to change liability options. The latter exceptions are designed to prevent an employer from shifting his pension plan obligations to the termination insurance program through such actions. A tax, rather than a charge which would require expensive collection procedures, was believed to be desirable for this purpose.

In order to give adequate time to prepare for the new insurance program, it is made effective for plan years beginning on or after January 1, 1975. However, plan employees will generally not be eligible for

[27] insurance benefits until the plans in which they are participants have been covered by the insurance program for 3 years. In addition, for insurance benefits to be payable, the plan must have been covered by the insurance program 5 years where the employer has elected the option of paying the higher 70 cents premium tax in order to avoid employer liability. This means that premium taxes will be paid for a minimum of 3 years before any benefits are paid out. Under the bill funds automatically are authorized for the insurance program equal to the taxes collected. This will give the insurance program time to accumulate funds with which to make payments. After that time the rate of tax can be changed by the Federal corporation as experience shows more or less funds are needed for the insurance program. It is anticipated that because of their different characteristics, multi-employer plans and plans established by individual employers will ultimately pay different premium taxes for their insurance program. Any changes made in these premium taxes by the corporation will become effective only if approved by a concurrent resolution of the Congress (originating in the House).

Equalizing tax treatment; in general.—Another objective of the committee bill is to provide more rational and equitable tax treatment under retirement plans.

The committee believes that there is need on equity grounds to grant individuals who are not covered by any kind of qualified pension plan some of the tax advantages associated with such plans by providing them with a limited tax deduction for their retirement savings.

In addition, there is no justification for the present widely disparate treatment which places no specific limitation on the amount of deductible retirement plan contributions for corporate proprietary-employees and at the same time limits the deductible contributions to pension plans on behalf of the self-employed to a maximum of 10 percent of earned income or $2,500 a year.

This unjustifiable difference in treatment has resulted in unduly large tax advantages for certain proprietor-employees of closely held corporations; it also discriminates against the self-employed and has had the undesirable result of encouraging large numbers of self-employed people to incorporate merely to secure the larger tax advantages available with respect to corporate retirement plans. This includes large numbers of professional people who are now permitted by all 50 States and the District of Columbia to incorporate. For example, in just the four-year period 1968 to 1971, the number of corporate tax returns filed by physicians and surgeons increased from about 1,600 to 20,000 while the number of such tax returns filed by legal service firms rose from 158 to over 3,000. Moreover, there is evidence that in the State of California more than 70 percent of the professional corporations are one-man organizations.

In view of these considerations, the committee has provided the following three changes which should be regarded as one package in the sense that the adoption of all three changes are needed at the same time in order to improve the tax laws in regard to pension plans.

Equalizing tax treatment; individual retirement plans.—Any individual who is not an active participant in a qualified retirement plan will be permitted under the bill to make tax deductible contributions

[28] of up to $1,000 a year of earned income toward his own qualified retirement plan. Both employees not covered by qualified employer-financed plans and self-employed individuals who have not established qualified retirement plans (H.R. 10 plans) will be eligible to establish such individual retirement plans. In addition, the employer of any individual who establishes such a personal retirement plan will be allowed to make tax deductible contributions to that individual retirement account on behalf of the employee which will not be currently taxable to the employee so long as the sum of the employee's own contribution and the employer's contribution do not exceed $1,000.

In order to encourage the widespread use of such individual retirement plans, the committee has provided that the contributions to such plans can be invested in a wide range of investments, including special government retirement bonds which would be issued for this purpose, annuity contracts sold by insurance companies, mutual funds, corporate securities, and savings institutions.

The committee further anticipates that by encouraging employers to make modest contributions initially for the retirement needs of their employees, such individual retirement plans will lead eventually to the establishment of a significant number of new qualified retirement plans by employers. An employer who believes he cannot afford the entire cost of a retirement plan can start by contributing small amounts for employee individual retirement accounts, can increase his contributions over the years (but still less than $1,000 per participant), and then can subseqently convert to an employer-financed qualified plan.

Equalizing tax treatment; increasing deductions for H.R. 10 plans.—Under the bill the maximum deductible contributions a self-employed individual is allowed to make on his own behalf to a qualified retirement plan (H.R. 10 plan) is increased from 10 percent of earned income up to $2,500 a year, to 15 percent of earned income up to $7,500 a year (or $500 of earned income if greater). The committee believes that such an increase in the allowable deductions for such contributions is justified by the need to make the tax treatment of plans of the self-employed more nearly comparable to that of owner-employees of closely held corporations. The bill also establishes limitations applicable to aggregate funded plans covering such individuals.

In addition, provision is made to insure that self-employed individuals who wish to utilize the full maximum tax allowance for their own contributions will also provide significant pension contributions for their regular employees who are covered by the pension plan. This is achieved by allowing self-employed people to count no more than $100,000 of their earned income in computing pension contributions or benefits for themselves. This prevents a self-employed individual with an extremely large income from achieving the $7,500 maximum annual deduction for his own pension contribution through the use of a low contribution rate which would be detrimental to his employees since the pension contributions on their behalf are computed using the same contribution rate. For example, a self-employed individual who counts his first $100,000 of earned income for this purpose, must contribute to the plan at least 7.5 percent of the wages of his covered employees in order to be permitted a deductible contribution of $7,500 on his own behalf.

[29] *Equalizing tax treatment; proprietary employees of closely held corporations.*—The bill provides that contributions on behalf of proprietary employees under closely held corporate plans are to be subject to the same general limitations as apply to self-employed people. More specifically, contributions on behalf of corporate proprietary employees who (1) own at least 2 percent of the stock and (2) together account for at least 25 percent of the accrued benefits of all employees under the plan are in general limited to 15 percent of earned income with a maximum annual ceiling of $7,500. In the case of fixed benefit plans, percentage limitations on benefits related to salary and years of coverage achieve a result which is similar in effect. In addition, as in the case of self-employed people, the deductible pension contributions or benefits provided for such owner-employees may be provided only with respect to the first $100,000 of their earned income.

The committee concluded that a limit on deductible contributions is essential in order to achieve equality of tax treatment under pension plans for the self-employed and corporate proprietary employees. The present action of the committee, in effect, represents the culmination of the consideration of similar provisions on a number of occasions in recent years. The 1969 Tax Reform Act, for example, provided for taxing certain owner-employees covered by pension plans established by subchapter S corporations (small business corporations) on pension contributions made on their behalf which are in excess of the maximum deductible contributions permitted self-employed people under H.R. 10 plans.

An appropriate limitation on plan contributions on behalf of proprietary employees of closely held corporations is essential not only to equalize the tax treatment of plans of such proprietary employees with those of self-employed people but also in order to prevent high pensions for stockholder employees without significant costs being incurred for nonstockholding employees. Since in many instances, the firms in which such proprietary employees work have few regular employees, the requirement to finance nondiscriminatory benefits for the regular employees under qualified plans does not involve sufficient costs to limit the pension of the proprietary employees. However, as the contributions and benefits for regular employees become more substantial, the costs that they involve under nondiscriminatory plans tends to place a very real practical limitation on the size of the contribution or benefit that can be provided for the owners or managers. This is the reason why the committee provision specifically confines the limitation on deductible contributions on behalf of the proprietary employee to cases where such employees each own 2 percent of the stock and together account for 25 percent of the total accrued benefits under the plan.

Moreover, it can hardly be argued that the application of the $7,500 annual contribution limits to the proprietary employees who would be affected by this limitation would cause hardship. A $7,500 contribution limit permits the accumulation of substantial retirement funds and adequate retirement annuities. For example, annual contributions of $7,500 over a period of 25 years will result in the accumulation of $411,484, assuming a 6 percent interest rate. This amount would be sufficient to provide an annual straight life annuity beginning at the age of 65, amounting to $37,132. Even larger annuities could, of

[30] course, be financed where the $7,500 annual contributions are made for a greater number of years or the interest earnings are higher than in the above example.

Portability.—Ours is a highly mobile economy and employees frequently transfer from one job to another, particularly in their early years. As a result, employees frequently acquire vested rights to pensions under a number of different retirement plans established by previous employers. In view of the fact that some of the retirement rights will generally have been acquired many years before the employee retires, he may forget to claim all his retirement benefits. In addition, in such cases, the plans involved may not be able to locate the employee to pay him his retirement benefit. Moreover, although this is not a matter of major concern, it probably is preferable from the standpoint of the employee to receive his retirement benefits in one check rather than in a number of separate payments from different plans.

The committee has adopted provisions to ameliorate these problems. The Pension Benefit Guaranty Corporation which is established to administer the termination insurance program established by the bill is also authorized to establish a central portability fund to receive deposits of sums representing the present value of an employee's vested rights when he is separated from the firm prior to reaching retirement age. The employee's interest in the portability fund could then either be transferred to his next employer's retirement fund or retained in the portability fund until he retires when it would either be paid out to him or used to purchase an annuity from an insurance company for him.

The payments made out of this central portability fund to the employee or his beneficiaries will be taxed in the same manner as payments made to such individuals by qualified retirement plans (except that no special tax treatment will be available for lump sum distributions). However, the committee has specifically provided that the transfer of amounts representing the employee's interest in a retirement plan to the central portability fund as well as transfers from the central portability fund to the plan of a new employer are not to give rise to tax liability. The former provision is essential since, under present law, such transfers would probably be taxable, making the central portability fund unworkable.

The transfer of amounts representing vested rights to pensions to, or from the central portabality fund will be entirely voluntary. Former employers can, if they choose, make termination payments directly to the fund, or to the employee, who then can, within a limited period of time, transfer the payments to the fund. It also will be up to the employee and the new employer whether the amounts involved are left in the central portability fund or transferred to the retirement plan of the new employer.

After careful consideration, the committee decided to make the use of the central portability fund optional rather than mandatory because it believes that a clearinghouse system of this kind would not be workable on a mandatory basis. For example, it often would be difficult to place a specific value on the vested rights of an employee in a fixed benefit pension plan in view of the fact that the formulas

[31] under which benefits are computed, as well as the actuarial assumptions used, vary widely. Also, the compulsory transfer of funds representing an employee's vested rights from an employer's pension plan to the central portability fund would raise further difficulties where the pension plan is not fully funded since the transfer of funds under such circumstances might be considered detrimental to the remaining covered employees in the pension plan.

In order to encourage the development of portability arrangements, it is expected that the corporation administering the central portability fund provided in the legislation will provide assistance to employer-employee organizations, trustees and administrators of pension plans in such matters as the development of reciprocity arrangements between plans in the same industry or area and the development of special arrangements for portability of credits within a particular industry or area.

The committee has also made it possible for the voluntary transfer of sums of money representing an employee's vested rights from one pension plan to another directly without the use of the central portability fund. Also permitted under certain circumstances are transfers from a qualified pension, etc., plan to an individual retirement account, a new retirement savings provision added by the bill which is explained below. In both of these cases the tax laws are amended to make it clear that such voluntary transfers are to be nontaxable, subject to specified conditions designed to prevent abuses.

Finally, in order to insure that employees will actually receive the pension benefits to which they are entitled when they retire, the Social Security Administration will keep records regarding the vested rights of employees which will be sent in to the Social Security Administration by employers at the time that employees terminate their employment. The Social Security Administration will then furnish this information regarding vested employee rights to individuals both on request and at the same time that official information is supplied to the employee or his beneficiary regarding social security benefits.

Fiduciary responsibility.—Employees have a right to expect that trustees and administrators will handle the funds of employee benefit plans properly for the purposes for which they are intended and will not neglect their duties in this regard or divert the funds to improper uses. Unfortunately, instances have arisen in which pension funds have been used improperly by plan managers and fiduciaries. The committee believes that this situation should not be permitted to continue and has adopted measures designed to reduce substantially the potentialities for abuse in this regard.

The committee bill establishes fiduciary standards for trustees and other parties in interest of private employee benefit plans. It also prohibits individuals who have been convicted or imprisoned for certain specified serious crimes from serving as an administrator or employee of employee-benefit plans for a period of 5 years after conviction. Penalties, including fines of up to $10,000 or imprisonment for up to one year, are provided for willful violations of this prohibition.

Fiduciaries are required to discharge their duties solely in the interest of participants and their beneficiaries and in a manner which will not jeopardize the income or assets of the fund. They are also spe-

[32] cifically prohibited from engaging in actions where there would be a conflict of interest with the fund, such as representing any other party dealing with the fund. Any fiduciary who breaches any of the responsibilities imposed on him by the committee provision is personally liable to make good to the pension fund any losses resulting from his failure to comply with the fiduciary standards. To enforce these obligations, the Secretary of Labor or a participant or beneficiary of a plan is authorized to bring a civil action in the courts for appropriate relief to redress or restrain any violation of the fiduciary standards.

The committee bill also completely changes the method of enforcing the prohibited transaction rules governing plans qualified under the tax laws. For violating the prohibited transaction rules the bill imposes an excise tax on the fiduciaries and parties in interest who have engaged in the prohibited transaction. This is in contrast to the present situation, where the trust loses its tax exemption upon engaging in a prohibited transaction, thereby imposing a sanction on the employer but also imposing one on the employees as well. In addition, the committee bill establishes new rules that define the transactions that are prohibited, substantially strengthening these rules.

Under the bill, parties in interest and fiduciaries who engage in prohibited transactions will be subject to a two-level excise tax on the amount involved in the prohibited transaction. The first level tax generally will be 5 percent of the amount involved; if the transaction is not corrected to make the trust whole, a second level tax of 100 percent will be imposed. These taxes will not be deductible. Since payment of the 100 percent tax would be more expensive than restoring the amount involved to the trust, it can be expected that the trust will be the ultimate beneficiary of these sanctions.

The new rules specifically prohibit a number of transactions between employee trusts and certain specified parties in interest. Currently, transactions are prohibited generally when the dealings involved are on other than an arm's length basis. However, arm's-length standards require substantial enforcement efforts, resulting in sporadic and uncertain effectiveness of these provisions. A similar problem was faced by the Congress in 1969 when it acted with respect to prohibited transactions involving private foundations. At that time the Congress concluded that the arm's-length standards did not preserve the integrity of private foundations and amended the definitions of prohibited transactions to eliminate the problems involved. The committee's bill generally follows the solution that was developed in 1969, establishing definitions for prohibited transactions that will make it more practical to enforce the law. The committee's definitions of prohibited transactions, and the exceptions from these transactions, also take account of the unique situation of employee benefit trusts.

The committee also concluded that it is not in the best interest of covered employees to permit the assets of a pension plan to be invested in the stock or securities of the employer. Even where the employer's stock generally constitutes a high grade investment, the purchase of employer stock by a pension plan adds a substantial risk factor from the standpoint of the employees since in the event the firm's fortunes decline, they may lose not only their jobs but their pension benefits as

[33] well. For this reason, the committee bill specifically prohibits qualified pension plans from investing in the securities of the employer after August 21, 1973. However, pension plans are not specifically prohibited from retaining indefinitely employer securities purchased before this date in order to avoid hardship and to preclude the possibility that the forced sale of such securities might have a disruptive effect on the market for them.

Since profit-sharing and stock-bonus plans are intended to a large extent to serve as an incentive to employees by allowing them to participate in the profits of the company, the committee bill generally places no restriction on the purchase of employer securities by such plans. However, where the employer securities are not readily tradable on an established securities market (exchanges or over-the-counter markets) the bill limits the investment in employer securities by profit-sharing trusts to 10 percent of their assets. Where the securities involved are not readily marketable, large investments in employer securities would involve considerable risk.

In order to prevent hardship, appropriate transition rules are provided for trusts that have entered into transactions which are not prohibited under present law but would be prohibited under the committee bill.

Enforcement.—The committee bill relies heavily on the tax laws in order to secure compliance with the new requirements that it imposes on pension plans. Plans, for example, are required to comply with the new coverage, vesting, and funding standards in order to qualify for favored tax treatment under the Internal Revenue Code. In addition, excise taxes are imposed for failure to meet the funding standards and in cases where there has been a prohibited transaction. As a result, these substantive pension provisions would be administered by the Internal Revenue Service.

The committee believes that primary reliance on the tax laws represents the best means for enforcing the new improved standards imposed by the bill. Historically, the substantive requirements regarding nondiscrimination which are designed to insure that pension plans will benefit the rank and file of employees have been enforced through the tax laws and administered by the Internal Revenue Service. As a result, the Internal Revenue Service is already required to examine the coverage of the retirement plans and their contributions and benefits as well as funding and vesting practices in order to determine that the plans operate so as to conform to these nondiscrimination requirements. Also, the Internal Revenue Service has administered the fiduciary standards embodied in the prohibited transactions provisions since 1954.

The committee believes that the Internal Revenue Service has generally done an efficient job in administering the pension provisions of the Internal Revenue Code. The very extensive experience that the Service has acquired in its many years of dealing with these related pension matters will undoubtedly be of great assistance to it in administering the new requirements imposed by the committee bill.

However, because the bill increases the administrative job of the Service in this respect, the committee believes that it is desirable to add

[34] to its administrative capability for handling pension matters. For this reason, the committee bill provides for the establishment by the Internal Revenue Service of a separate office headed by an Assistant Commissioner of Internal Revenue to deal primarily with pension plans and other organizations exempt under section 501(a) of the Internal Revenue Code, including religious, charitable, and educational organizations. In order to fund this new office, the bill authorizes appropriations equal to the sum of (1) a tax of $1 per participant per year covered by a qualified retirement plan, and (2) one-half of the revenue raised by the present 4 percent excise tax on private foundations. It is intended that the Internal Revenue Service obtain from all appropriate pension administration sources annual statistical data to indicate the operations of the private retirement system for the purpose of evaluations and public information.

In addition to providing additional opportunities for redress in case of disagreement with the decisions of the Internal Revenue Service on pension matters, both employees and employers will be allowed to appeal determination letters issued by the Internal Revenue Service to the Tax Court after exhausting their remedies under the Internal Revenue Service administrative procedures. Employees are also given the right to submit disputes with pension plan administrators to the Labor Department for decision. It is anticipated that this will provide employees with a ready and efficient procedure to resolve disputes involving such matters as whether a particular employee has qualified as a participant under the pension plan in the light of the particular facts, whether he is entitled to a benefit, and the size of the benefit to which he is entitled under the plan provisions.

Lump-sum distributions under qualified plans.—Prior to the Tax Reform Act of 1969, lump-sum distributions made by qualified pension plans were generally taxed as long-term capital gains. Such capital gains treatment, however, had the disadvantage of allowing employees to receive substantial amounts of deferred compensation in the form of lump-sum pension distributions at more favorable tax rates than other compensation received currently. The 1969 Tax Reform Act sought to ameliorate this problem by providing that any part of such lump-sum distributions which represented employer contributions accrued in plan years beginning after 1969 was to be taxed as ordinary income rather than as capital gains. In addition, the 1969 Act provided a special 7-year averaging procedure for the portion of the lump-sum distribution taxed as ordinary income.

However, while the 1969 provisions were intended to provide more equitable treatment for such lump-sum pension distributions, they have not achieved their purpose. The Treasury has had great difficulty in providing regulations to carry out this provision. Problems have arisen both in determining the amount of the ordinary income element of a distribution and in determining the precise amount of tax imposed on account of the "ordinary income" element. Moreover, in practice the new proposed regulations have proved to be very complex and it is frequently maintained that individuals receiving lump-sum distributions have been unable to compute their taxes and that

[35] accountants and tax lawyers have been refusing to attempt the computations.

The committee believes that this situation cannot be permitted to continue. For this reason, it has provided a new method of taxing such lump-sum pension distributions which is relatively simple and yet at the same time equitable. Under the new provision, that portion of the distribution representing pre-1974 value receives capital gains treatment. The balance of the lump-sum distribution is to be taxed as ordinary income under a separate tax schedule (the tax schedule applicable to single people) generally without reductions, exclusions, or consideration of the taxpayer's other income. However, to insure that the tax paid by lower income individuals on their lump-sum distributions will generally not be more than under present law, a special minimum distribution allowance is provided under the separate tax rate schedule. In addition, averaging relief is provided for the portion of the lump-sum distribution which is taxed as ordinary income under the separate tax rate schedule by providing 15 year averaging for such income. This in effect provides a tax payable at the time of the distribution, but no greater in amount than the taxpayer could expect to pay were the income to be spread over his remaining life expectancy.

III. REVENUE EFFECT

There are several different kinds of revenue effects which can be expected to arise from this bill. These are summarized in table 1. First, three provisions designed to equalize the tax treatment of pensions have an impact on tax deductions. These are the provisions raising the maximum deductible amount that the self-employed can set aside annually for their retirement, making provision for a retirement savings deduction for those not now covered under any retirement provisions, and a provision which limits the tax deduction of a limited number of proprietary-employees of corporations.

Tax revenues are also affected by the modification of the tax treatment of lump-sum distributions.

A third category of revenue effect occurs as a result of the imposition of two new taxes. One of these is the audit fee tax, designed to pay for the cost of the administration of pension plans by the Internal Revenue Service, and the second is the premium tax, to provide necessary revenue for plan termination insurance. However, since both of these taxes are deductible for income tax purposes, the revenue gain which would otherwise occur is decreased to some extent.

Finally, a fourth category of revenue effect from the bill arises not because of any change in tax deductions as such, but rather because amounts are expected to be set aside for vesting and funding. The bill imposes additional requirements in the areas of vesting and funding which must be met if the present favorable treatment for pensions is to continue to be available. It is expected that these new requirements will result in employers making larger contributions to retirement plans, resulting in larger income tax deductions.

[36] *Table 1.—Estimated annual revenue effects of the Comprehensive Private Pension Security Act of 1973 at 1973 levels of income and employment*

	Millions
I. Provisions designed to equalize tax treatment under pension plans:	
Increase in maximum allowable deductible contributions by the self-employed under H.R. 10 plans to 15 percent of earned income up to $7,500 a year [1]	−$175
Allowing individuals not covered by pension plans to deduct up to $1,000 a year for contributions to personal retirement plans (long-run effect) [1]	−270
Applying to certain corporate owner-employees the same limitations on deductible pension contributions that apply to self-employed people under H.R. 10 plans [2]	+125
Total, provisions designed to equalize tax treatment under pension plans	−320
II. Revised tax treatment of lump-sum distributions from qualified plans (long-run effect) [1]	+35
III. Revenue effect of new taxes:	
Audit fee tax of $1 a year for each employee covered by plan [1] (to finance IRS administration of provisions relating to pension plans and exempt organizations)	+30
Tax to finance plan termination insurance (50¢ or 70¢ per plan participant) [3]	+18
Gross revenue collections	+48
Revenue loss due to tax deductions taken by employers:	
For audit fee tax [1]	−14.4
For tax to finance plan termination insurance [2]	−9.0
Total offset of new taxes against income tax collections	−23.4
Net revenue effect of new taxes	+24.6
IV. Revenue effect of minimum vesting provisions: [4]	
Case 1: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute a substitute for cash wages	−130
Case 2: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute an addition to cash wages	−265
Case 3: Assuming that benefit levels of pension plans are adjusted downward to absorb the additional employer contributions to pension plans resulting from the minimum vesting requirement	0

[1] Takes effect Jan. 1, 1974.
[2] Takes effect Jan. 1, 1974, for proprietary plans adopted after July 24, 1973, and Jan. 1, 1975, for proprietary plans in existence on July 24, 1973.
[3] Takes effect Jan. 1, 1975.
[4] The minimum vesting provision is effective Jan. 1, 1976, for plans in existence on the date of enactment. For plans adopted after the date of enactment, the vesting requirement applies to plan years beginning after the enactment date. Existing plans which have been subject to collective bargaining agreements are not subject to the vesting requirement until the the expiration of the collective bargaining agreement or 1981, whichever is sooner.

NOTE.—There will be some revenue loss from funding but data are not available to determine the extent of this loss.

Provisions designed to equalize tax treatment of pensions.—It is estimated that the provision increasing the maximum deductible pension contributions by self-employed persons on their own behalf to 15 percent of earned income up to $7,500 a year will result in an annual long term revenue loss of $175 million. The provision allowing individuals not covered by pension plans to deduct up to $1,000 a year

[37] for contributions to personal retirement plans is expected to involve a revenue loss amounting to $170 million in 1974 and rising to $270 million by 1977 (at 1973 income levels). On the other hand, extending the same limitations that apply to deductible pension contributions of self-employed people to proprietary employees (who own a 2 percent interest in the stock of the corporation and who together account for 25 percent of the present value of the accrued benefits under the plan) is expected to increase annual revenue by $125 million a year by 1975. Altogether, when fully effective, these three provisions involve an estimated annual net revenue loss of $320 million.

Tax treatment of lump-sum distributions.—The revised tax treatment of lump-sum distributions from qualified plans (which provides for taxing that part of lump-sum distributions which is attributable to 1974 and later years as ordinary income under a separate tax rate schedule) is expected to result in relatively small increases in revenue over the next few years since the bulk of the lump-sum distributions in such years will be attributable to pre-1974 years. However, after a transition period, this provision can be expected to result in annual revenue gains amounting to $35 million a year based on 1973 levels of income.

New taxes and their effect on income tax deductions.—An audit fee tax of $1 a year for each employee covered by a pension, profit-sharing, or stock bonus plan is expected to produce an estimated $30 million of revenue annually. The proceeds of this tax are allocated by the legislation for financing the Internal Revenue Service administration of provisions relating to pension plans and exempt organizations.

The second new tax is imposed on employers with qualified plans and is to be used to finance plan termination insurance (50 cents or 70 cents per plan participant, depending on whether the employer has liability for losses) which is effective January 1, 1975. This tax is expected to raise an estimated $18 million annually.

However, there is an offset to the revenue gain expected from the two new taxes. Employers can take income tax deductions for the new taxes which, of course, will have the effect of reducing the net cost of these taxes to them. It is estimated that an annual revenue loss of $14.4 million will be incurred in 1974, and later years, as a result of deductions taken for payments of the audit fee tax; similarly it is estimated that revenue will be reduced $9 million a year in 1975, and later years, as a result of deductions taken for the taxes required to be paid to finance plan termination insurance.

These deductions against income tax reduce the revenue from the new taxes from $48 million to about $24 million.

Revenue effect of minimum vesting and funding provisions.—The new minimum vesting standard, which becomes effective January 1, 1976, will also involve an indirect loss of revenue, ranging from zero to an estimated $265 million a year (at 1973 income levels).

The minimum vesting requirement involves little or no revenue loss to the extent that plans adjust their benefit levels to absorb the increased employer costs resulting from the requirement. This is because, in that event, the requirement would have no effect on the deductions taken for contributions to plans or on the taxable income of covered employees. If the additional amounts required to be contributed to

[38] pension plans as a result of the vesting standard are a substitute for cash wages rather than a net addition to cash wages the annual revenue loss is estimated at $130 million. This could occur, for example, if the additional employer payments into the pension plan are taken into consideration in setting future wage increases. In this event, the revenue loss results from the fact that the covered employees are permitted to postpone payment of tax on the employer contributions involved, instead of being required to pay tax currently, as would be the case had they received an equivalent amount of wages. Some part of this postponed $130 million of taxes presumably will be recovered in the future in tax payments on the benefits paid out by the plan.

The upper range of the estimate, $265 million, represents the revenue loss if it is assumed that the additional employer payments into the pension plans required by the new vesting standard constitute an addition to the cash wages that will be paid in any event. In this case employers will have larger total wage bills (for the sum of cash wages and wage supplements) and hence will take larger tax deductions, giving rise to a $265 million revenue loss.

It appears to the committee that realistically there is likely to be a combination of the three effects suggested above. However, it appears probable that the annual revenue loss will be in the vicinity of $130 million, the mid-point of the range.

No revenue estimate is given for the increased funding requirements under the bill. Data are not available which would make a precise estimate of this type possible. However, it is believed that the minimum funding requirements will have a relatively modest revenue effect.

IV. GENERAL EXPLANATION

A. Administration

Title I of the bill establishes an office in the Internal Revenue Service to facilitate the administration of tax provisions relating to pension (profit-sharing, etc.) plans, and also provides for certain clearinghouse functions for the Social Security Administration with regard to employees who leave employment with deferred vested benefits before being eligible for current retirement benefits.

The provisions relating to the new office in the Internal Revenue Service are discussed at "H. Enforcement," below. Briefly, those provisions establish an Office of Employee Plans and Exempt Organizations, to administer the parts of the tax laws relating to these plans and organizations. The bill also authorizes appropriations to fund these activities, in the amount of the sum of (1) the collections from a new tax imposed with regard to employee plans under this bill and (2) half of the existing tax on investment income imposed on private foundations.

The bill's provisions relating to the Social Security Administration clearinghouse function are discussed under "E. Portability," below. Under those provisions, each pension (or profit-sharing, etc.) plan is to report to the Social Security Administration the vested benefit status of employees who leave employment with the employer who established the plan. When the employee (or his survivors) apply for

[39] Social Security benefits (or on certain other occasions) the Social Security Administration is to notify the employee (or his survivors) if vested benefits are available under such a plan, as well as how to obtain benefits under the plan.

B. Participation and Coverage

(Secs. 201 and 261 of the bill and secs. 401 and 410 of the Code).

1. PLAN PARTICIPATION—AGE AND SERVICE REQUIREMENTS

Present law

The Internal Revenue Code does not generally require a qualified employer pension, profit-sharing, stock bonus, annuity, or bond purchase plan to adopt any specific age or service conditions for participation in the plan.[1]

Existing administrative practice allows plans to exclude employees who (1) have not yet attained a designated age or (2) have not yet been employed for a designated number of years, so long as the effect is not discriminatory in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. Also, under administrative practice, a plan may exclude employees who are within a certain number of years of normal retirement age (for example, 5 years or less) when they would otherwise become eligible, if the effect is not discriminatory.

On the other hand, in the case of a plan benefiting owner-employees,[2] the plan must provide that no employee with 3 or more years of service may be excluded (sec. 401(d)(3)).

General reasons for change

The committee believes that, in general, it is desirable to have as many employees as possible covered by private pension plans and to begin such coverage as early as possible, since an employee's ultimate pension benefits usually depend to a considerable extent on the number of his years of participation in the plan. This is particularly important for employees who, because of the nature of their employment, shift from employer to employer over their working careers. In addition, early participation tends to spread the cost of providing employees with adequate pensions more evenly over the various firms for which the employee has worked over his entire working career, instead of concentrating the cost on his last few employers.

Of course, the general desirability of early participation must be balanced against the cost involved for the employer. Also from an administrative standpoint, it is not desirable to require coverage of transient employees, since benefits earned by short-term employees, in any case, are quite small. On the other hand, the committee believes that overly restrictive age and service eligibility requirements can arbitrarily

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[1] As described below (B.2. Plans Where a Collective Bargaining Unit is Involved; Other Anti-discrimination Provisions), a qualified plan must meet certain coverage standards. Several of the alternative standards require certain percentages of employees, or of eligible employees, to be covered by the plan, but in such cases the employer is permitted to exclude employees who fail to meet the plan's service requirements, not exceeding five years of service.

[2] An owner-employee is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[40] frustrate the effective functioning of the private pension system. In view of these considerations, the committee has concluded that it is appropriate to specifically limit age and service eligibility requirements which an employer may incorporate in a qualified pension plan.

Explanation of provisions

In view of the considerations outlined above, the committee bill provides that a plan which is qualified under the Code is not to require, as a condition of participation, more than one year of service, or an age greater than 30 (whichever occurs later).[3] The committee believes that this rule will significantly increase coverage under private pension plans, without imposing an undue cost on employers. From an administrative point of view, however, the rule will allow the exclusion of employees who, because of youth or inexperience with the job in question, have not made a career decision in favor of a particular employer or a particular industry.

For the purposes of these rules, an employee is to be considered to have performed a year of service if he was employed for more than 5 months during the year.[4] It is intended that employment for 80 hours or more during a month will be considered as employment for a month. The "year" of service may be a calendar, plan, or fiscal year, whichever is applied on a consistent basis under the plan. The committee intends, by adopting this provision, to facilitate the coverage of seasonal employees under qualified pension plans. For example, if a fisherman is employed by a company having a qualified pension plan for 5 months and one day during 1975, and is reemployed by the same company in a later year, he is not to be ineligible for participation in the plan upon his reemployment by reason of a minimum service requirement.

The committee intends that Treasury regulations specify the extent to which service with a predecessor of the employer is to be counted for purposes of the eligibility requirements. In the case of a multiemployer plan, service with any employer who was a member of the plan is to be counted toward an individual's participation requirement (see sec. 705 of the bill).

The bill does not provide any authority to exclude from the plan those employees hired within any specified number of years of normal retirement age.

The provisions of present law with respect to coverage under an owner-employee (H.R. 10) plan are not changed by the committee's bill. Present law already requires relatively early participation (after 3 years of service) and 100-percent immediate vesting in the case of owner-employee plans. The committee concluded that the retention of these provisions of present law was needed to protect the rights of employees in such cases. The Treasury Department may provide by regulations for those cases where a plan shifts in or out of owner-employee status, for example, because of fluctuating partnership interests.

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[3] This rule applies whether or not the plan is a trusteed plan. That is, a plan funded through purchase of annuities from an insurance company is subject to these rules, as is a plan with investments managed by a trustee.

[4] This test of service is to be applied with regard to the actual employment of that employee. In this respect, it differs from similar definitions under present law (secs. 401(a)(3)(A) and 401(d)(3)), which determine employment service on the basis of the employee's "customary employment".

[41] Proprietary employee plans (see I. Limitation on Contributions, below) and H.R. 10 plans where there are no owner-employees (i.e., where no partner has a greater than 10-percent interest) are not now subject to the 3-year-participation and immediate-full-vesting rules. Under the bill, they are to be subject to the new one-year-service and age-30 participation requirements (and the new vesting requirements, see C. Vesting, below) in the same manner as regular corporate plans.

Effective date

These provisions generally apply to plan years beginning after the date of enactment. However, to allow time for amendment, in the case of a plan already in existence on the date of enactment of the bill, the provisions apply to plan years beginning after December 31, 1975 (or December 31, 1980, in the case of a government plan). Where the plan is subject to the provisions of a collective bargaining agreement in effect on the date of enactment of the bill, the effective date is further postponed until the expiration of the collective bargaining agreement, but, in any event, all plans are to be subject to these provisions in plan years beginning after December 31, 1980.

Revenue effect

The revenue effect of these provisions is expected to be minimal.

2. PLANS WHERE A COLLECTIVE BARGAINING UNIT IS INVOLVED; OTHER ANTIDISCRIMINATION PROVISIONS

Present law

Under present law (sec. 401(a)(3)), a qualified retirement plan must cover either (1) a specified percentage of all employees (generally, 70 percent of all employees, or 80 percent of those eligible to benefit under the plan if at least 70 percent of all employees are eligible) [5] or (2) such employees as qualify under a classification which is found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. (A plan is not *per se* discriminatory for purposes of these rules merely because it is limited to salaried or clerical employees.)

Also, under present law, either the contributions or the benefits provided under a qualified plan must not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees.

General reasons for change

Where employees covered under a collective bargaining unit prefer current compensation or some other form of benefits to coverage under a pension plan, employers sometimes are unable to establish a plan for other employees because the percentage requirement cannot be satisfied if the bargaining unit employees are not covered. It is then necessary for the plan to qualify as one which has coverage requirements that do not discriminate. The Service's approach (see Rev. Rul. 70–200, 1970–1 CB 101), which has generally been upheld by the courts, has

[5] In applying these numerical tests under present law, there are excluded employees who have been employed not more than a minimum period prescribed by the plan (up to 5 years), part-time employees (customary employment for not more than 20 hours in any one week), and seasonal employees (those whose customary employment is for not more than 5 months in any calendar year).

[42] been to look at the composition of the group which is covered under the plan, and to allow the plan to qualify if the compensation of most of the participants is substantially the same as that of the excluded employees, the plan covers employees in all compensation ranges, and employees in the middle and lower ranges are covered in more than nominal numbers. Where most of the lower-paid nonsupervisory personnel are members of a collective bargaining unit which elects not to be covered by a pension plan, the remainder of the employees may include relatively large percentages of supervisors or highly compensated employees. As a result, under present law it may be impossible—because of the antidiscrimination requirements—to establish a qualified plan for the remaining employees.

The committee believes that this situation can result in a hardship, where all employees of an employer are forced to forego the benefits of a pension plan merely because those employees who are covered under a collective bargaining argreement choose nonpension benefits, or nonpension benefits plus pension benefits at a lower level than those provided nonunion employees. At the same time, the committee is concerned that any change in the law should not result in a situation where an employer might be able to exclude these employees from the pension plan without compensation for this in the form of other types of benefits. To deal with this situation, the committee bill provides that collective bargaining employees may be excluded for purposes of applying the coverage test, but only where there is evidence that retirement benefits have been the subject of good faith bargaining between the union employees and the employer.

Explanation of provisions

Collective bargaining unit.—The committee bill eases the application of the provisions of existing law by providing that employees covered under a collective bargaining agreement can be excluded for purposes of the coverage requirement, and for purposes of the antidiscrimination provisions (of sec. 401(a)(4)), but only if there is evidence that the retirement benefits have been the subject of good faith bargaining between the union employees and the employer.

If pension plan coverage had been discussed with the representatives of the union employees and no pension coverage was provided, either because the union employees were covered under a union plan (which might or might not offer comparable benefits to those provided under the employer plan), or because the employee representatives opted for higher salaries, or other benefits, in lieu of pension plan coverage, or for some other valid reason, then it would be permissible to exclude those union employees from the calculations. In effect, the collective bargaining agreement employees could then be excluded from the plan, or could be provided with a lesser or different level of benefits.

The committee anticipates that in any case where collective bargaining unit employees were excluded from a plan under this provision, the Internal Revenue Service will receive information as to the justification for the exclusion before ruling that the plan is qualified.[6] There is no requirement that the collective bargaining agreement specifi-

[6] Additional protection for the employees would be provided under the part of the bill (sec. 601) which establishes a right on the part of an employee to participate in IRS proceedings to determine if a plan is qualified and to petition the Tax Court if he disagrees.

[43] cally state that the employees have elected to be out of the plan or to take a lower level of benefits. However, there must be evidence that the retirement benefits have been the subject of good faith bargaining between the union employees and the employer.

Nonresident alien employees.—The bill provides for the exclusion, for purposes of applying the coverage requirements and the antidiscrimination requirements, of those employees who are nonresident aliens with no United States income from the employment in question. It was believed that the United States tax laws should not impede appropriate pension plan benefits for United States citizens or persons with United States earned income, merely because comparable benefits were not afforded to nonresident aliens with no United States income from the employment in question. Also, the mere processing of such cases would take an inordinate amount of time because of the complexity of applying rules to integrate the appropriate foreign equivalent of Social Security with the benefits or contributions provided by the employers under such plans.

Affiliated employers.—The committee bill also provides that in applying the coverage test, as well as the antidiscrimination rules and the vesting requirements, employees of all corporations who are members of a "controlled group of corporations" (within the meaning of sec. 1563(a)) are to be treated as if they were employees of the same corporation. Thus, if two or more corporations were members of a parent-subsidiary, brother-sister, or combined controlled group, all of the employees of all of these corporations would have to be taken into account in applying these tests. The committee, by this provision, intends to make it clear that the coverage and antidiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation. For example, if managerial functions were performed through one corporation employing highly compensated personnel, which has a generous pension plan, and assembly-line functions were performed through one or more other corporations employing lower-paid employees, which have less generous plans or no plans at all, this would generally constitute an impermissable discrimination. By this provision the committee is clarifying this matter for the future. It intends that prior law on this point be determined as if this provision had not been enacted.

At the same time, however, the committee provision is not intended to mean that all pension plans of a controlled group of corporations must be exactly alike, or that a controlled group could not have pension plans for some corporations but not others. Thus, where the corporation in question contains a fair cross-section of high and low-paid employees (compared to the employees of the controlled group as a whole), and where the plan is nondiscriminatory with respect to the employees of the corporation in question, it is anticipated that the Internal Revenue Service would find that the plan met the antidiscrimination tests, even though other corporations in the controlled group had a less favorable retirement plan, or no plan at all. On the other hand, if, looking at the controlled group as a whole, it were found that a disproportionate number of highly compensated employees were covered under the plan of the corporation in question, or that the average compensation of covered employees was substantially higher in that plan than the average compensation of noncovered employees,

[44] it would be anticipated that the plan would not be found to be qualified, because the corporation does not contain a fair cross section of the controlled group employees.

Supervisory employees.—Under the committee bill, the category of "supervisors" is to be dropped from the list of personnel which a plan may not discriminatorily favor. The committee understands that all persons who are supervisors within the intent of present law also are officers, shareholders, or highly compensated employees, and that as a result this deletion can be made without any substantive change in the antidiscrimination provisions of present law.

Temporary and seasonal employees.—In applying the coverage rules, the bill makes several small changes from present law. In applying the 70 percent and 80 percent coverage tests, employees who fail to meet the minimum age and service requirements prescribed by the plan may be excluded. These requirements may not be more than the top limit of one-year-service and 30-year-age requirements described above with respect to participation. Of course, the plan may provide lower age and service requirements.

Present law defines excludable part-time employees as those whose customary employment is for not more than 20 hours in any one week. To conform the definitions closely to those used for participation (described above), the bill defines excludable part-time employees as those whose customary employment is for not more than 80 hours in any one month. Present law permits exclusion from these calculations of employees whose customary employment is for not more than 5 months in any calendar year; the bill retains the 5-month period but permits computations to be made on the basis of calendar, plan, or fiscal years, depending upon the period specified in the plan itself.

Effective date

These provisions apply generally to plan years beginning after the date of enactment of the bill. However, to allow time for amendment in the case of plans in existence on the date of enactment, the provisions are to take effect for plan years beginning after December 31, 1975 (or December 31, 1980, in the case of a government plan). Where the plan is subject to the provisions of a collective bargaining agreement in effect on the date of enactment of the bill, the effective date is further postponed until the expiration of the collective bargaining agreement (but without regard to any extension made after the date of enactment), but, in any event, all plans are to be subject to these provisions in plan years beginning after December 31, 1980.

Revenue effect

The revenue effect of these provisions is expected to be minimal.

C. Vesting

(Secs. 221, 261, and 705 of the bill and secs. 401, 411, 413, 6688, and 6690 of the Code.)

Present law

Plans which qualify under the Internal Revenue Code are now required to provide vested (i.e., nonforfeitable) rights to participating employees when they attain the normal or stated retirement age.

[45] Employees must also be granted vested rights if the plan terminates or the employer discontinues his contributions.

However, qualified employer plans are generally not required to provide vested rights to participating employees before normal retirement age unless this is considered to be necessary—in view of the likely pattern of employee turnover—to prevent discrimination against the rank and file employees in favor of officers, shareholders, supervisors, and highly paid employees. In other words, preretirement vesting is required only where its absence would cause discrimination in favor of officers, etc., who could be expected to remain with the firm long enough to retire and qualify for benefits, while the rank and file employees would continually be separated from the firm and lose their benefits.

Under an owner-employee plan,[1] the rights of all employees must vest in full as soon as they become participants. (sec. 401(d)(2)(A)).

General reasons for change

Unless an employee's rights to his accrued pension benefits are nonforfeitable, he has no assurance that he will ultimately receive a pension. Thus, pension rights which have slowly been stockpiled over many years may suddenly be lost if the employee leaves or loses his job prior to retirement. Quite apart from the resulting hardships, the committee believes that such losses of pension rights are inequitable, since the pension contributions previously made on behalf of the employee may have been made in lieu of additional compensation or some other benefits which he would have received.

Today, slightly over two-thirds of the private pension plans provide some vested rights to pension benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have been employed for a fairly long period with a firm or are relatively mature. Since there is no general applicable legal requirement for preretirement vesting, some plans do not offer this type of vesting at all, and among those plans which do, there is no uniformity in the vesting rules as provided. At present, only one out of every three employees participating in employer-financed plans has a 50-percent or greater vested right to his accrued pension benefits. Even for older employees, a substantial portion do not have vested rights. For example, 58 percent of covered employees between the ages of 50 and 60, and 54 percent of covered employees 60 years of age and over, still do not have vested rights to even 50 percent of their accrued pension benefits.[2] As a result, even employees with substantial periods of service may lose pension benefits on separation from employment. Extreme cases have been noted in which employees have lost pension rights at advanced ages as a result of being discharged shortly before they would be eligible to retire. In addition, the committee believes that more rapid vesting is desirable because it will improve the mobility of labor, and in this manner promote a more healthy economy.

For reasons indicated above, the committee concluded that it is necessary and desirable to provide a minimum standard of vesting

[1] An owner-employee is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[2] U.S. Treasury Department—Fact Sheet. Pension Reform Program, as reprinted in Material Relating to Administration Proposal Entitled the "Retirement Benefit Tax Act," Committee on Ways and Means, 93d Cong., 1st sess., p. 37, Table B.

[46] for all qualified pension plans. Clearly, however, it would be counterproductive to increase employer costs by more rapid vesting to such an extent as to significantly curtail the creation of new retirement plans (or to significantly curtail the increase of benefits in existing plans). The committee bill deals with this problem by requiring relatively early vesting (beginning not later than an employee's fifth year of service or 30th birthday, whichever occurs later) for some of the employee's rights but does not require that they be vested fully until after 15 years of service or age 40. This is known as gradual (or graded) vesting.

Explanation of provisions

General rule.—The committee's bill provides that a qualified retirement plan (whether trusteed or insured) would be required to give each employee vested rights to at least 25 percent of his accrued benefit from employer contributions after 5 years of service, plus 5 percentage points a year for each of the next 5 years and 10 percentage points a year thereafter. This would mean that there must be 100 percent vesting after 15 years of service.[3] (Note that, because of the participation rules described above, vesting could be delayed in the case of an employee who started employment before age 25.)

This approach has the advantage of providing some vesting at a relatively early point in the employee's career. Thus, if the employee changes jobs after 5 years of service, he would be protected in his rights to at least some of his accrued pension benefits.

Also, because vesting occurs gradually under the committee bill, this tends (by comparison to proposals presented to the committee that would have required full vesting in as short a time as five years) to bring down the cost of the vesting requirement to manageable levels by minimizing the cost of establishing a new plan or improving benefits under an existing plan. It also avoids the serious "notch" effect of providing 100 percent immediate vesting after any specified number of years. In other words, if employees receive too much of their vested rights in any one year, it could give the employer an incentive to dismiss an employee rather than to absorb the resulting sharp increase in pension plan costs.

The committee bill takes the approach of being "age-neutral," which means that an employee's rights to vested benefits depend solely on his years of service, rather than on some combination of service and age. Age-weighted proposals have been advocated to the committee because they provide early vesting to the older worker.[4] However, the committee believes that this approach would tend to discourage the hiring of older employees, who already are faced with difficult problems in finding employment, and would not generally protect the rights of younger employees, who are more likely on the average to change jobs and, therefore, lose pension rights. Such continual losses of pension rights when they are young tends to make it difficult for employees to accumulate adequate pensions over their working careers.

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[3] Under the bill, each employee would have to be fully and immediately vested in his accrued benefit derived from his own contributions. In general, the rules described in the text relate only to benefits derived from employer contributions.

[4] It is recognized that age has some effect in that it may be relevant to participation (see B. Participation and Coverage, above); however the committee's decision on vesting gives no direct effect to age.

[47] Moreover, even when an adequate pension is to be provided, the loss of pensions accrued in previous employment due to the absence of vesting at an early age may throw most of society's cost of providing an adequate pension (if it is to be provided) on the employers for whom the employee works in his later years.

It should be made clear that the standards of vesting provided in the committee bill are only intended as minimum standards. The bill's provisions are not intended to prohibit plans with more rapid vesting than that required under the standards in the bill.

The provisions of the committee bill relating to vesting, of course, are not intended to modify the anti-discrimination requirements of current law. Presently, more rapid vesting requirements are sometimes required to prevent discrimination under a plan in favor of officers, shareholders, or highly compensated employees. The committee has not modified the present relationship between the vesting and anti-discrimination provisions. On the one hand, the higher vesting standards provided in the bill are likely to reduce somewhat the need to apply vesting in order to prevent discrimination. On the other hand, there undoubtedly still will be cases where it will be necessary to provide additional vesting over and above the minimum vesting standards in this bill in order to prevent discrimination. It has also been suggested to the committee that the antidiscrimination provisions have not been interpreted uniformly throughout the country, and it believes that appropriate guidelines should be provided to the district offices to achieve a uniform interpretation of the law.

Pre-participation service.—Once an employee becomes eligible to participate in a pension plan, his years of service with an employer before becoming a participant in the plan, up to a maximum of 5 years, are to be credited toward his required years for minimum vesting. This means that if an employee joins a firm at age 25, he would have to become a plan participant on or before age 30 (the maximum permissible attained age requirement, under the participation provisions of the bill). However, he would at that time (because of his 5 years of preparticipation service) have to become at least 25 percent vested in any pension benefits he accrues after becoming a participant. For purposes of this "look back" rule, however, years of preparticipation service would not be counted unless the pension plan was in existence during those years.

Although the committee recognizes the desirability of permitting the exclusion of transients by setting up participation requirements (the one-year-of-service and age-30 rules described above), it seemed to the committee that those years ought to count for something once the employee has stayed long enough to be a participant. This provision requires that the employee receive credit for up to 5 years of preparticipation service in computing his position on the vesting schedule. There is precedent for such a "look back" rule, since the committee has been informed that many existing pension plans already take preparticipation service into account for vesting purposes.

Benefits accrued in the past.—Generally, the vesting requirements of the bill are to apply to all accrued benefits, including those which accrued before the effective date of the provision. Years of service prior to the effective date also are to be counted for purposes of determining

[48] the extent to which the employee is entitled to vesting. For example, if an employee joined a company at age 30 (at which time a plan was in effect), became a participant in the plan at age 35, and was age 40 on the effective date of the vesting provisions, he would have to become at least 50-percent vested at that time. However, he might not have more than 5 years of accrued benefits since the minimum benefit accrual is based on participation.[5] This would occur because of his 5 years of participation under the plan plus his 5 years of preparticipation service. Without this pre-effective date rule, it was apparent to the committee that employees who are now older employees would receive the advantages of required vesting only for the accrued benefits they would be able to build up gradually in the future and would receive no protection for benefits accrued prior to the effective date of these provisions, which would usually be the bulk of the benefits earned during their lifetimes.

The committee considered various methods of providing that pre-effective date service be taken into account in the case of older employees only, but concluded that most such methods provided some type of undesirable "notch" effect and in most cases would result in little cost saving to the employer relative to the rule adopted by the committee on this point.

Multiemployer plans.—In the case of a multiemployer plan governed by a collective bargaining agreement, the vesting requirements of the committee bill generally are to be applied as if all employers who are parties to the plan constituted a single employer. For example, years of service with employers A and B under the plan will be counted together in determining vesting, even though the employee now works for employer C.

Service that is seasonal, intermittent, etc.—For purposes of the minimum vesting rules, an employee is to be treated as having performed a year of service if he was actually employed at least 80 hours a month, for at least 5 months during the year (which may be a calendar, plan, or fiscal year, whichever is applied on a consistent basis under the plan). A plan would be permitted to provide that up to 3 of the 5 years of service required for minimum vesting must be consecutive. Service with a predecessor of the employer would also be counted, for purposes of the vesting rules, to the extent provided in regulations. The committee anticipates that the regulations in this area will prevent a situation where an employee might lose his rights to vesting as the result of a business reorganization.

Once having satisfied the consecutive service requirement, however, an employee would not lose his vesting because of breaks in service. For example, an employee with 5 years of service and 4 years of participation who left the plan and rejoined in a later year would become a 25-percent vested participant immediately, and he would become 30-percent vested in his accrued benefits after one additional year of service, 35 percent after a second additional year, etc. Even if the employee had received a lump sum distribution of the benefits accrued during his prior period of service, because of that earlier service the

[5] The employee need have only 5 years of accrued benefits, because the vesting provisions are to apply to pre-effective date service only to the extent of the employee's accrued benefits. The new participation standards are not to apply before the effective date of those standards; if these facts were to occur in the future, the employee would be at least 50-percent vested in at least 9 years of accrued benefits.

[49] employee would still be partially vested in any additional pension benefits which he accrued during his later service.

Recordkeeping requirements.—To carry out the intent of the vesting provisions (primarily those involving intermittent employment), the employer would be required to keep records of the years of service of his employees and the percentage of vesting which the employees had earned, together with any additional information required by the Secretary or his delegate in order to determine the employee's benefits. In the case of a multi-employer plan, the employer would furnish the required information to the plan administrator (who would be required to maintain the records), in accordance with regulations.

Failure to maintain or furnish the required records would result in a civil penalty of $10 for each employee with respect to whom the failure occurs, unless it is shown that the failure is due to reasonable cause. The committee expects that the necessary records will be retained by employers for at least 10 years following a break in service. After that, the employee could still establish his right to vesting based on prior service, but the burden of producing the evidence would shift to the employee.

Class year plans.—A class year plan is a profit-sharing or stock bonus plan which provides for the separate vesting of employee rights to contributions (or rights derived from contributions) to a plan on a year-by-year basis and the withdrawal of these amounts on a class-by-class basis as they mature. The minimum vesting requirements of the bill applicable to a class year plan are satisfied under the bill if the plan provides for 100-percent vesting of the employer contributions within 5 years after the end of the plan year for which the contributions were made. A separate rule is needed for class year plans since they are structured differently than most other types of plans. The 5-year full vesting rule provided in this case by the committee bill assures an employee who terminates his employment under a class year plan that he will not forfeit his rights to more than 4 years of employer contributions.

Permitted forfeitures of vested rights.—A qualified retirement plan under the committee bill may provide that an employee's vested rights in accrued benefits derived from employer contributions (but not from his own contributions) may be forfeited in the event of the employee's death (although this exception is not to apply if the employee had retired and had elected to take a survivor annuity prior to his death).

Also, in the case of retirement plans requiring mandatory employee contributions, an employee who voluntarily withdrew all or part of his contributions[6] may forfeit all of the benefits derived from any employer contributions made on his behalf. A class year plan may provide that an employee will forfeit all of the benefit derived from employer contributions—if he withdraws any part of his own mandatory contributions, but these forfeitures may only occur on a class-year-by-class-year basis.

The committee is very concerned, however, that an employee withdrawing his own mandatory contributions should be made fully aware

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[6] So long as part of the employee's contributions remained in the plan, he would retain a vested right to the benefits derived from those contributions.

[50] of the consequences of doing so, and expects that the Service and the Labor Department will coordinate efforts to require that plans containing these forfeiture clauses make full and adequate disclosure to the employee, prior to withdrawal, including disclosure of the current value of the accrued right the employee will forfeit and (at least in the case of a defined benefit plan) the amount of the pension he could expect to receive at normal retirement age.

With the limited exceptions noted above, no rights, once they are required to be vested, may be lost by the employee under any circumstances (although, as under present law, the plan may pay the employee the actuarial value of his vested rights upon separation from service).[7] For example, a vested benefit is not to be forfeited because the employee later went to work for a competitor, or in some other way was considered "disloyal" to the employer.[8] Also, rights to benefits are not to be forfeited merely because the employer (or plan administrator) cannot find the employee. However, in such a case, if it appears that the employee's whereabouts would remain unknown for so long a time that the value of the benefits would escheat to the State, then before that happens the plan is to transfer the value of the benefits to the Pension Benefit Guaranty Corporation to be created under Title IV of the bill.

Prohibited discrimination.—Under present law, there are regulations designed to ensure that in the event of early plan termination, the benefits under the plan are not paid to employees who are officers, shareholders, or highly compensated employees in a discriminatory manner. The committee bill contains a provision to make it clear that the vesting requirements under the bill are not intended to operate to overturn these rules. Thus, for example, in the event of an early plan termination, a highly compensated employee might receive less than his otherwise vested benefit under the bill, if this were necessary to prevent discrimination.

Plan termination.—Under present law, all accrued benefits in a qualified pension plan must become fully vested (to the extent then funded) in the event of a termination, or the complete discontinuance of contributions under a pension plan. This rule will no longer be necessary with respect to discontinued contributions, because the committee bill (sec. 241) now provides for an excise tax on underfunding. However, the committee bill makes clear that this rule of full immediate vesting is still to apply in the case of a termination, or a partial termination. (Examples of a partial termination might include, under certain circumstances, a large reduction in the work force, or a sizeable reduction in benefits under the plan.)

Accrued benefits.—Under the committee bill, the vested employee is protected in his rights to all, or a certain percentage, of his "accrued benefit." This term refers to pension or retirement benefits and is not intended to apply to certain ancillary benefits, such as medical insurance or life insurance, which are sometimes provided for employees

[7] In turn, this distribution may be transferred tax free by the employee to the portability fund, or to the qualified plan of his new employer under provisions in title III of the bill.

[8] Some plans also provide that an employer may have lien rights against employee interests in a pension plan. These clauses would also be prohibited under the committee bill, except where the plan requires that the employee be given prior notice of any inpending lien and there is a judicial hearing on the probable validity of the employer's claim.

[51] in conjunction with a pension plan, and are sometimes provided separately. To require the vesting of these ancillary benefits would seriously complicate the administration and increase the cost of plans whose primary function is to provide retirement income. Also, where the employee moves from one employer to another, the ancillary benefits (which are usually on a contingency basis) would often be provided by the new employer, whereas the new employer normally would not provide pension benefits based on service with the old employer.

It is necessary to provide a statutory definition of an "accrued benefit" because, unless this is a defined amount, vesting of an "accrued benefit" in whatever form is specified by the plan has little, if any, meaning. In the case of any retirement plan other than a defined benefit pension plan, under the bill the employee's "accrued benefit" is the balance in his plan account. This would include, for example, a money purchase pension plan and a profit-sharing plan. In the case of a defined benefit pension plan (under which benefits may vary with such factors as wages and service), the bill provides that the minimum accrued benefit is to be a fraction of the amount the employee would receive at normal retirement age, under the plan as in effect at the time for which the accrued benefit is to be determined. (As discussed below under F. Insurance, a collectively-bargained plan in which the employer participates in the setting of defined benefits is a defined benefit plan, even though the collective bargaining agreement may specify only the level of contributions.) In making this computation, the retirement benefit is to be computed as though the employee continued to earn the same rate of compensation annually as he had earned during the years which would have been taken into account under the plan, had the employee retired on the date in question. This amount is then to be multiplied by a fraction, the numerator of which is the employee's total number of years of active participation in the plan up to the date when the computation is being made and the denominator of which is the total number of years of active participation he would have if he continued his employment until normal retirement age.[9] The term "normal retirement age" is to be defined by regulations. It is expected that a minimum and maximum age will be taken (perhaps 55 and 65) and that the "normal retirement age" in this range will be based on the age at which the retirement benefit has the greatest actuarial value.

In the case of a defined benefit pension plan funded through an insurance contract, the accrued benefit is to be the annuity which may be purchased by the cash surrender value of the policy. In the case of a variable annuity plan, the term accrued benefit is to be defined by regulations.

Allocations between employer and employee contributions.—In plans where there are both employer and employee contributions, it will be necessary to allocate the accrued benefit between the portion derived from the employer contributions, and the portion derived from the employee contributions. This allocation may have to be made because the employee is always fully vested with respect to amounts attributable to his own contributions but not necessarily with respect to those of the employer. Also, information of this type would be

[9] The fraction may not exceed one, under the committee bill, since at this point the employee would receive the full pension to which he was entitled under the plan.

[52] needed if an employee, upon leaving employment, desires to withdraw his own contributions.

In the case of any plan other than a defined benefit pension plan, the accrued benefit derived from the employee's contributions under the bill is the amount in his own separate account. If employee and employer contributions were not accounted for separately, the employee-contributed portion of the total accrued benefit would be treated as the fraction of the total which is the ratio of employee to total contributions (after taking account of withdrawals, and, to the extent necessary, the timing of the contributions).

In the case of a defined benefit pension plan which provides an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), the accrued benefit derived from mandatory employee contributions would be treated as the total amount of the employee's "accumulated contributions" multiplied by a conversion factor.[10] In general, the conversion factor, which initially is to be fixed at 10 percent for a normal retirement age of 65, is to be used to convert the amount of the accumulated contributions to a single life annuity commencing at normal retirement age. For other normal retirement ages, the conversion factor is to be determined by regulations.

In determining the employee's accumulated contributions, under the bill, interest on the employee's mandatory contributions is to be compounded annually, initially at a rate of 5 percent (beginning with the first plan year subject to the vesting requirements imposed under the committee bill) to the date when the employee would reach normal retirement age. In addition, any interest accumulated on the employee's contributions (either compounded or simple) in accordance with the terms of the plan, prior to the date when the vesting provisions of the bill first apply to that plan, are to be treated as part of the employee's accumulated contributions.

The bill authorizes the Secretary or his delegate to adjust the conversion factor, and the assumed rate of interest on employee contributions, on a prospective basis, from time to time, as may be appropriate, but requires him to give at least one year's notice of any such action. The adjustment in the interest rate would be made by comparing the long-term money rates and investment yields for a 10-year period ending at least 12 months prior to the year in which the adjustment would first apply, with the corresponding rates and yield for the 10-year period from 1964 through 1973.[11]

The committee anticipates that the Treasury, in determining money rates and investment yields, will use a composite of a number of indicators. For example, one possible approach might be to give equal values to the dividend yields of the Dow-Jones Industrial Average and the Standard and Poor's 500-Stock Average, and to the interest rates of Barron's or Moody's highest-rated bonds and United States Treasury long-term obligations. This composite, for the 1964–1973 base period, would be set at 5, and the interest rate in the future would be determined by the Treasury Department's comparison of this com-

[10] Voluntary employee contributions are to be treated the same as a separate account.

[11] To forestall the need for plan amendments, the committee anticipates that a plan could satisfy the requirements of these provisions if it provided that interest on mandatory employee contributions would be computed at a rate of 5 percent, or at such other rate as may be required from time to time under the Internal Revenue Code of 1954, and the regulations issued thereunder.

[53] posite for the base period, with the same composite for the then most recent 10-year period. It is contemplated that this interest rate will be adjusted less often than annually, and that due regard will be given by the Treasury Department to the impact of any such adjustment on existing plans.

Some of the principles discussed above may be illustrated by the following example. Assume that employee A was born on January 1, 1926. On January 1, 1975, A enters employment with company M and on January 1, 1976, A becomes a participant in M's pension plan, requiring mandatory employee contributions, providing an annual benefit, at the normal retirement age of 65, of 3 percent of average compensation for each year of active plan participation. From 1976 through 1984, A earns a salary of $10,000 per year. On January 1, 1985, A leaves the employ of M. As of that date, A's employee contributions to the plan, including interest at a rate of 5 percent per annum (compounded annually) total $6,000. A will become 65 on January 1, 1991.

The minimum vested benefit to which A is entitled equals the sum of (1) 100 percent of the accrued benefit derived from his own contributions and (2) 50 percent (due to his 10 years of service) of the accrued benefit derived from M's contributions.

If A had continued to work for M at the same salary until age 65, he would have been entitled to receive an annual benefit of $4,500 (3 percent of $10,000=$300 times 15 years of service=$4,500). His accrued benefit, commencing at age 65, is therefore 9 (years of participation in the plan) divided by 15 (years of participation if A had continued to work through normal retirement age) times this amount, or an annuity of $2,700 per year.

Interest on A's contributions, at an assumed rate of interest of 5 percent per year (compounded annually), plus the principal of this amount, would total $8,040.75 on January 1, 1991. After applying the conversion factor of 10 percent, this is determined to be the equivalent of an annual annuity of $804.08 as of the date when A will reach 65, and A is 100-percent vested in this annuity, because it is derived from his own contributions.

Then, taking the total accrued benefit of $2,700 per year, and subtracting from this amount the amount of $804.08 per year, there is determined to be an annuity of $1,895.92 attributable to the employer contributions. A is 50-percent vested in this amount. His total vested benefit from his 9 years of employment by M thus equals $1,752.04 per year (50% of $1,895.92, or $947.96, plus $804.08) starting on January 1, 1991.

Where a defined benefit plan provides a benefit other than an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), or if the employee's mandatory contributions are applied toward some other form of benefit, then the accrued benefit, or amount of accrued benefit derived from employee contributions, is to be the actuarial equivalent of the single life annuity (without ancillary benefits) as determined under regulations.

Comparability of plans having different vesting provisions under the antidiscrimination rules.—There are certain classes of employees, such as engineers, whose rate of job mobility is so high, that many of them would not receive protection even under the vesting provisions

[54] provided under the bill. To be effectively covered under a pension plan, these employees would have to receive a very substantial amount of vesting during their first 5 years of employment. At the same time, if all employees were to be provided with vesting on this rapid a basis under the plan, the cost might be so high that the employer would terminate the plan, or drastically reduce the benefits under the plan. To meet this situation, the committee bill contains a provision which would allow the engineers and other employees with a similar problem, in effect, to trade off some of their benefits in exchange for earlier vesting.

Under present law a single plan may satisfy the antidiscrimination requirements (sec. 401(a)(4)), if either the contributions or the benefits do not discriminate in favor of certain enumerated employees. Generally, profit-sharing plans, stock bonus plans, and money purchase plans can satisfy this requirement if the contributions are nondiscriminatory even though the benefits may discriminate. Defined benefit plans can satisfy this requirement if benefits are nondiscriminatory even though the contributions are discriminatory. A target benefit plan, a type of money purchase plan, may satisfy the requirement if the benefits do not discriminate even though the contributions do. Also under existing law, two plans can be considered as one for purposes of satisfying the antidiscrimination requirements, either as to contributions or benefits.

Under the committee bill an employer might set up two retirement plans, one with very rapid vesting, the other with slower vesting, but with higher benefits. The bill provides that for purposes of applying the antidiscrimination rules, the two plans could be considered as a unit (as under present law) and the plan with more rapid vesting would not be considered discriminatory merely because of this feature (even if highly compensated employees were covered under the plan), if contributions were comparable or (in the case of defined benefit plans) if benefits under this plan were scaled down appropriately in relation to benefits provided under the plan with less rapid vesting. (Of course, each plan would have to at least meet the minimum vesting schedule provided in the commitee bill and would also have to be nondiscriminatory as to the employees covered by it.)

Thus, in the case of a defined contribution plan, the tax deductible contributions to both plans would be required to be the same in proportion to covered compensation. This would mean, in effect, that employees in the plan with less rapid vesting would receive increased benefits as the result of forfeitures,[12] whereas there would be relatively few forfeitures under the plan with earlier vesting.

In the case of a defined benefit plan, the same principle of comparability would apply, but here the level of benefits under the plan with earlier vesting would have to be lower, in relation to the benefits provided under the other plan. Generally, these comparisons would be made on an actuarial basis, in accordance with regulations.

By this provision the committee is clarifying this matter for the future. It intends that prior law on this point be determined as if this provision had not been enacted.

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[12] If the employer reduced his tax deductible contributions under the plan because of forfeitures, the tax deductible contributions to the plan with early vesting would also have to be reduced; comparatively, the employees in the plan with less rapid vesting would always have to accumulate a larger accrued benefit in proportion to compensation.

[55] *Effective date*

The vesting provisions generally are to apply to plan years beginning after the date of enactment of the bill. However, in the case of a plan already in existence on the date of enactment, the provisions take effect for plan years beginning after December 31, 1975. Where a plan is subject to a collective bargaining agreement in effect on the date of enactment, the effective date is further postponed until the expiration of the agreement (without regard to any extension of the agreement agreed to after the effective date) but, in any event all plans are to be subjected to these provisions for plan years beginning after December 31, 1980.

In the case of a government plan, the provisions of the committee bill are not to apply to plan years beginning prior to January 1, 1981. These plans can generally only be amended by a legislative act, and the committee believes it is appropriate under these circumstances to afford such plans additional time to comply with the vesting requirements of the bill.

The committee bill also provides a transitional rule under which any plan which provides, on the date of enactment, for 100 percent vesting of employer contributions by the end of the 10th plan year in which the employee is a participant is not subject to the vesting schedule provided under the bill, with respect to employer contributions, until plan years beginning after December 31, 1980. Plans which provide full vesting after 10 years of participation are generally considered liberal under current standards and the 10-year-100-percent formula is commonly used in pension plans today. Thus, the committee believed that it was appropriate to give these plans additional time to comply with the vesting provisions of the bill. Such plans will have to comply with the participation requirements, and the vesting requirements with respect to employee contributions, however, as of the generally applicable effective date.

Revenue effect

Estimates of the revenue effect of the minimum vesting provisions vary with the assumption made about the relationship between additional employer contributions to pension plans and cash wages. If it is assumed that the additional employer contributions will be a substitute for cash wages, the estimated revenue loss is $130 million. On the other hand, if it is assumed that the additional employer contributions will be an addition to cash wages, the estimated revenue loss will be $265 million. The estimates under both cases assume that benefits under pension plans are not decreased and that no benefit increases are foregone as a result of the bill. The estimates are based on 1973 levels of income and employment.

D. Funding

(Secs. 241, 281 and 671 of the bill and secs. 275, 404, 4971, 4972, 6058, 6692, and 7517 of the Code)

Present law

The annual contributions to a qualified pension plan generally must be sufficient to pay the pension liabilities accruing currently (the normal pension costs) plus the interest due on unfunded accrued pension

[56] liabilities (past service costs). This keeps the amount of unfunded pension liabilities from growing larger, but does not require any contributions to be made to amortize the principal amount of the unfunded liabilities.

Pension plan costs generally are estimates and are based on actuarial calculations. Consequently, all actuarial methods, factors, and assumptions used must, taken together, be reasonable and appropriate in the individual employer's situation. When applying for a letter of determination from the Internal Revenue Service that a plan is qualified, the actuarial methods, factors, and assumptions used generally must be reported to the Service, along with other information to permit verification of the reasonableness of the actuarial methods used. Changes in actuarial assumptions and methods must be reported annually to the Service.

The value of plan assets also affects the amount of contributions. Under administrative rulings, assets may be valued by using any valuation basis if it is consistently followed and results in costs that are reasonable.

Actual experience may turn out to be different from anticipated experience, resulting in experience loss or experience gain. Depending on the circumstances, the contributions needed to make up experience losses may be deducted currently or may be added to past service costs and deducted only on an amortized basis. Similarly, depending on the circumstances. experience gains may reduce the plan cost currently, or reduce costs under one of the spreading methods used to determine the amounts deductible.

If an employer does not make the minimum required contributions to a qualified plan, under administrative practice the deficiency may be added to unfunded past service costs. However, the plan also may be considered terminated, and immediate vesting of the employees' rights, to the extent funded, may be required.

General reasons for change

The available evidence has demonstrated that a significant portion of existing pension plans have not been adequately funded and are not accumulating sufficient assets to pay benefits in the future to covered employees. As a result, many employees now covered by pension plans may not actually receive the pensions they have been promised, because the needed funds will not be available. The committee believes that the present minimum funding requirement for plans qualified under the Internal Revenue Code is not adequate to prevent this underfunding, since it does not require any payment to reduce the amount of the outstanding unfunded liabilities, which may be substantial. As a result, the committee's bill provides that unfunded past service liabilities must be amortized over no more than 30 years (and experience deficiencies must be amortized over no more than 15 years).

The committee recognizes that the amount required to fund a pension plan is in large part determined by actuaries' estimates of future plan costs, which in turn are based on the actuarial methods and assumptions used for each plan. Consequently, the determination of the amount of contributions that must be made to a plan to adequately fund the plan benefits is significantly affected by the plan's actuary.

[57] There is no existing government regulation or licensing requirement for actuaries as there is for, *e.g.*, lawyers and accountants, and the committee believes that minimum standards of competence should be established for persons who make actuarial computations for qualified plans. Consequently, the committee's bill requires the Secretary of the Treasury to set standards of competence for persons who make actuarial reports to the Internal Revenue Service. The bill also provides that actuaries enrolled to practice before the Service must certify the plan costs and report the actuarial methods and assumptions used for each pension plan. The committee also intends that the Secretary establish an actuarial advisory board to provide assistance in setting standards for enrolling actuaries, setting guidelines for actuarial assumptions and in other pertinent matters.

Additionally, the committee believes that current sanctions on an employer for failure to adequately fund his qualified plan are inappropriate, since they may not affect an employer's decision to underfund his plan. For example, an employer may not feel any reason to make the minimum required contributions to his plan if the only consequence of underfunding is to give his employees vested rights in the amounts that are already funded. To resolve this problem, the committee's bill provides an excise tax on the failure to meet the minimum funding requirements.

The committee also recognizes that, within limits, employers who are financially unable to meet the funding requirements should be allowed to postpone paying contributions to their plans. Therefore, the committee's bill allows the Internal Revenue Service to waive certain minimum funding requirements if the employer demonstrates that substantial business hardship will otherwise result. The amount waived must be amortized over no more than 10 years.

Explanation of provisions

Minimum funding rules, in general.—The committee's bill establishes new minimum funding requirements for qualified pension, profit-sharing, and stock bonus plans so these plans will accumulate sufficient assets within a reasonable time to pay benefits to covered employees when they retire. These rules apply to any pension, profit-sharing, or stock bonus plan which, after December 31, 1975, has qualified (or has been determined to qualify by the Internal Revenue Service) under section 405(a), section 404(a)(2) or section 401(a) of the Code. The minimum funding requirements will continue to apply to such plans and trusts even should they later lose their qualification.

Generally, under these requirements the minimum amount that an employer must annually pay under a defined benefit pension plan includes the normal costs of the plan (as under current law), plus amortization of past service costs, experience losses, etc. The minimum amortization payments required by the bill are calculated on a level payment basis—including interest and principal—over various stated periods of time. Generally, initial past service costs (and past service costs established by substantial plan amendments) must be amortized over no more than 30 years, and experience losses must be amortized over no more than 15 years. If an employer would otherwise incur substantial business hardship, the Internal Revenue Service may waive

[58] payment of normal costs, and amounts needed to amortize past service costs and experience losses; the amount waived must be amortized in no more than 10 years, and no more than 5 waivers may be granted for any 10 consecutive years.

For money purchase pension plans and profit-sharing and stock bonus plans, the minimum amount that an employer must annually contribute to the plan is the amount that must be contributed for the year under the plan formula. For purposes of this rule, a collectively bargained plan which provides an agreed level of benefits and a specified level of contributions during the contract period is not to be considered a money purchase (or other type of defined contributions) plan. This type of plan is subject to the funding provisions of the bill, and must make contributions which are adequate to fund the agreed benefit on the basis required under the bill.[1]

Under the minimum funding rules, each plan must maintain a new account called a "funding standard account." This account is established to aid both the taxpayer and Internal Revenue Service in administering the new funding rules. The account also is used to assure that a taxpayer who has funded more than the minimum amount required is properly credited for that excess and for the interest earned on the excess. Similarly, where a taxpayer has paid too little, the account will assist in enforcing the funding standards, and will assure that the taxpayer is charged with interest on the underfunding.

Each year the funding standard account is charged with the liabilities which arise in meeting the minimum funding requirements. Also, each year the funding standard account is credited with contributions under the plan and with any other decrease in liabilities (such as amortized actuarial gains). If the plan meets the minimum funding requirements at the end of each year, the funding standard account will show a zero balance (or a positive balance, if the employer has contributed more than the minimum required). If the plan is underfunded, the funding standard account will show a deficiency.

The funding rules established by the bill are in addition to the present rules which provide the maximum deduction limits for contributions to a plan. However, in any event a contribution that is required by the minimum funding rules is deductible currently.

If the employer wishes to contribute and deduct more than the minimum required, the amount deductible will continue to be subject to the rules of present law (slightly modified by the committee bill). In general, under present law the maximum annual deduction available is normal cost plus 10 percent of accrued unfunded past service costs.[2] Since the 10 percent figure includes interest as well as principal, depending on the interest rate, it is estimated that an employer usually may deduct amounts needed to fund accrued past service costs over 12 to 14 years. As a result, the maximum allowable annual deduction which may be taken to fund past service costs generally is significantly higher than the minimum contributions required to fund these costs. If the contributions made are greater than the maximum allowable deductions in any year, as under present law, the excess may be carried over to future years and deducted at that time.

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[1] The only exception might be an instance where employers, in the aggregate, had no substantial voice in the determination of the levels and forms of benefits.

[2] This is the deduction limit under sec. 404(a)(1)(C) of the Code: in some circumstances, greater deductions are allowed under sec. 404(a)(1)(B).

[59] *Funding normal costs and initial past service costs.*—The committee's bill specifically continues the requirement of present law that the normal costs (arising from current liabilities) of a defined benefit pension plan must be currently funded. However, in order to give assurance a plan will have sufficient assets to pay benefits, the bill establishes new minimum requirements for funding accrued past service costs. In general, the bill requires that an employer's contributions to a defined benefit pension plan for initial past service costs be sufficient to amortize these costs, on an accrued basis, over no more than 30 years from the date that the plan is established. For plans in existence on the date of enactment, unfunded past service costs existing as of the first plan year beginning after December 31, 1975, are to be treated as initial past service cost to come under the minimum funding rule and to be amortized over no more than 30 years.

The minimum funding requirement for initial past service costs in effect is analogous to payment over 30 years of a loan secured by a home mortgage. It requires the payment of a level amount over 30 years, and each payment includes both interest and principal. For example, if the past service cost is $1,000,000 at the time a plan is established, the minimum level payment that must be made each year, for 30 years, to meet the funding requirement (calculated at an interest rate of 6 percent per annum over the 30-year period) is $68,537 per year (assuming contributions are made at the beginning of each year). In addition, the employer would be required to contribute annually to the plan an amount equal to the normal cost of the plan.

The interest rate to be used in calculating the minimum payments under 30-year amortization is the same rate as that used in determining the plan cost, at the time the plan is established, or January 1, 1976, in the case of plans in existence prior to that time. (Similarly, the interest rate used to amortize past service costs arising from amendments, to amortize experience deficiencies, and to amortize contribution waivers also is the rate used to determine plan costs at the time the liability in question first arose.) If the interest rate used to determine plan costs is changed as of a later date in order to conform with experience, the initial amortization schedule of level payments is not to be changed prior to that date, but the consequent increase (or decrease) in plan costs is to be classified as an experience deficiency (treated in the manner described below).

Under the committee's bill, the minimum funding rules—both those which apply to all past service costs and those which apply to normal costs—require funding on the basis of accrued (that is, both vested and nonvested) liabilities, not merely on the basis of vested liabilities. The use of accrued liabilities for this purpose appears appropriate because it provides the most orderly and comprehensive method for funding the plan's entire costs. In this way, gradual payments will be made to fund all of a plan's present liabilities, including the presently nonvested accrued liabilities which are expected to vest in the future. Moreover, funding on the basis of accrued liabilities tends to produce somewhat more rapid funding, and as a result provides more protection to plan participants.

Generally, the 30-year amortization requirement initially adds only moderately to an employer's existing funding cost. This is true because under present law interest on unfunded accrued past service

[60] costs (which accounts for the bulk of the level amortization payments required under the bill in the early years) must be contributed to a qualified pension plan. Therefore, the committee believes that 30-year amortization will not hamper an employer in starting a new plan, or in adding a plan amendment, that includes past service costs.

Plan amendments.—The committee bill provides that plan amendments that create substantial changes in past service costs are to be treated in the same manner as in the case of past service costs of new plans for purposes of the minimum funding rules. To establish an objective standard for "substantial" (for this purpose only), the bill provides that these are additional past service costs attributable to plan amendments which increase past service cost by at least 5 percent (at the time of amendment). Under the minimum funding rule these costs are to be amortized (separately) over a 30-year period from the date the amendment is adopted (even if this precedes the date on which benefits increase). Smaller plan amendments are to be amortized over the same period as experience losses (see next section below).

For example, where the unfunded accrued past service cost existing at the time of an amendment is $1,000,000, if the unfunded accrued past service cost added by an amendment is $100,000 (which is more than 5 percent of $1,000,000), the employer is to amortize this increase in past service cost in 30 annual payments of $6,854 (assuming an interest rate of 6 percent and that contributions are made at the beginning of each plan year).

Plan amendments which decrease past service costs (by decreasing plan benefits) are treated consistently with plan amendments increasing benefits; that is, those amendments which result in a decrease of 5 percent or more (at the time of amendment) are to be amortized over not less than 30 years. If the decrease is less than 5 percent, the decrease is to be amortized over the same period as experience gains. Consequently, the minimum amortized annual payments that must be contributed by an employer who decreases plan benefits generally will not be less, in any one year, than amortized payments required for an employer who started out with a plan providing the same (lower) benefits. (Of course, a decrease in benefits will usually decrease the normal cost which must be funded annually.)

Experience losses and gains.—During the course of a pension plan, actual plan experience often turn out to be poorer than anticipated. For example, the value of plan assets may turn out to be less than expected. Where this occurs, there will be an "experience loss" which must be funded if the plan is to pay the benefits owed. The committee's bill provides that under the minimum funding rule these losses are to be amortized (with level annual payments, including principal and interest) over not more than 15 years from the date the deficiency is determined, or over the average remaining service life of the plan participants if this is a shorter period.

The committee believes that a 15-year amortization period generally will provide adequate funding of experience losses, while at the same time protecting employers from potentially harsh financial burdens arising from uncontrollable events. However, where the average remaining service life of the participants is shorter than 15 years, the committee believes that it is appropriate for experience losses to be

[61] funded over the shorter period, to be sure that the plan will accumulate assets at a sufficiently rapid rate to provide the plan benefits.

The 15-year period will prevent discrimination against pension plans such as "final pay plans" which increase accrued benefits as pay increases, and thus are generally desirable from the employer's view. Under final pay plans, an unexpected increase in pay can cause an experience loss that significantly increases plan costs. On the other hand, plan costs increase much less under other types of plans which are less favorable to the employees, such as career average plans. If a short period of time were required to amortize experience losses, it is feared that employers may be given a substantial incentive to shift out of final pay plans, to the detriment of their employees. However, the committee understands that with 15-year amortization, employers generally will not tend to avoid using final pay plans.

Additionally, it is believed that under the 15-year requirement employers will not be subject to unnecessary financial burdens where they have experience losses beyond their control. For example, if a plan is almost fully funded (with a high ratio of assets to liabilities), decreases in the market value of plan assets could require very substantial increases in employer contributions if the decrease in value were to be amortized over less than 15 years. With this same longer run point of view the committee concluded that short-run fluctuations in market value are not likely accurately to reflect the long-range value of the assets. As a result, the bill provides that, in determining experience deficiencies, plan assets are to be valued by using a moving average over 5 or fewer years. The 5 year moving average is discussed below.

A pension plan also may have experience gains during the course of its operation. These gains would occur because experience is more favorable than anticipated. For example, the value of plan assets may be greater than expected. The bill treats experience gains symmetrically with experience deficiencies, so that gains are spread over no less than 15 years from the date they are determined (or average remaining work life, if shorter).

The bill provides that changes in accrued plan liabilities resulting from changes in actuarial methods and assumptions are to be treated as experience losses (or gains). Generally, assumptions are only changed to reflect differences between assumptions and experience. Additionally, the bill provides that changes in plan cost that result from changes in the Social Security Act (or other retirement benefits created by State or Federal law) or in the definition of wages under section 3121 of the Code are treated as experience losses (or gains).

Waiver of funding requirements.—At times an employer's financial circumstances may prevent him from meeting the minimum funding requirements. The committee does not believe that in such a situation an employer should be forced to abandon his plan. To deal with cases of this type the bill provides that upon a demonstration by the employer of substantial business hardship, the Internal Revenue Service may waive all or part of the minimum funding requirements for a year, including normal costs, amortization of past service costs and amortization of experience losses. However, to limit the underfunding which may occur in cases of this type, the bill provides that

[62] the Service may not waive all or part of the funding requirements for more than five years (whether or not consecutive) in any ten-year period. Also, the Service may not waive amortization of previously waived contributions.

In determining whether a waiver should be granted, the committee contemplates that substantial business hardship generally will only occur in situations where the employer did not foresee, and could not reasonably have been expected to foresee (at the time the plan or plan amendment which gave rise to the liability in question was established), the event which causes the business hardship. The committee contemplates that the Service will grant a waiver of funding normal cost only in unusual situations and will make a separate determination for each instance of waiving normal costs. Additionally, the committee expects that only in rare situations will the Service waive normal cost for more than one or two plan years based on the same business hardship.

The committee intends that in all cases the Service will condition a waiver of funding requirements by providing that the employer may not amend any plan in a way that would increase plan liabilities as long as there are any unfunded waived contributions outstanding under any of his qualified plans. (However, the committee contemplates that regulations will provide that an employer may reduce waived liabilities at a rate faster than that provided by the minimum funding requirements.) It is also expected that in considering whether a waiver should be granted, the Service will weigh as a factor against the waiver any recent plan amendment (i.e., within three years before the request for waiver) that increases plan liabilities; however, as a condition of waiver the Service may require plan amendments that eliminate these previous recent increases in liabilities and is to condition the waiver on the absence of future plan amendments increasing liabilities until the amount waived has been paid with interest. If a plan were to violate a condition of waiver, the committee intends that the amount waived and not yet amortized immediately become part of the current minimum funding requirement in the year the condition is breached (consequently this amount would immediately be charged to the funding standard account).

The amount waived by the Service must be amortized in no more than 10 equal annual payments (including interest and principal), beginning the year after the year the waived contributions were due. If a shorter period were required, after several years of waiver an employer's total contributions could be so high that it would be quite difficult to meet this obligation, particularly if the employer were just returning to financial stability. The bill provides that the amortization of the amount waived may not itself be waived in subsequent years.

The committee's bill provides a special relief provision for multiemployer plans in existence on the date of enactment and established under a collective bargaining agreement. Under the bill, the Internal Revenue Service may allow a period greater than 30 years to amortize the past service costs of such a plan existing on the effective date. This extension of time may be given at the discretion of the Internal Revenue Service, upon a finding that two requirements are met. First, in

[63] the first year that the new funding requirements apply to the plan, these new requirements must require contributions to the plan to increase by more than 10 percent over the contributions that would have applied under present law (using the method for determining plan contributions used for the previous year). Second, for this special relief to be available, 30 year funding must be shown to impose a substantial business hardship upon a substantial portion of the employers contributing under the plan.

The Internal Revenue Service, upon finding that these two requirements are met, may allow amortization of initial past service costs over a period longer than 30 years to the extent that it is necessary to alleviate the substantial business hardship otherwise imposed on a substantial portion of the employers. The committee believes that a strong showing of hardship must be made for long extensions to be made available and it is intended that only rarely are amortizations of more than 45 years to be allowed. Furthermore, as is the case generally with waivers, the committee intends that if the plan is amended to increase plan liabilities during the period that the waived liabilities are unfunded, the waiver is immediately to terminate and the waived liabilities are to become a part of the current year's minimum funding requirements.

It is intended that applications for waiver be made before the last day for timely contribution of the amount in question, and be acted upon expeditiously by the Internal Revenue Service.

The funding standard account.—As previously indicated the committee's bill requires that each qualified defined benefit pension plan must maintain a funding standard account. The purpose of this account is to facilitate the determination of whether a plan has met the minimum funding standard. A plan will meet the minimum funding requirements only if, at the end of each plan year, the account does not, on a cumulative basis, have an excess of charges for all plan years over credits for all plan years. The account is to be charged each year with the normal costs for that year and with the minimum amortization of past service costs, experience losses, and waived contributions for each year. On the other hand the account is to be credited with the contributions made for the year, with amortized portions of cost decreases, resulting from plan amendments and experience gains, and with any waived contributions.

To determine if the plan meets the minimum funding requirements, the funding standard account is to be reviewed as of the end of a plan year. However, an employer may contribute to a plan after the end of his taxable year and up to the date of filing his tax return, and these contributions are to relate back to the previous taxable year. This should provide an employer with sufficient time to reconcile the funding standard account and make the contributions needed to avoid underfunding.

If the account has a positive balance at the end of the plan year, the employer will have contributed more than the minimum funding standard requires. Since the contributed amounts will earn income in the trust, the bill provides that the positive balance is to be credited with interest,[3] which will reduce the need for future contributions to

[3] As with the amortization requirements, the interest rate to be used is the interest used to determine plan costs.

[64] meet the minimum funding standards. On the other hand, if the funding standard account has a deficit balance, the employer will have contributed less than required under the minimum funding rules, and the deficiency is to be charged with interest. Interest is charged in this case because the deficiency will become larger over time by the amount of income the trust would have been earned had the minimum requirements been complied with and the employer will have to pay more to the trust than just the amount he failed to contribute in the plan year.

An example of the operation of the funding standard account for a defined benefit pension plan is described below.

It is assumed that in 1978 the plan is established with a past service liability of $1 million and a normal cost of $70,000. The interest rate used to determine liabilities under the plan for 1978 and for all years in this example is 6 percent per year. In the first plan year, the employer contributes $138,537. The plan's funding standard account for 1978 will be as follows:

Credits:	
Employer contributions	$138, 537
Charges:	
Normal cost	70, 000
Amortization—initial past service cost (30 years)	68, 537
Total	138, 537
Net Balance	0

In the year 1979 the plan is amended, increasing past service liabilities by $100,000 (an increase of more than 5 percent of the past service cost existing at the time of amendment). The plan's normal cost for benefits as amended is $75,500. There is a net actuarial gain of $5,000 over the prior year, and the average remaining future service lifetime of plan participants exceeds 15 years. In this year, the employer's contribution is $165,975. The plan's funding standard account for 1979 will be as follows:

Credits:	
Employer contributions	$165, 975
Amortization—actuarial gain (15 years)	486
Total	166, 461
Charges:	
Normal cost	75, 500
Amortization—initial past service cost	68, 537
Amortization—past service cost from amendment (30 years)	6, 854
Total	150, 891
Balance	15, 570
Interest on balance	[1] 934
Net balance	16, 504

In 1980 the normal cost of the plan is $76,200. There is an actuarial loss for the preceding year of $10,000 and the average remaining future service lifetime of plan participants exceeds 15 years. The

[1] This assumes that all amounts other than interest are charged and credited at the beginning of the year.

[65] employer contribution is $135,572. The plan's funding standard account for 1980 will be as follows:

Credits:	
Employer contributions	$135,572
Amortization—actuarial gains	486
Total	136,058
Charges:	
Normal cost	76,200
Amortization—initial past service cost	68,537
Amortization—past service cost from amendment	6,854
Amortization—actuarial loss (15 years)	971
Total	152,562
Net	−16,504
Balance from previous year	16,504
Balance	0
Interest on balance	0
Net balance	0

The funding standard account—special rules—insured plans.—If the qualified plan is funded with certain individual insurance contracts (described below), the committee's bill provides that the funding standard account is to be annually charged only with the annual contract premiums, and is to be credited with the premiums paid—thereby maintaining a zero balance in the account through the life of the plan if the premiums are timely paid. The committee believes that this is the correct result since if qualified insurance contracts are used to fund a plan, the plan generally will be properly funded.

The contracts that are to qualify for this treatment are level premium, individual insurance contracts where the premium is paid from the first date of an individual's participation in the plan (and from the time an increase in benefits becomes effective) and is not paid beyond the individual's retirement age. Also, the benefits under the plan must be the same as the benefits provided by the individual contracts at normal retirement age. In addition, the benefits must be guaranteed by the insurance company to the extent that premiums are paid. For the contracts to qualify, the insurance company must be licensed to do business in the State (or the District of Columbia) where the plan is located. Furthermore, premiums for all plan years must have been timely paid (or the policy reinstated), rights under the contracts must not have been subject to a security interest during the plan year, and no loans must have been made on the policy during the plan year. (If any of these requirements are not satisfied, then the normal rules with respect to the funding standard account must be followed by the employer.)

The funding standard account—special rules—full funding limitation.—In some cases, the difference between the total liabilities of the plan (normal cost for all years plus all accrued liability) and the total value of the plan assets may be smaller than the minimum funding requirements for the year. For example, this could occur where the plan assets had increased substantially and unexpectedly in value. Where the excess of total plan liabilities over assets is less than the minimum

[66] funding requirement otherwise determined, the committee believes that an employer should not have to contribute more than the amount of this excess liability, for upon contribution of this amount the plan will become fully funded. As a result the bill provides that the amount to be charged to the funding standard account (and to be contributed), is to be limited to the difference between the total liabilities of the plan and the value of the plan assets.

In a year in which the value of the assets of the plan equals or exceeds the total plan liabilities, the amortization schedules for charges and credits to the funding standard account are to be considered as fully amortized, and these schedules are to be eliminated from the calculations under the funding standard account. However, if the plan is amended in later years to increase plan liabilities, a new amortization schedule would be established with respect to this increase in liabilities. For years after the full funding level is reached, the funding standard account will continue to be charged with the normal cost of the plan. Consequently, unless asset values increase correspondingly with the increase in plan liabilities, eventually the full funding limitation will not be applicable and the employer will have to make contributions to the plan to meet the minimum funding requirements.

If the employer fails to make the required contributions and the full funding limitation is applicable, the excise tax on underfunding, described below, is to be based only on any amount that should have been contributed, given the full funding limitation.

For the purpose of calculating the full funding limitation, the bill provides that plan liabilities are to be determined under the funding method used by the plan to determine normal costs for the year, if the liabilities can be directly calculated under this funding method. However, if this cannot be done under the plan's funding method, in order to allow the full funding limitation to apply, the bill provides that the accrued liabilities are to be calculated under the entry age normal method, solely for the purpose of determining the application of the full funding limitation. Additionally, the committee believes that short-run fluctuations in the value of plan assets will not accurately reflect value for the long-range purposes of retirement plans; consequently, assets are to be valued on the basis of a moving average for 5 or fewer years, determined in accordance with regulations prescribed by the Secretary of the Treasury.

The funding standard account—special rules—multiemployer plans.—In the case of a multiemployer plan maintained pursuant to a collective bargaining agreement, in maintaining the funding standard account, a plan year would be considered to extend for the term of the collective bargaining agreement. This provision is intended to adapt the minimum funding standard to those multiemployer plans where contributions are fixed by contract in accordance with a fixed standard, such as a specific dollar amount per hour of covered employment or a specific dollar amount per ton of coal mined. Under such a plan, if the actuarial assumptions were reasonable and the actuarial calculations were correct as of the beginning of the term of the agreement, and the agreed contributions were made, there would be no deficiency in the funding standard account for the term of the collective bargaining agreement. Any experience deficiencies could be made up

[67] by adjustment of the contribution rate or the level of benefits for the term of the next agreement. The special definition of plan year would not affect the required periods of amortization or the computation of the excise tax.

The funding standard account—money purchase pension, profit-sharing, and stock bonus plans.—Generally, the funding standard account for money purchase pension plans and profit-sharing and stock bonus plans is to be charged annually with the amount that must be contributed for the year under the plan formula, and is to be credited with the amount that is paid. As a result, employers who have these plans must annually make the minimum payments required under the plan. If the employer does not make sufficient contributions to meet the minimum funding requirements, he is to be subject to the excise tax described below. However, the Internal Revenue Service may waive the contributions required, in the same manner as it may waive these contributions for defined benefit pension plans.

Valuation of assets.—Plan assets are to be valued under a moving average over 5 or fewer years in determining the minimum funding contributions and for purposes of determining the allowable deductions under a plan. The period chosen must be used consistently by the plan. The moving average method will be established under regulations issued by the Secretary of the Treasury. One possible way this might be defined would be as the average value of the entire portfolio as of the current valuation date and the preceding four valuation dates, with adjustment made for contributions under the plan and benefits paid under the plan. The adjustments might be made annually or more frequently. Income under the plan might be treated in the same manner as unrealized appreciation; administrative and investment expenses might be treated in the same manner as unrealized depreciation. It is contemplated that the regulations will provide that even if an asset is disposed of by the plan, the value of that asset will be used in calculating the prior year's portfolio values; this would appear necessary to prevent avoidance under the moving average method by changing the portfolio composition in a manner either that realizes only losses or only gains, depending on whether it is desired to move the asset balance up or down.

Government plans.—It has been argued that government plans should be exempt from funding standards since the taxing power can be viewed as a practical substitute for these standards. On the other hand, the committee is concerned with reports that in the case of a number of governmental units, such generous pension promises have been made and so little funds have been set aside currently, that the practical likelihood of imposing sufficient taxes to pay those benefits may be open to question. In view of this conflict, the committee does not believe present law should be changed at this time regarding government plans which are qualified under the Federal tax laws, and, therefore, that these plans will continue to be governed by present law. However, the bill requires the Secretary of the Treasury to study whether these plans are adequately funded and to report his findings and recommendations to the Senate Committee on Finance and the House Committee on Ways and Means no later than December 31, 1976.

[68] *Actuarial considerations—enrollment of actuaries to practice before the Internal Revenue Service.*—Defined benefit pension plan costs generally are actuarial estimates of future costs of the plan. In estimating pension costs, actuaries must make assumptions ("actuarial assumptions") about a number of future events, such as the rate of return on investments ("interest"), employees' future earnings, and employee mortality and turnover. Actuaries also must choose from a number of methods to calculate future plan liabilities. The amounts required to fund any given pension plan can vary significantly according to the mix of these actuarial assumptions and methods. As a result, the assumptions and methods used by actuaries are basic to the application of minimum funding standards for defined benefit pension plans.

The committee believes that actuaries who perform services for qualified pension plans and report to the Internal Revenue Service regarding these plans should meet a reasonable standard of competence and be held to a standard of reasonableness in choosing their methods and assumptions. Consequently, the committee's bill requires that the actuarial assumptions which are used be reasonable in the aggregate; this restates present law. However, there is no existing government regulation of the actuarial profession as there is, for example, for lawyers and accountants. To resolve this problem, the committee's bill provides that the Secretary of the Treasury is to establish rules and regulations for actuaries to practice before the Internal Revenue Service and is to enroll persons who meet the standards of competence for practice before the Service (with regard to actuarial matters only).

The committee intends that actuaries be enrolled to practice before the Service under a procedure similar to that now used for enrollment of persons to practice before the Service who are neither attorneys nor certified public accountants. Generally, an examination will be required of persons who apply for enrollment, and proof of sufficient actuarial experience regarding pension plans may also be required. However, at the Service's discretion, the examination may be conducted by actuarial professional organizations, and not by the Internal Revenue Service. In addition, at the Service's discretion, the examination may be waived (for a limited period) for persons who present independent evidence that demonstrates they have special competence in actuarial matters relating to pensions because of their experience at the time the enrollment system is instituted. The committee contemplates that the procedure for enrollment of actuaries will appropriately recognize the need for independent, competent professional work, and consequently practice without enrollment will be allowed only in unusual cases.

The committee intends that the Secretary also establish duties relating to practice before the Internal Revenue Service by actuaries who are enrolled to practice. These duties may be similar to those required for attorneys, certified public accountants, and others who practice before the Internal Revenue Service, appropriately modified to take account of the special requirements of actuarial practice. For example, it is contemplated that the regulations will require an enrolled actuary to notify the Secretary if he discovers that an actuarial statement he prepared was not filed with the Secretary.

It is contemplated that the Secretary of the Treasury would reserve the power to suspend from practice before the Service any person en-

[69] rolled to practice as an actuary after due notice and opportunity for hearing. Discipline might be imposed upon an enrolled actuary shown to be incompetent, or who refuses to comply with the rules and regulations established by the Secretary. The committee intends that proceedings brought against enrolled actuaries will be instituted in the same general manner as proceedings against others practicing before the Service and will follow the same general procedure as other disciplinary proceedings. Generally, disciplinary proceedings would involve a complaint served on the actuary, an opportunity for answer, and an evidentiary hearing before a hearing examiner who would render a decision (appealable to the Secretary of the Treasury). An actuary involved in such a proceeding would have a right to be represented by counsel. It is contemplated that the discipline imposed could include suspension from practice before the Service, and that under appropriate circumstances a petition for reinstatement could be granted.

Actuarial considerations—reports of actuaries.—The Internal Revenue Service must receive detailed information on the actuarial assumptions and methods used to be able to evaluate whether the costs of a qualified defined benefit pension plan have been properly determined. To resolve this problem, the committee's bill requires periodic actuarial reports to be filed with the Internal Revenue Service by plan administrators. Actuarial reports must be made for the first plan year (or the first plan year to which this section applies) and every third thereafter. Under the bill the Secretary may require more frequent reporting if necessary. The Secretary might require more frequent reporting in particular cases (for example, where a plan has had frequent or substantial actuarial losses) or in all cases. If the plan administrator fails to file the required actuarial reports, he will be subject to a penalty unless failure was due to reasonable cause.

The periodic actuarial reports must be prepared by actuaries enrolled to practice before the Internal Revenue Service. The reports must include a description of the plan, a description of the funding method and actuarial assumptions used to determine costs under the plan, a certification that the plan is adequately maintaining a funding standard account, and any other information regarding the plan as the Secretary may require. For example, it is contemplated that the periodic reports will include detailed information on the basis for any change in actuarial assumptions.

The actuary who prepares the reports must certify that, to the best of his knowledge, the report is complete and accurate. He must also certify that, in his opinion, the funding method is reasonable and the actuarial assumptions used to determine the plan costs are reasonable in the aggregate. It is contemplated that the actuary will be subject to discipline and may be suspended from practice before the Internal Revenue Service if he falsely certifies a report.

Since a change in the actuarial method used can have a substantial effect on a plan's cost, the bill also provides that the Internal Revenue Service must approve, pursuant to regulations, a change in the plan's funding method before the new method may be used to calculate plan costs. Similarly, approval must be obtained for a change of the plan year. It is expected that the regulations under this provision will establish rules similar (but appropriately modified) to the regula-

[70] tions governing approval of changes in accounting methods. Therefore, it is expected that generally before a change in actuarial method or plan year will be approved a taxpayer must establish a substantial business purpose for the change and that consideration will be given to all the facts and circumstances with respect to the change. It is contemplated that a change in funding method is to be allowed only if it does not significantly adversely affect the funding of the plan. Also, the committee contemplates that upon approving a change in actuarial method or plan year, conditions are to be established to prevent distortion of income or distortion of funding of the plan.

The committee recognizes that frequently there is a range of actuarial assumptions which may be appropriate for determining the costs of a defined benefit pension plan, and the choice of the appropriate assumptions is very much a matter of judgment. In this circumstance, an employer may attempt to substitute his judgment for that of his actuary, which may lead to situations where plan costs are not being independently determined by an actuary. The committee believes that it is inappropriate for an employer to substitute his judgment in these matters for that of a qualified actuary, and the committee contemplates that if such a circumstance were to arise an actuary would have to refuse giving his favorable opinion with regard to the plan.

Actuarial considerations—actuarial advisory board.—The committee believes that the Secretary of the Treasury could be significantly aided in resolving a number of problems regarding actuaries and actuarial assumptions, etc., if he had the advice of experienced actuaries drawn from different areas of practice. Accordingly, the committee intends that the Secretary establish an advisory board chosen from among experienced actuaries in government, teaching, business and insurance, and independent consulting practice.

The committee intends that the board advise the Secretary in such matters as the enrollment system for actuaries, reasonable standards and criteria for determining actuarial assumptions to be used for plans, and determining what constitutes generally accepted principles of actuarial practice.

Enforcement.—The sanctions under present law on the failure to meet the minimum funding requirements appear to have little effect on an employer's decision to fund a plan at the required minimum levels. To resolve this problem, the committee's bill imposes an excise tax on the employer if he fails to fund the plan at the minimum required amounts (only if a waiver has not been obtained).

The tax initially is to be 5 percent of the accumulated funding deficiency—that is, the deficit in the funding standard account—at the end of the plan year. The 5 percent tax is to be imposed for each plan year in which the funding deficiency has not been corrected. For example, if a funding deficiency for 1978 is not corrected until the end of 1980, the tax with respect to the 1978 deficiency will be 5 percent of the deficiency for 1978, 5 percent (on the 1978 deficiency) for 1979, and 5 percent (on the 1978 deficiency) for 1980. Additionally, in any case in which the 5 percent tax is imposed and the accumulated funding deficiency is not corrected within the correction period allowed after notice by the Internal Revenue Service, a 100 percent tax is imposed on the

[71] accumulated funding deficiency. In accord with present law respecting the excise taxes with regard to private foundations, neither the 5 percent nor the 100 percent taxes are to be deductible.

The minimum period allowed for correcting any funding deficiency after notice from the Service is 90 days from the date of mailing the notice. However, this period may be extended for the time that the Internal Revenue Service determines is reasonable and necessary to eliminate the accumulated funding deficiency (and is automatically extended for any period in which a deficiency cannot be assessed under section 6213(a) relating to petitions to the Tax Court). It is intended that the Secretary require significant reasons before granting an extension under this provision, and that in no case is the extension to be for a period longer than 10 years from the year the deficiency first occurred, that regular payments must be made toward funding the deficiency, and that (as a condition of the extension) no amendment increasing plan costs will be permitted until the deficiency is paid off. To correct a funding deficiency the employer must contribute to the plan the amount of the deficiency plus interest to the date of payment, at the rate used to determine plan costs for the years the deficiency remained unpaid.

Effective date

The new minimum funding requirements generally apply to plan years beginning after the date of enactment of the bill. However, with respect to qualified plans in existence on the date of enactment, the new funding standards apply to plan years beginning after December 31, 1975. However, if the existing plans are maintained under a collective bargaining agreement, then the new funding standard applies to plan years beginning after December 31, 1980, or the date on which the agreement terminates, whichever is earlier.

Revenue effect

It appears clear that the new funding provisions will give rise to additional income tax deductions by employers in the immediate years ahead. However, the statistical data available do not provide any method for determining the size of this revenue effect. It is believed, however, that it will not represent a large revenue loss. In the longer run, it appears unlikely that the greater immediate funding expected under this bill will have any appreciable effect on revenues. Although funding occurs earlier under the bill than under present law, the income tax deductions taken by employers under the bill would for the most part also ultimately be taken.

E. Portability

(Secs. 151, 152, 153 and 301 through 310 of the bill and secs. 402 and 403 of the Code)

Present law

Under administrative practice, when an employee changes jobs his vested interest in his former employer's qualified retirement plan may in certain circumstances, be transferred to the retirement plan of his new employer without the employee being taxed on the transfer.

[72] For this to be done, both his former and new employers must agree to the transfer, the transfer must be possible under the terms of both the plans and trusts involved, and the Internal Revenue Service's administrative requirements as to the method of transfer must be met. However, transfers of employee interests between qualified plans upon changes in employment do not appear to be usual.

General reasons for change

The mobility of labor in the United States has been steadily increasing. From the standpoint of the economy, this is generally viewed as a desirable factor since it enables us to overcome labor shortages in limited areas or specific industries. It also tends to decrease frictional unemployment. However, those employees who move from job to job have had difficulty in earning vested retirement benefits, and even where these benefits are earned, they have faced difficulties in collecting the benefits upon retirement. On retirement, these employees will have to deal separately with each of their employers to arrange for their retirement benefits, and since each employer may have a different type of plan, working out retirement programs may be difficult for these employees. Also, the employees have had difficulties in contacting former employers if the employers have merged or changed name or address. Additionally, employees in some cases have not maintained sufficient records to enable them to determine from whom retirement benefits are due.

The committee's bill includes several provisions designed to help with these problems. First, the bill provides that employees who leave an employer may, with the consent of the employer (or directly if he receives a lump-sum distribution) have their vested retirement plan benefits transferred to a central portability fund. The employee can leave these amounts in the central fund until he retires or, with the consent of a new employer, can transfer his account to a qualified retirement plan of his new employer. Transfers between qualified plans and the central fund are to be tax free, and the central fund will be tax-exempt.

Second, the committee's bill allows an employee to receive a cash distribution from his former employer's plan and contribute it within 60 days to the plan of a new employer, without being taxed.

Third, the bill permits an individual, subject to limitations, where he receives a final distribution from an employer under a qualified plan, to contribute this amount to his own individual retirement account without these transfers giving rise to any tax.

Finally, the bill provides that the Social Security Administration is to keep records of the plans in which an employee has a vested interest, so upon retirement the employee (or his beneficiaries) will know who to contact for retirement plan benefits.

Explanation of provisions

Central portability fund, in general.—The committee's bill provides for a voluntary central portability fund that will enable an employee who changes jobs to consolidate all of his vested retirement benefits under one program. Under the bill, when an employee leaves an employer who has registered with the central fund, he may direct the employer's qualified plan to pay the value of his entire vested benefits

[73] to the central fund. (Alternatively, if an employer makes a final distribution to an employee, as explained below, the employee can contribute this amount to the central portability fund without tax consequences.) Thereafter, the employee may leave his account in the central fund until his retirement or may have the fund transfer his account to the qualified trust of a new employer (who has registered with the fund and consents to the transfer). The central fund will invest its assets, and income earned will be allocated to the participants' accounts. However, this income will not be taxed until it is distributed to the participants or their beneficiaries. Transfers between the fund and qualified plans will be tax free.

The central fund will be operated by the Pension Benefit Guaranty Corporation; its administrative expenses are to be provided for by appropriations. The Corporation is to establish the rules which govern the fund's operation, including its relations with individual participants and employers. To the extent its assets are not needed for current operations, the fund may invest its assets in obligations of the United States, or may deposit its assets in interest bearing accounts (or purchase certificates of deposit) of banks, savings and loan associations and credit unions which are part of the Federal insurance system (e.g., Federal Deposit Insurance Corporation). However, no more than 10 percent of the fund's investment may be deposited with any one savings institution.

An annual report is to be made to the Congress on the operation and status of the central fund; annual reports will also review and recommend changes in policies governing the fund's management. In addition, the committee intends that the fund will be subject to an annual audit.

The central fund also will assist employers, labor unions, and plan administrators to provide better retirement protection for persons who leave employment. This assistance may include developing reciprocity and portability arrangements between plans in the same industry or geographical area.

Portability fund, registration by employers.—Employers with an employee benefit plan that is qualified under the tax law may register with the central fund, pursuant to its rules, so their employees may participate in the fund's program.[1] If an employer is registered with the fund, the persons who leave his employment may require his plan to pay to the central fund an amount equal to their total vested interest in the employer's qualified plan (or plans), on a tax-free basis. Also, new employees of a registered employer may, with the employer's consent, transfer the value of their accounts with the central fund to a qualified plan of the employer, on a tax-free basis.

It is contemplated that an employer may register at the time an employee leaving employment desires to have the value of his total vested rights transferred to the central portability fund. Also, an employer may register with respect to all of his employees, or may register for only a group of employees, if the group is reasonably defined and has a special need for the central portability program. This limited registration will make it easier for an employer to register

[1] It is contemplated that a stock bonus plan will be able to sell stock held for an employee solely for the purpose of paying the total value of his interest to the central fund.

[74] with the central fund for employees who have the greatest need for the portability program. (An employer otherwise may be reluctant to register because if substantial numbers of all his employees were to use the program, it might significantly limit the plan's ability to pay benefits.) For example, an employer of engineers who frequently change jobs may wish to register with the central fund only with respect to these engineers. In this case, only the employees within the registered class would be able to use the central fund.

It is expected that an employer will be able to withdraw his registration at any time. Additionally, he may re-register with respect to all or part of his employees. However, if an employer withdraws and re-registers in order to discriminate against a particular employee or group of employees in an unlawful manner or in a manner that violates the nondiscrimination rules (sec. 401(a) (3) or (4) of the Code), the employer will be treated as having been registered during the whole period in question.

For an employer to register with the central fund, his plan and trust must be qualified under the tax laws. It is contemplated that the central fund will require the employer to demonstrate that these requirements are met, and that usually a determination letter from the Internal Revenue Service stating that the plan and trust are qualified will constitute satisfactory evidence. Where a plan loses its qualified status, registration will be terminated. It is expected that the Internal Revenue Service will periodically notify the central fund of plans which it determines are no longer qualified. If the plan regains qualified status, the employer may again register with the fund.

Transfers to the portability fund.—If an employer is registered with the central fund, an employee who is within the registration group and is no longer employed by the employer may require the employer's qualified plan (or plans) to pay to the central fund an amount equal to his total vested benefits in the plan. However, amounts equal to the employee's nondeductible contributions to the plan may be distributed to the employee and not to the central fund, since these amounts generally may be withdrawn by the employee without tax. If the payment to the fund does not fully discharge the plan's liabilities to the employee, and this was due to reasonable cause, it is contemplated that upon discovery of the error a reasonable period will be allowed for correction. Transfers to the central fund by a qualified plan will not be taxed. Payment to the central fund must be in cash or its equivalent. Payment must occur within 180 days of notice by the employee, and the employee must give notice to the plan no later than one year after termination of employment. As is indicated below, where a final payment has been made to an employee from a qualified plan, he can also contribute this amount to the central portability fund.

On receipt of an amount from a qualified plan, the central fund will establish a separate account for the employee. The amounts received will be invested by the fund, and accounts will be periodically adjusted, under the rules of the fund, to reflect changes in the financial condition of the fund.

The taxation of benefits ultimately paid to the employee will be affected by the source of the contributions to his account. Consequently, when amounts are transferred from a qualified trust to the central

[75] fund, the transferor (the former employer or the employee) will be required to provide the fund with information respecting this payment, such as the amount which constitutes the employee's contributions.

The central fund may receive transfers only from employee benefit plans (or from employees receiving final distributions from these plans) that are qualified under the Internal Revenue Code. If the fund receives notice from the Secretary of the Treasury that a final determination has been made that a plan was not qualified at the time that a transfer was made to the fund, the balance of each participant's account attributable to transfers from that plan (in the year the plan is not qualified) will be paid from the fund to the participant. The amount paid is to be included in the participant's income in the year it is paid to the participant. This generally follows present law, since plan participants currently are taxed as receiving ordinary income when they receive transfers from plans which are not qualified in the year of distribution.

It is intended that the fund may not receive transfers from a plan with respect to persons who have participated in the plan as self-employed persons (but employees of self-employed are covered) or as proprietary employees. Similarly, the central fund may not receive transfers from individual retirement accounts. These rules are necessary to prevent circumvention of the restrictions on owner-employees, proprietary employees, and individual retirement accounts. It is also intended that no amounts may be received by the central fund on behalf of a participant who is age 59½ or older. Under this limitation, the fund will be used to establish retirement programs, rather than becoming a depository for amounts which are transferred to the fund after retirement.

After a plan has paid a former employee's vested interest to the central fund, the plan generally will not have any further liability with respect to this employee.

Payments from the portability fund.—A participant in the central fund may leave his account with the fund until retirement. In this case, upon reaching age 59½ or becoming disabled the participant may direct the central fund to make a lump-sum payment to him in the entire amount of his account, or may direct that periodic payments of at least $100 be made to him. It is intended that these must be specified in advance but could be changed from time to time as designated by the participant. Alternatively, he may direct the fund to purchase an annuity contract on his behalf, and distribute the annuity contract to him. This may be a single premium life annuity payable during the participant's life and commencing no earlier than age 59½ (or disability) and no later than age 70½. (Or, this may be a single premium joint and survivor annuity payable during the lifetime of the participant and his spouse, beginning no sooner than the participant reaches 59½ (or becomes disabled) and no later than when he reaches, or would have reached 70½.) The participant may choose the insurance carrier which issues the annuity contract, but this carrier must be licensed to sell such contracts in the State in which the participant resides.

Amounts held by the central fund on behalf of a participant must be paid to him no later than age 70½. If the participant does not select

[76] the method of payment, the fund will pay him the total amount credited to his account, in a lump sum.

If the participant dies before the entire amount credited to his account has been distributed to him (or to a qualified plan), the remaining amount would be paid to his beneficiary, designated pursuant to the rules of the fund. At the direction of the beneficiary, the amount will be paid in a lump-sum, or in periodic payments of at least $100, or used to buy an annuity contract. The total amount in the account must be distributed to the beneficiary within 10 years after the participant's death.

A participant (or his beneficiary) is to be taxed on receiving a payment from the central fund in the same manner as if he had received the payment from a qualified trust. The participant or beneficiary is not to be taxed upon the purchase of an annuity contract by the fund from a qualified insurance carrier, but is to be taxed when the annuity payments are made. In addition, the provisions of section 2039(c) and 2517 of the Code will not apply to accounts with the central fund.

If a participant in the fund obtains employment with another employer registered with the fund, he may request that the amount in his account be paid to the qualified plan of his new employer. A request for transfer must be made within one year after the person becomes a participant in a qualified plan maintained by this employer, or one year after the new employer registers with the plan, whichever is later. With the consent of the new employer, the central fund is to transfer the amount credited to the participant's account to the new employer's plan, to purchase benefits under the plan. (Because the status of each employee under a plan may be different, depending upon his age and the status and terms of the plan, it is expected that an employer may consent on a case-by-case basis with respect to transfers from the fund to his qualified plan, but the consent must not violate the nondiscrimination rules that govern qualified plans.) It is intended that the actuarial value of the benefits purchased be equal to the amount transferred from the central fund; it is also intended that the benefits purchased be immediately vested. The transfer from the central fund to a qualified plan is not to be taxable to the participant.

Tax-free "rollover" for transfers between qualified plans.—The committee's bill also facilitates the reinvestment for retirement purposes of amounts received from a prior employer's qualified plan. Under the bill, an employee may receive, tax-free, a complete distribution of his interest from a qualified retirement plan, if he reinvests the full amount of the assets received in another qualified plan or in the central portability fund within 60 days after receipt. (However, amounts equal to the employee's voluntary nondeductible contributions to the plan need not be reinvested with another plan.)

To prevent avoidance of the restrictions on self-employed plans, proprietary employee plans, and individual retirement accounts, the bill limits the rollover in these cases. The rollover is not available for transfers of amounts from an H.R. 10 plan with respect to a person who has been self-employed under the plan. Similarly, the rollover is not available for transfer of amounts with respect to a person who has been a proprietary employee under the plan. The rollover is available

[77] for amounts transferred from a qualified plan to an individual retirement account (except for transfers by self-employed and proprietary employees as discussed above) and for transfers from one individual retirement account to another. However, the rollover is not available for transfers from an individual retirement account to any other type of plan.

The tax-free rollover is only available with respect to complete distributions of an employee's interest in a qualified plan that occur within a 12-month period after termination of employment. Therefore, the employee must receive the total amount of his account in the plan of his former employer within that 12-month period and must recontribute any amount received within 60 days of receipt.

If the employee does not receive the full amount of his account from the plan of his former employer within 60 days, he may contribute this to another plan or to the central fund in anticipation that he will receive a distribution of the entire amount of his account. However, if he is uncertain about whether he will ultimately receive the full amount of his account, it is intended that he may contribute the cash received to the central portability fund. If it turns out that the full amount is not distributed within a year, he will be taxed in the year of receipt on the amount he received, and any amount contributed to the central portability fund must be repaid to him.

Registration with Social Security.—The committee understands that, upon retirement, employees who frequently changed employment during their working years may have difficult problems in locating their former employers and the retirement plans in which they may have vested benefits. At times, this results from their former employers (or the plans) having changed name or address, or having merged with other organizations. At other times, the employees themselves may not have been able to maintain the records needed to enable them to contact their former employers. Alternatively, they may have forgotten that they had vested rights in plans with former employers.

To resolve this problem, the committee's bill provides that the Social Security Administration is to maintain records of the retirement plans in which individuals have vested benefits, and is to provide this information to plan beneficiaries.

The bill requires retirement plans to file an annual statement with the Secretary of the Treasury regarding individuals who have a right to a deferred vested benefit in the plan and who have terminated employment with the employer who maintains the plan. The Secretary of the Treasury will provide this information to the Secretary of Health, Education and Welfare; in this way it is contemplated that the statement can be filed together with other statements filed with the Secretary of the Treasury.

The annual statement must be made by each qualified pension, profit-sharing, stock bonus, or annuity plan, and pension plans operated by Federal, State, and local governments. The statement must include the name and taxpayer identification number (generally the Social Security number) of every individual who has terminated employment in the year for which the statement is filed and who has a right to a deferred vested benefit in the plan. The statement also must include any

[78] other information required by the Secretary of the Treasury, such as the amount of the individual's deferred vested benefits in the plan. However, the statement need not include information about persons who terminated employment if they received retirement benefits, such as annuities, from the plan during the year of termination. In addition, if a plan has filed an annual statement at any time, it must notify the Secretary of the Treasury of any change of name or address, any plan termination, or any merger or consolidation with any other plan.

Upon the request of the participant (and in accord with regulations), the social Security Administration will furnish him any information which it has relating to his vested retirement plan benefits. In addition, when a person applies for Social Security retirement, disability, death, or hospital insurance benefits, on determining whether these benefits are due the Social Security Administration will also inform the claimant of any information which it has relating to the vested retirement plan benefits of the worker whose wages form the basis of the claim.

These provisions will take effect in years beginning after the date of enactment of this bill. However, the bill provides that, before the effective date of the registration provisions, the Secretary of the Treasury is also to receive reports relating to the vested retirement benefits of any person who has terminated his employment with the employer.

Effective date

The effective dates of both the provisions regarding the central portability fund and the provisions relating to the tax-free rollover are taxable years beginning after December 31, 1974. The effective date of the Social Security Administration provisions is taxable years beginning after the effective date of this bill.

Revenue effect

The revenue effect of the central portability fund provisions, the tax-free rollover provisions, and the Social Security Administration registration is expected to be negligible.

F. Plan Termination Insurance

(Secs. 401 through 482 of the bill and secs. 162, 401, and 4981 of the Code)

Present law

Present law does not require pension, profit-sharing, etc., plans to insure their liabilities.

General reasons for change

If a pension plan terminates, for example, because of a closing of operations or a sale of assets by the employer, employees who are pension plan participants may receive nothing or receive less than they had expected if their rights are not fully funded at the time of the termination. The classic illustration of this danger resulted from the closing of the Studebaker plant at South Bend, Indiana, when some 4,000 employees between the ages of 40 and 60 received only approximately 15 percent of their vested benefits although the plan's vesting

[79] was fairly generous and the funding would apparently have been adequate had the plant remained in operation.

A joint study by the Treasury Department and the Department of Labor indicates that there were 683 plan terminations in the first seven months of 1972 that were reported to the Internal Revenue Service.[1] These terminations resulted in the loss of benefits with a present value of some $20 million, by about 8,400 pension claimants (participants, retirees, and beneficiaries) in 293 of the terminated plans. The average loss of benefits for claimants amounted to $2,400. About $11 million of the total losses were suffered by 3,100 claimants who were retired, eligible for retirement, or vested in their benefits. Their losses averaged $3,600 per person.[2]

On the average, retirees and beneficiaries lost 42 percent of the value of their current pensions, participants eligible for retirement lost 57 percent of the value of their benefits (one-tenth of them lost their entire benefits), participants who were fully vested but not yet eligible for retirement lost 65 percent of the value of their benefits (two-fifths of them lost their entire benefits), and former employees with deferred vested benefits lost 97 percent of the value of their benefits.[3]

This survey did not take into account the extent, if any, to which employees left the employer before their rights to benefits vested, during the year or so before formal termination of the plans. It was suggested to the committee during the hearings[4] that sometimes formal plan terminations are delayed while employees are laid off to reduce the aggregate amount of liabilities, by allowing forfeitures, thus increasing the benefits of those who remain.

The data thus far published from the Treasury-Labor study covers a short period (only 7 months) and there is no indication that this period is representative of the past or, more importantly, of what may fairly be expected for the future. Nevertheless, as imprecise as these data may be, they are the best available starting point in estimating the magnitude of the losses that might be expected for the future.

On the one hand, it is noted that only 0.04 percent of all pension plan participants suffered any losses (both vested and unvested) during this period. Also, on the basis of the losses suffered by retirees and their beneficiaries, participants eligible for immediate retirement, participants with vested benefits and former employees with vested benefits, it is frequently estimated that public losses covered by the insurance program would approximate $18–20 million a year. On the other hand, it is noted that, in the Studebaker case alone, more than 4,000 participants age 40 to 60 lost $14 million (then current value) of vested benefits—about 85 percent of the then current value of their vested benefits.[5] Also, if 0.04 percent of participants lost benefits on account of terminations in only 7 months, then perhaps one-quarter to one-third of a million participants may lose benefits over 20 years.

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[1] Department of the Treasury and Department of Labor, Study of Pension Plan Terminations, 1972—Interim Report, February, 1973; p. 2.

[2] Treasury-Labor Study, *op. cit.*, p. 18.

[3] Treasury-Labor Study, *op. cit.*, p. 23.

[4] See testimony of Prof. Merton Bernstein, June 4, 1973.

[5] Hearings on Private Pension Plans before the Subcommittee on Fiscal Policy of the Joint Economic Committee, 89th Cong., 2d Sess., pp. 103–106 (Clifford M. MacMillan, Vice President, Studebaker Corp.) and 123 (Willard Solenberger, Assistant Director of the Social Security Department, UAW). Also other workers under 40 lost some unspecified amount of vested benefits.

[80] With a strengthening of funding requirements, plan participants would be more assured of receiving their full vested benefits upon the termination of a plan. Nevertheless, so long as the new funding requirements do not (and could not, as a practical matter) provide for immediate funding of all unfunded vested liabilities, including past service liabilities and "actuarial deficiencies", plan participants will be endangered by premature plan terminations.

To deal with these problems, the committee bill requires that pension plan benefits be insured up to specified limits (in general, not more than the lesser of $750 per month or 50 percent of wages). The bill creates a corporation, the Pension Benefit Guaranty Corporation, to administer the insurance program and set premium-type taxes (initially, the tax rates are to be 50 cents or 70 cents per participant per year). It is expected that treating the insurance charges as taxes, rather than premiums, will greatly reduce the costs of collection.

Several provisions are designed to protect against abuse, among them are: (1) no coverage for benefit improvements put into effect in the 3 years before the plan fails and (2) residuary liability on an employer for a portion of any losses incurred by the insurance system on account of failure of his plan. A higher premium rate is established for those who wish to avoid this residuary liability, but the insurance then would not cover benefit improvements from plan amendments put into effect in the 5 years before the plan fails.

Different premium tax rates are to be permitted ultimately in the case of multiemployer plans.

Explanation of provisions

Administering agency.—To administer the insurance of employee benefits, the committee bill (sec. 402 of the bill) creates a Pension Benefit Insurance Fund, to be administered by a federal government corporation known as the Pension Benefit Guaranty Corporation (sec. 401 of the bill). This Corporation is to be governed by a board of directors consisting of the Secretaries of Commerce, Labor, and Treasury. The Secretary of the Treasury is to be the chairman of this board of directors unless the board should decide to appoint another chairman. The Secretary of Labor is to have the Corporation's bylaws published in the Federal Register not less often than annually.

To facilitate the carrying out of the duties of the Corporation, the committee intends that the Corporation and the Internal Revenue Service coordinate their requirements as to any forms that are required by either of those agencies, that either agency notify the other of any actions taken (or, generally, proposed to be taken) with respect to a pension plan or trust, and that other relevant information (such as W–2 forms filed by employers or sec. 6103 disclosure of tax return data) be made available by the Service under regulations to the Corporation.

Plans covered.—Pension plans (under sec. 401(a)) and employees' annuity plans (under sec. 404(a)(2)) that are "qualified" for the special tax treatment granted certain employee benefit plans under the Internal Revenue Code at any time after December 31, 1974, must participate in the insurance program (sec. 421 of the bill). For these purposes, a successor plan (i.e., a plan for substantially the same employees, which provides substantially the same benefits) is to be treated as the continuation of a predecessor plan. This type of con-

[81] tinuation may arise, for example, when a plan of one employer is merged into another plan of that employer (with or without a reorganization involving the employer) or is merged into a multiemployer plan.

Excluded from participation in the insurance program are: money purchase, profit-sharing, and stock bonus plans; government plans; and (under certain circumstances) church plans.

Money purchase, profit-sharing, and stock bonus plans are excluded from the insurance program since they generally are characterized by some type of promise with regard to contributions and no promise with regard to benefits—the participant is merely entitled to benefits determined by reference to his own account. Since no particular benefits are promised in these cases there appears to be no appropriate amount to insure. A collective bargaining plan where defined benefits are determined under a process in which the employers in the aggregate have a voice (e.g., under sec. 302(c)(5)(B) of the Labor Management Relations Act of 1947, where employers are required to have a substantial voice) in the determination of the forms and levels of benefits, is not to be treated as a money purchase plan for these purposes (in the insurance provisions, and elsewhere under the committee bill where distinctions are made between defined benefit plans and money purchase or other kinds of defined contributions plans), even though the collective bargaining agreement may specify only the level of employer contributions into the plan. Thus, these collective bargaining plans are covered by the insurance program.

In the case of government plans, it is believed that the ability of the governmental entities to fulfill their obligations to employees through their taxing powers is an adequate substitute for termination insurance.

At the option of an exempt church (or of a convention or association of churches), plans covering its employees may be included in the insurance coverage. The committee is concerned that the examinations of books and records that may be required in any particular case as part of the careful and responsible administration of the insurance system might be regarded as an unjustified invasion of the confidential relationship that is believed to be appropriate with regard to churches and their religious activities. However, if the church itself has determined to consent to such examinations, to the premium tax payments, and to the contingent employer liabilities, then it may elect to have the insurance program apply to its plan or plans. The Corporation is to prescribe the manner and time of the elections.

The insurance system is to apply to a church plan, even in the absence of such an election, if the plan is only for employees of the church's unrelated trades or businesses, or if the plan is a multiemployer plan and one of the employers in the plan is not a church.

Benefits covered.—In general, the insurance under the bill covers vested benefits, but not more than $750 per month and not more than 50 percent of wages (sec. 422). This limitation is placed on the insurance coverage because the insurance is not intended as a full replacement of a pension plan, but rather as covering the basic retirement benefits provided under it. However, in practice, it is expected that this will fully cover the great bulk of all benefit payments. In addition, there is an advantage in not fully covering all pension bene-

[82] fits in that this encourages those receiving the larger benefits, and who often are in a management position, to see to it that there is adequate funding of the pension plan.

In addition to vested benefits, the insurance covers such ancillary benefits as the plan may provide (of the type and to the extent that the plan could do so without losing qualified status) which the participant or his beneficiaries would be entitled to upon the occurrence of a specified contingency. Thus the insurance protection is to be comprehensive. The insurance is to cover the current value of the benefit and not necessarily the form of the benefit. For example, if the insurance covers a disability policy, under the insurance coverage there might be distributed to the beneficiary (if the plan fails) the current value of that policy. Similarly, the insurance of a basic annuity could be paid out in the form of a lump sum, an annuity contract from an insurance carrier, or periodic annuity payments.

As a way of applying the $750–50 percent limitations to the ancillary benefits, the bill provides that the actuarial value of the entire package of insured benefits is not to exceed the actuarial value of a monthly benefit in the form of a life annuity (with no ancillary benefits) commencing at age 65, equal to the lesser of $750, or 50 percent of the employee's average monthly wage during his highest paid 5 years of employment.[6]

In order to take into account inflation and the possibility of increases in costs of living, the $750-per-month maximum is to be adjusted according to changes in the contribution and benefit base for Social Security.[7] This adjustment is to bear the same ratio to the $750-per-month initial maximum as the Social Security contribution and benefit base for the year the plan terminates bears to the base for 1974. So, if the base in the year the plan terminates were to be $13,200 (an increase of about 4.8 percent over the 1974 base of $12,600), then the maximum insured annuity would be $786 per month (an increase of about 4.8 percent over the 1974 base of $750 per month).

To prevent avoidance of the limitations by including an individual in two or more plans, this maximum limitation is also to apply to all payments by the Corporation with respect to a participant, inclusive of all types of benefits and numbers of plans in which he participated. For example, the benefits of a participant entitled to retirement benefits under plans of two unrelated employers would be guaranteed only to the extent of the $750-per-month limitation, even though the participant had insured vested benefits of $500 per month under each of these plans (or $1,000 per month combined). If one plan were to fail with no assets available for payment of this benefit, the insurance system would pay $500 per month (or its equivalent). If the second plan were then to fail with no assets available for payment of this benefit, the insurance system would cover only $250 per month of the vested benefits under the second plan.

In order to prevent abuse of the insurance system, the committee bill provides that the insurance is not to cover benefits arising from a plan

[6] Under this rule, for example, a right to receive $750 per month beginning at age 60 would be less than fully insured, since it exceeds the value of a right to receive $750 per month beginning at age 65.

[7] Under section 230 of the Social Security Act (42 USC 430), as amended by section 202(b) of Public Law 92–336 and sec. 203(c) of Public Law 93–66, the contribution and benefit base for 1974 is to be $12.600. and is to be adjusted in multiples of $300 in proportion to changes in average taxable wages.

[83] or amendment put into effect less than 36 months before the plan fails. The committee was concerned that otherwise there might be a temptation to increase benefits irresponsiblly.[8]

The time a plan has been in effect is to include for this purpose the time a predecessor plan was in effect. For these purposes, a plan or amendment is treated as having been put into effect on the later of the date it is adopted or the effective date of the plan or amendment.

If, under the plan, benefits depend on the participant's wages and the participant receives a raise, the resulting increase in benefits is not considered as arising from a plan amendment. However, a scheduled future raise in benefits (or a future cost-of-living increase in benefits) is to be treated as arising from a plan amendment. In effect, the insured benefits are to be calculated in accordance with the facts as of the time the plan fails, but are not to exceed what would have been available under the plan provisions and benefit schedule in effect 36 months earlier.

For example, suppose that A begins to participate in a plan in 1980 and that the plan fails in 2000. In 1998, the formula for calculating benefits is changed from 1.5 percent of high 5-year average wages times years of service, to 1.6 percent of high 3-year average wages times years of service. Also, suppose that A receives a raise in 1998. In this case, since the changes from 1.5 percent to 1.6 percent and from high-five to high-three were adopted less than 36 months before the plan failed, the insured benefits would be calculated on the basis of 1.5 percent and the high-five years. However, since in this hypothetical the pre-1997 rules would take wage raises into account, the 1998 wage rate would be used in computing the high-five average.

As indicated below (under *Effective date*), the insurance system covers losses of plans failing after December 31, 1977. This postponed effective date is to allow the build-up of a fund out of which to pay the claims and also to gain experience in determining the appropriate premium tax rate.

Benefits under plans and amendments put into effect before January 1, 1973, are to be covered in full in the case of plan failures occurring after December 31, 1977. Benefit increases and plans put into effect after December 31, 1972 (in the case of plan failures occurring after December 31, 1977), are to be covered in full after 6 years, covered to the extent of 80 percent after 5 years, to the extent of 60 percent after 4 years, and to the extent of 40 percent after 3 years. These limits, relating to the time the plan and its amendments have been in effect, are to be applied before the limitations discussed above (the $750-per-month or 50-percent-of-wages limit and the treatment of several plans as one plan).

Under the bill, to encourage at least minimum funding, the amount of benefits otherwise payable by the insurance Corporation to an owner-employee[9] or a proprietary employee[10] is to be reduced but

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[8] See *Employer liability*, below, for a discussion of contingent employer liability for insurance system losses and for the circumstances under which a 60-month waiting period is to be substituted for this 36-month period.

[9] An owner-employee, in an "H.R. 10 plan", is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[10] A proprietary employee (discussed in I. Limits on Contributions, below) is a 2-percent owner of a corporation, where those 2-percent owners' accrued benefits in the plan have an aggregate present value of more than 25 percent of the present value of all benefits in the plan.

[84] only by his *pro rata* share of any accumulated funding deficiency [11] of the plan at the time the plan terminates. This is the same amount on which a 5 percent excise tax applies because of under-minimum funding. The deficiency, in such a case, is to be allocated among the owner-employees (or proprietary employees) in proportion to their benefits otherwise payable from the insurance fund. This limitation is to be applied to anyone who is an owner-employee (or proprietary employee) at any time during the plan year in which the plan terminates, or during any of the three next preceding plan years.

The committee bill generally covers accrued benefits of qualified plans (and certain types of employees' annuity plans under sec. 404(a)(2)). If a plan ceases to be qualified or ceases to meet the requirements of section 404(a)(2), then the insurance guarantee is not to apply to any benefits accrued after the date the Internal Revenue Service issues a notice that the plan has ceased to qualify or to meet the appropriate requirements. If this cessation of preferred status results from an amendment to the plan, then the insurance guarantee can be applied to post-notice accrued benefits if the amendment is, as of the date it was first effective, revoked or amended to comply with the requirements.

Allocation of assets.—To protect against evasion of the above-described limits on insurance benefits by use of pension fund assets to first pay uninsured benefits (e.g., those resulting from recent amendments, those exceeding the 50-percent or $750-per-month limits, or those which would be reduced because of an accumulated funding deficiency) the committee bill (sec. 444) sets forth an order of priorities for allocation of plan assets on failure of the plan. Plan assets are to be allocated, in order, to voluntary contributions of employees, mandatory contributions of employees, benefits "in pay status" for at least three years, and insured benefits (other than those falling into any of the prior categories). Where all these categories could be paid in full from plan assets, there would be no insurance corporation losses. Any remaining assets would then be allocated under any order of priorities that would allow the entire allocation to meet the antidiscrimination requirements.

The assets to be so allocated are those that are available for the payment of benefits; i.e., net of investment liabilities such as mortgages or commercial borrowings that may have been made in order to provide needed liquidity or to permit additional investments.

Accrued benefits derived from voluntary contributions of employees (and the plan assets represented by the contributions) are to be treated as being under separate plans which are not subject to these insurance provisions (this allocation section authorizes them to be set aside first, in the event of failure of a plan).

The second priority of allocations is for mandatory contributions of employees—the amounts contributed to the plan by the participants, which amounts are required as a condition of participation in the plan, or in order to obtain benefits under the plan attributable to employer contributions. The mandatory contributions are to be offset

[11] In general, an accumulated funding deficiency is the shortfall in employer contributions compared to the minimum the employer should have contributed to the plans. (See D. Funding, above.)

[85] by the amounts paid to the employee under the plan prior to the plan's failure. If the assets are insufficient to cover all the mandatory contributions, they are to be allocated among the participants in the same proportion as the mandatory contributions of the participants.

After the allocations of voluntary and mandatory contributions, any remaining assets are to be allocated to participants who began receiving benefits at least three years before the plan failure (without regard to the $750 and 50 percent limitations). This allocation is to be in accordance with the value (as of the date the plan fails) of the remaining benefits of each participant, at the benefit level in effect 36 months before the date the plan failed. In other words, increases in benefit levels during this 36-month period are not to receive this priority status. (Of course, those increases could, if appropriate, be paid under one of the other allocation priority categories.) As with mandatory contributions, if there are insufficient assets to meet these obligations, the assets available for this priority level are to be allocated pro rata in proportion to the present values of the benefits at this priority level.

The next priority category is for other benefits guaranteed under this pension insurance system. If the plan's assets are insufficient for this purpose, they are to be allocated pro rata in proportion to these other guaranteed benefits.

As indicated above, assets remaining after this allocation are to be allocated in accordance with the plan's provisions, to the extent that, together with the priority category allocations, they conform to the antidiscrimination requirements of the Internal Revenue Code.

Recapture of certain payments.—In order to prevent the use of lump-sum or other preferential distributions to evade the above-described limitations, the Corporation is authorized to recapture all or part of any distributions which commenced within the 3-year period immediately preceding the failure of the plan (sec. 445). If a lump-sum distribution was made more than 3 years before the plan's failure, or an annuity or similar series of distributions began more than 3 years before the plan's failure, then those distributions are not to be recaptured under this provision.

Even though the distributions began during this 3-year period, they are not to be recaptured if (1) they were made on account of the participant's death, (2) the participant's death occurred before the plan's termination, even though the distributions did not relate to the participant's death, or (3) the distributions were made on account of the participant's disability and the participant is eligible to receive disability benefits under the social security laws.

If none of these exceptions apply then the distributions to be recaptured are the amounts actually received by any person, reduced by the sum of (1) the amounts the participant would have received during this period if he had elected to receive his interest as a straight annuity beginning at age 65 (adjusted by actuarial values) and (2) the amount by which the present value of that participant's insured benefits exceed his pro rata share of the insurance Corporation's total liability on account of the plan's failure.

Since the distributions to be recovered in this case presumably would have been taxed to the recipient in the years when they were paid, the

[86] recipient, upon payment of the recovery to the insurance Corporation, is to be permitted to file amended tax returns for those years. In order to permit such amended tax returns, the statute of limitations for any such year is not to expire until 1 year after the recovery by the insurance Corporation.

Establishment of Fund (premiums, etc.).—The insurance Corporation is to establish a Pension Benefit Guaranty Fund, into which there is to be deposited funds, as appropriated each year, equal to the insurance premium tax collections which this bill authorizes for the Pension Benefit Guaranty Fund. In addition, there is to be deposited in this fund amounts borrowed by the Corporation from the United States Treasury, any income received by the Corporation from the investment of its assets as provided under the bill (sec. 402 of the bill), and any recoveries of employer liability.

The premiums determined by the Corporation are to be assessed and collected as a tax and permanently authorized for appropriation to the Fund. The premium tax rates are to be set at such levels that, together with any earnings on Fund investments, they may be expected to cover the insurance benefits provided by this system and the administrative and operational costs of the Corporation. Although the entire assets of the Fund are to be available for any of the liabilities of the Corporation, separate risk accounts are to be maintained for regular plans and for multiemployer plans (discussed below), and for limited-employer-liability plans and for no-liability plans (discussed below). The bill establishes the premium rates to be charged for the first three years under the system (plan years that begin after December 31, 1974, and before January 1, 1978). Thereafter, the tax rates (and the bases to which the rates apply) may be set from time to time by the Corporation. However, the new rate is not to go into effect until it has been approved by concurrent resolution, originating in the House of Representatives and approved by both Houses of Congress. Under the bill, the Congress has the right only to approve or reject the corporation's proposal to change the rate as of a specified effective date. The bill provides for expedited procedures to be used by each of the Houses in dealing with any such proposed rate changes.

For plan years beginning during the first three years of the program, the basic premium tax rate is to be 50¢ per participant in any covered plan. The premium is to be imposed upon each multiemployer plan and is to be imposed upon each employer who maintains a plan other than a multiemployer plan. If an employer maintains more than one plan, and some of his employees are participants in more than one plan, then that employer will be required to pay the premium for each plan the employee participates in. (The premium tax rates for no-liability plans will be discussed below, under *Liability of employer*.)

For the first three years, no benefits are to be paid under the insurance system. The premium taxes to be collected are to be used to establish a basic fund to enable the Corporation to have adequate reserves and to give it an opportunity to collect such data as may be helpful in determining the levels of losses to be insured against. Although the committee recognized that logical arguments could be made for one or another premium rate base (e.g., accrued liabilities, unfunded vested liabilities, current normal costs), the committee concluded that insti-

[87] tution of any such rate base was apt to be complicated and difficult to establish by the time the insurance system is to go into effect. For this reason, the committee determined that the premium rate for the first three years of the system should be based on a relatively simple "head tax".

These premiums are to be assessable against the employers who maintain covered plans (other than multiemployer plans) and against the assets of multiemployer plans. The premiums are to be deductible as ordinary and necessary business expenses in most circumstances.

The bill authorizes the Corporation to borrow up to $100,000,000 from the United States Treasury, by the issuance of notes or other obligations, with such maturities and subject to such other terms and conditions as may be prescribed by the Secretary of the Treasury.

The assets in the Fund may be invested in banks insured by the Federal Deposit Insurance Corporation, savings and loan institutions insured by the Federal Savings and Loan Insurance Corporation, and credit unions insured under title II of the Federal Credit Union Act. Also, they may be invested in certificates of deposit issued by such financial institutions and in United States Treasury obligations. In no event is more than 10 percent of the assets of the Fund to be invested in any one institution at any time.

Liability of employer.—Concern was expressed to the committee that in the absence of appropriate safeguards under an insurance system, an employer might establish or amend a plan to provide substantial benefits with the realization that its funding may be inadequate to pay the benefits called for. Such an employer might, it was argued, rely on the insurance as the backup which enables it to be more generous in promising pension benefits to meet labor demands than would be the case if it knew that the benefits would have to be paid for entirely out of the assets of the employer. On the other hand, it was clear to the committee that the imposition of heavy obligations on employers would discourage provisions for adequate pension plans.

To deal with these competing considerations, the committee determined to impose on the employer a limited liability to reimburse the insurance system for a portion of the payments that must be made by the insurance Corporation in satisfaction of its obligations if the employer's plan fails. Under the bill (sec. 461 of the bill), the employer generally is to be liable to reimburse the Corporation in an amount equal to the lesser of (1) one-tenth of the insurance Corporation's insurance liabilities on account of the plan failure or (2) one-half of the net worth of the employer. If the employer is a corporation whose stock is traded on a national exchange, then the employer's net worth is the aggregate value of the corporation's stock. Otherwise, the net worth is to be determined as the fair market value of the employer's assets less its liabilities (determined in a manner consistent with the estate tax rules). If some of the employer's ownership securities are traded on an exchange and some are not (as where the common stock is traded on an exchange and the preferred is held either by a single family or traded over the market), then the aggregate value of the ownership interests is to be determined by the Corporation in a manner consistent with what would be done for estate tax purposes if all of the ownership interests in the employer had been held by one decedent.

[88] In order to avoid manipulation of the market on the date the plan fails (which otherwise might be done in order to limit liability), the bill provides that this valuation is to be made as of 120 days before the date of the failure of the plan and is to be determined without regard to any liability of the employer under this provision. If the employer has more than one plan, the liability of the employer under this provision in the case of the second or any later plan to fail is not to be reduced on account of the employer's liability for any earlier plan's failure. However, in this connection, it must be noted that the limitations on the benefits that may be insured as to any one employee ($750 per month, 50 percent of wages), described above, may well operate so as to significantly reduce the insurance Corporation's liabilities on subsequent plan failures. Since the employer's liability to reimburse the Corporation is not to exceed 10 percent of the Corporation's losses, any reduction of the Corporation's losses will reduce indirectly the liability of the employer.

The committee was concerned that this contingent liability of the employer, which is rarely likely to be converted into a current liability, should not be permitted to significantly affect the opportunity of employers to obtain necessary business credit. As a result, the bill provides that the employer's liability is to be subordinated to all claims of general creditors existing at the time the plan terminates.

Under the bill, a successor employer is treated as the employer to which the liability rules apply—whether the change has come about because of a reorganization which involves a mere change in identity, form, or place of organization, or by reason of a liquidation into a parent corporation, or by reason of a merger or consolidation. In other words, a potential liability cannot be avoided where the employer is bought out by another company and ceases to exist because it is merged into the other company. Indeed, the committee understands that such mergers have, in numerous instances in the past, been the occasion for termination of existing pension plans to the great injury of many participants. The committee intends that the Corporation so administer these rules that such transfers of ownership will not result in incentives to terminate plans in the future. If experience indicates that the authority granted to the Corporation under this provision is insufficient for this purpose, then the matter will be reexamined. The Internal Revenue Service and the insurance Corporation, as the agencies most apt to acquire information about such mergers or buy-outs, are expected to make studies of the resulting plan terminations (those where the termination results in no insurance loss as well as those where insurance losses occur); they are expected to provide this information to the Congress and are expected to make any recommendations that may be appropriate if their studies reveal that participants continue to be injured as a result of these buy-outs or mergers.

Although the employer's liability under this section is to be subordinated to claims of general creditors, it is not to be defeated by transfers of assets which have the effect of dividends or distributions in full or partial liquidation to the employer's shareholders or to others who have, as a practical matter, ownership interests in the employer.

The Corporation is authorized to make arrangements with employers for payment of their liabilities under this provision, including arrangements for deferred payment on such terms and for such periods as the

[89] Corporation concludes are equitable and appropriate. In making its determinations, the Corporation is to give due regard to hardships that may result to the employer and to the employer's shareholders. However, the Corporation is to apply these rules in such a way as to not defeat the purpose for imposing this contingent liability—deterrence of unrealistic promises and of abuse of the insurance system.

As indicated above, if an employer elects to pay the appropriate increased premium tax (for the first 3 years under the program, the premium tax is to be 70 cents per participant in each plan, rather than the regular 50-cents rate) the employer is permitted to avoid the contingent liability discussed above. In such a case, there is to be no contingent liability unless the employer remains in business after the plan terminates. A reorganization, merger, or liquidation of the sort described above is to result in the employer being treated as continuing in business and therefore subject to this contingent liability. If the employer ceases business at that location but carries on a similar business elsewhere, then this liability remains. As a safe harbor, if the employer's gross sales during the year of plan termination are less than 25 percent of the average for the 3 preceding years, the employer is to be treated for these purposes as having ceased to do business.

In order to obtain this limited liability, the employer must have been paying the increased premium tax rate (the 70-cents per person rate for the first 3 years of the insurance program) for at least 5 years immediately preceding the plan's failure. For these purposes, payment with respect to a predecessor plan is to be treated as payment with respect to the current plan. The insurance Corporation is to provide for the manner and the time of election to pay the higher premium tax in exchange for the elimination of contingent liability. If the employer has chosen this higher rate, then liabilities are not covered under the insurance system to the extent they arise from plans or plan amendments put into effect less than 5 years before the plan's failure. In the case of benefits that first became effective before January 1, 1973, the insurance will cover the entire amount of the benefits as to plan failures occurring in 1980 or thereafter. Benefit increases and plans put into effect after December 31, 1972, are to be covered in full after 10 years, 90 percent covered after 9 years, 80 percent after 8 years, 70 percent after 7 years, 60 percent after 6 years, and 50 percent after 5 years. These limits, relating to the time the plan and its amendments have been in effect, are to be applied before the $750-per-month or 50-percent-of-wages limit and before the rules regarding the treatment of several plans as one plan, discussed above under *Benefits covered.*

If, after termination of the plan, the value of the assets (hence, the extent of the insurance Corporation's liability to pay benefits under the program) changes, or if the liability changes because other events (such as death or disability) have occurred, then these experience losses are to be borne by the insurance Corporation and these experience gains are to inure to the benefit of the insurance Corporation, and are not to affect the contingent liability of the employer.

Multiemployer plans.—The figures in the Joint Treasury-Labor Study suggest that termination losses are less likely to occur on termination of multiemployer plans.[12] In view of this, the committee con-

[12] Department of the Treasury and Department of Labor. Study of Pension Plan Terminations, 1972-Final Report, August 1973; pp. 3, 65 *et seq.*

[90] cluded that it is appropriate to authorize the insurance Corporation to establish separate premium rates for multiemployer plans. Since there is insufficient experience at present on which to base a determination as to the extent to which the premiums for multiemployer plans should differ from the premiums for other plans the bill establishes no difference in rates for the first 3 years (1975 through 1977), but authorizes differences for the future. Although separate risk accounts are to be maintained, on the basis of which future rates are to be determined, the funds derived from all the premiums are to be available to pay benefits for any plan losses, without regard to whether any particular funds were derived from multiemployer plans or from other plans.

A multiemployer plan is a plan to which more than one employer is required to contribute; is established or maintained pursuant to a collective bargaining agreement between employee representatives and employers; and is a plan where the benefits are payable with respect to each participant without regard to whether that participant's employer is still making contributions to the fund. All employers who are members of the same affiliated group (sec. 1504(a)) are to be treated as one employer for purposes of this definition. A plan is not a multiemployer plan for any year with respect to which the liability of any one employer for contributions to the plan is as much as 50 percent of the aggregate liabilities of all employers for contributions to the plan for that year.

A plan administrator of a multiemployer plan must notify the Corporation whenever a "substantial employer"[13] withdraws from that plan. The Corporation, upon notification of the withdrawal, will notify the substantial employer of a contingent liability that is the substantial employer's pro-rata share of the total amount of payment that would be made by the Corporation for the entire plan if the plan were terminated on the date of the withdrawal of the substantial employer. The total potential loss of the Corporation is to be apportioned in accordance with the relative amounts of liabilities for plan contributions during the 5 years ending with the withdrawal. As an alternative to payment of this contingent liability into an escrow account, the substantial employer could be required to furnish the Corporation a bond insuring payment of the substantial employer's contingent liability. The limitation to liability of 50 percent of the employer's net worth would be separately applied to each employer.

If the multiemployer plan is not terminated in the 5 years following the withdrawal of the substantial employer, the contingent liability payment would be returned to the substantial employer, or the bond would be cancelled, as the case might be. If the plan does terminate within that time, the Corporation would be entitled to the contingent liability payment, plus any additional amount required to meet the substantial employer's portion of the liability as finally determined.

The liability of an employer (other than a substantial employer) in a multiemployer plan for losses of the insurance fund because of terminations of the plan is generally to follow the rules for determin-

[13] If an employer's liability for plan contributions for each of two consecutive years is at least 10 percent of all employer liabilities for plan contributions for each of those years, then that employer is a "substantial employer" for each of the next 2 consecutive years.

[91] ing the liability limitations for plans of individual employers. The 50-percent-of-net-worth limitation is to be applied separately to each employer.

Within 6 months after the close of each plan year, the plan administrator must notify each substantial employer of its status as a substantial employer. Furthermore, any employer in a multiemployer group who contributes 10 percent or more of the total contributions to the plan during a plan year is to be notified of that fact even if it is not yet a substantial employer (because it has not been in this status for two consecutive years).

Termination—by plan administrator.—Before terminating a plan, the plan administrator must notify the insurance Corporation of the planned termination (sec. 441). This is to give the Corporation an opportunity to determine whether the plan can meet all of its liabilities before the termination occurs. No benefits are to be paid under the termination procedure of the plan until 90 days after the notice (or, if sooner, until the Corporation supplies the plan administrator with the notice of the Corporation's determination that plan assets are sufficient to discharge plan liabilities). Benefits already being paid as of date of the notice are to continue to be paid unless the plan administrator is informed by the Corporation that plan assets are insufficient to pay all benefits, if that should be the case.

If, after receiving a notice of sufficiency and proceeding with the termination, the plan administrator determines that the assets are insufficient, he is to so inform the Corporation. If the Corporation agrees, it is to terminate the plan.

If, upon notification by a plan administrator, the Corporation determines that the plan has insufficient assets to meet all guaranteed liabilities, the plan is to be treated as terminated on the date the Corporation so notifies the plan administrator.

The 90-day period during which the plan administrator may not proceed to terminate a plan without the Corporation's notice of sufficiency of assets may be extended by agreement for succeeding 90-day periods.

Termination—by Pension Benefit Guaranty Corporation.—The insurance Corporation may take steps to terminate a plan whenever the Corporation determines that (1) the plan has failed to meet the minimum funding standards (discussed above, under D. Funding), (2) the plan is unable to pay benefits when due (to the extent guaranteed under the insurance system), (3) if the plan is not terminated, the liability of the insurance Corporation is likely to increase, or (4) there is a lump-sum distribution in excess of $10,000 to a proprietary employee or an owner-employee and afterwards there are unfunded vested liabilities in the plan.

If the Corporation determines to institute procedures to terminate a plan, it is to notify the plan administrator of this determination and set forth the reasons. The notice is to specify what activities, if any, the administrator may engage in prior to the termination (or a notice from the Corporation directing the administrator to continue to operate the plan). If the administrator violates the conditions of the notice, the Corporation may apply to a Federal district court for equitable relief (injunction, mandamus, replacement of trustee, etc.). In

[92] addition, violation of the provisions of the notice is to be a violation of the administrator's fiduciary obligations.

The plan administrator has 15 days after the notice has been issued to demonstrate that termination is improper or no longer necessary. If the Corporation concludes that it is necessary to terminate the plan, it may apply to the appropriate district court (1) for appointment of a trustee and (2) for a court decree to terminate the plan. This action may be brought in the judicial district where the plan administrator resides or is doing business or where any property of the trust forming a part of the plan is situated. The court to which this action is brought may issue summonses regarding this action in any other judicial district. This power is provided so that the court may act promptly and effectively regardless of where the assets or the administrator of the plan may be located at any particular moment. In general, a trustee appointed under these provisions is to be subject to the same duties as a trustee appointed under section 47 of the Bankruptcy Act.

In order to simplify the administration of the Insurance Fund and to avoid abuses, the plan administrator is to be required to report promptly to the Corporation the occurrence of certain events: (1) a loss of qualified status by the plan or its trust, (2) plan amendments that would decrease a benefit of any participant, (3) a decrease in participants to less than 80 percent of those participating at the beginning of that plan year or less than 75 percent of those participating as of the beginning of the previous plan year, (4) a termination or partial termination of the plan under the Internal Revenue Code, (5) a failure to meet current funding requirements or to pay current benefits, (6) a charge by the Secretary of Labor that a fiduciary standard has been violated, or (7) a lump-sum distribution in excess of $10,000 (made other than on account of death or disability) to a proprietary employee or an owner-employee if, after the distribution, there are unfunded vested liabilities. In addition, the Internal Revenue Service is required to independently notify the Corporation of the first and fourth of the above-noted events since these would be normally brought quickly to its attention in the course of its duties.

For the purposes of the seventh category of reportable events described above, a distribution of an annuity contract is to be treated as a lump-sum distribution. Any lump-sum distribution which is a reportable event may be recaptured at any time within 3 years after the insurance Corporation is notified of the distribution.

If an insurable plan is changed in nature, to one not covered by the insurance provisions (e.g., is converted into a money-purchase plan), the change will be treated as a plan termination.

The trustee to administer a termination under the Corporation is to be appointed by a court order. This may be obtained regardless of the pendency of any bankruptcy, lien, foreclosure, liquidation, etc., proceeding.

Termination—powers and duties of trustees.—A trustee appointed pursuant to a decree to administer a plan is to have the power to do anything the plan administrator or any plan trustee might do under the terms of the plan or under the provisions of this bill. He could require the transfer to himself as trustee of all or any part of the assets, records, or other information pertaining to the plan; invest

[93] and reinvest the assets in accordance with the plan provisions and the applicable rules of law; and limit benefits to the amounts guaranteed under the insurance provisions. If the final determination is that a plan termination is improper, the trustee is to transfer back to the plan administrator all the assets, without liability for losses except for willful misconduct.

After a final decree that a plan should be terminated, the trustee is to collect amounts due the plan, pay benefits in accordance with the allocation rules already discussed, and receive payments from the insurance Corporation for funding of guaranteed benefits. In addition, he could perform the expectable functions of a fiduciary in such a situation, including arranging the liquidation of plan assets.

After his appointment, the trustee must give notice of that fact to the plan administrator and to all plan participants, beneficiaries, and employers who might be liable for insurance losses or who made contributions to the plan during the current or any of the previous three years.

The Corporation is to furnish the trustee and the court with a report showing benefits payable with respect to each participant, the amount of those benefits that are guaranteed, the value of the aggregate guaranteed benefits as of the termination, the fair market value of the plan assets as of the termination, and such other information as may be necessary to effectuate the insurance provisions.

Effective date

The insurance provisions generally are to take effect after the date of enactment. Premium taxes are to be collected after December 31, 1974. Insurable benefits are to be guaranteed beginning January 1, 1978.

Cost

The cost of plan termination insurance coverage to individual employers would be 50 cents per year per participant or, if the employer should choose to avoid limited employer liability, 70 cents per year per participant. It is estimated that this would produce about $18 million per year for the insurance fund. The Treasury-Labor Department study on planned terminations which has just been completed indicates a loss of vested benefits of $34 million in 1972. However, for several reasons, it is believed that this substantially overstates the revenue cost of providing term insurance. First, the term insurance payments with respect to any losses need not be paid immediately, but instead can be spread out over the lifetime of the annuitants. Second, the increased funding provided by this bill will significantly lessen the insurance losses. Third, the requirement that employers provide up to 10 percent of the liabilities arising from their own plan failures (except where the additional premium insurance cost is incurred) will further lessen the insurance cost to be paid from the corporation. Fourth, the requirement that improvements in the plan not be taken into account for 3 to 5 years before termination will still further reduce the insurance costs. Fifth, no amounts are paid out in the first 3 years with the result that the revenues raised in these years will be available to help meet future costs. Sixth, limits are provided on the size of the insurance payments which can be made with respect to

[94] individuals. For these reasons, it is believed that an annual $18 million premium commencing January 1, 1975, and collected 3 years in advance of the first years of insurance claims should be an adequate fund to cover insurance losses.

It is estimated that a revenue loss of $9 million per year will be realized on account of the plan termination insurance provisions, because of the tax deductions taken by employers for their premium payments to the Insurance Fund.

G. FIDUCIARY RESPONSIBILITY

(Secs. 501 and 551 of the bill and secs. 503 and 4973 of the Code)

Present law

A retirement plan trust may be qualified under the Internal Revenue Code only if it is impossible under the governing instrument for trust funds to be used for any purpose other than the exclusive benefit of the employees or their beneficiaries (sec. 401(a)(2)). In addition, a retirement plan trust will not be exempt from taxation if it engages in any of the specifically defined "prohibited transactions" (sec. 503).

Under administrative rulings, an investment generally meets the "exclusive benefit" requirement if it meets the following standards: the cost of the investment does not exceed fair market value, a fair return commensurate with the prevailing rate is provided, sufficient liquidity is maintained to permit distributions, and the safeguards and diversity that a prudent investor would adhere to are present. (IRS Publication 778 (February 1972)).

"Prohibited transactions" include the lending of funds to certain interested persons without receipt of adequate security and a reasonable rate of interest. Other prohibited transactions with disqualified persons include payment of excessive salaries, providing the trust's services on a preferential basis, substantial purchases or sales of property for other than adequate consideration, and engaging in any other transaction which results in a substantial diversion of trust assets.[1] If the trust engages in any prohibited transaction, it will lose its tax-exempt status for at least one year.

General reasons for change

Under present law, a trust forming part of a qualified retirement plan loses its exemption from taxation if it engages in a prohibited transaction. With loss of exemption, special tax benefits relating to qualified plans also may be denied, including deferral of taxation by employees and loss of deductions by employers contributing to the trust. In practice these sanctions have not been satisfactory in discouraging prohibited transactions. An employer, needing working capital or in bad financial condition, may forego a deduction in order to divert trust assets to his own use, and the trust fiduciary may acquiesce in his demand.

In addition, the present law's sanctions for engaging in prohibited transactions tend to fall upon innocent employees. For example, if a trust is disqualified because of an act of the trustee and the employer,

[1] More stringent rules govern trusts benefiting owner-employees who control the business (sec. 503(g) of the Code).

[95] the income tax imposed upon a disqualified plan may be paid out of funds otherwise available to provide employees' retirement benefits. Furthermore, because of the prohibited act of an employer and trustee, an employee may have to pay tax on contributions made on his behalf before he actually receives the amounts attributable to the contributions. This possible loss to innocent employees has caused the Service to be reluctant to impose the sanctions.

To resolve these problems, the committee bill changes the method of enforcing the prohibited transaction rules. It imposes sanctions for prohibited transactions upon the parties in interest and fiduciaries who engage in these transactions in place of the sanctions now imposed on the employee benefit trusts.[2] Under the bill the parties in interest and fiduciaries who engage in a prohibited transaction are to be subject to a two-level excise tax on the amount involved in the prohibited transaction. The first-level tax on parties in interest is to be 5 percent of the amount involved (2½ percent on certain fiduciaries) for each year. If the transaction is not corrected to make the trust whole, a second-level tax of 100 percent is to be imposed on the parties in interest (50 percent on fiduciaries who do not agree to correct the transaction). In accord with current law regarding similar taxes respecting private foundations, neither of these taxes is to be deductible. Since payment of the 100-percent tax would be more expensive than restoring the amount involved to the trust (and since payment of the tax would in no event remove the obligation to make the trust whole), it is expected that the trust will be the ultimate beneficiary of the possible imposition of these sanctions.

In some cases an additional remedy may be needed. For example, sometimes it is difficult to quantify the amount involved in a prohibited transaction and therefore difficult to impose a tax. Also, equitable remedies are sometimes necessary. To resolve these problems, the bill provides that the Secretary of Labor and plan participants and beneficiaries may sue to remedy a breach or anticipated breach of fiduciary obligations. This provision is analogous to the provisions in the Tax Reform Act of 1969 that strengthen the ability of State attorneys general to restore or correct acts of self-dealing involving private foundations.

An additional problem exists because of the present definition of prohibited transactions. Currently, transactions generally are prohibited when the dealings involved are on other than an arm's-length basis. However, arm's-length standards require substantial enforcement efforts, resulting in sporadic and uncertain effectiveness of these provisions. This is the same problem which was faced by the Congress in 1969 when it acted with respect to prohibited transactions and private foundations. At that time the Congress concluded that in most cases arm's-length standards did not preserve the integrity of private foundations, and amended these definitions of prohibited transactions for the most part to prohibit outright questionable transactions between the trust and interested parties. The committee's bill generally follows the approach that was developed in 1969, establishing definitions for prohibited transactions that will make it more practical to enforce the law. The committee's definitions of prohibited transac-

[2] When the term "trust" is used in this section, it means plan, whether or not in trust form.

[96] tions, and the exceptions from these definitions, however, are designed to take account of the unique situation of employee benefit trusts.

Explanation of provisions

Excise tax on prohibited transactions, in general.—For the reasons indicated above the committee bill establishes an excise tax on parties in interest and fiduciaries who participate in certain specified prohibited transactions respecting an employee benefit trust. The new provisions apply to a trust which after August 20, 1973, has qualified (or has been determined to qualify by the Secretary of the Treasury) under section 401 of the Code (and a plan described in section 404(a)(2), and a qualified individual retirement account under section 408(a)). The prohibited transaction rules and excise tax sanctions are to continue to apply even if the trust, etc., should later lose its tax qualification. Under the bill, a trust is not to lose its exempt status because it engages in a prohibited transaction, but the parties in interest and fiduciaries who engage in the transaction are to be subject to tax. These provisions (including the civil action provisions to be administered by the Labor Department, discussed below) are not to apply to church plans unless there has been an election with respect to these plans to obtain insurance coverage (See *F. Plan Termination Insurance*, above).

This excise tax generally follows the same procedures as the tax on self-dealing enacted in the 1969 Tax Reform Act with respect to private foundations. The tax is at two levels; initially, parties in interest who participate in a prohibited transaction are to be subject to a tax of 5 percent of the amount involved in the transaction per year. A second tax of 100 percent is imposed if the transaction is not corrected after notice from the Internal Revenue Service that the 5-percent tax is due.

The committee believes that where the party in interest and not the fiduciary benefits from the prohibited transaction, primary responsibility under the excise tax provisions should be on the party in interest and not on the fiduciary. Therefore, in these cases the tax rates generally are to be lower on fiduciaries than the party in interest. However, where the fiduciary benefits from the prohibited transaction, he is to be treated as a party in interest. Where the fiduciary is subject to tax as an interested party for a given transaction, he is not to be also subject to the fiduciary tax at that level for that same transaction.

The tax on a fiduciary who participates in a prohibited transaction, but does not benefit from it, is initially to be 2½ percent of the amount involved per year. To be liable, the fiduciary must have known (or would have known if he had exercised reasonable diligence), it was a prohibited transaction, and if his participation was not willful, and was due to reasonable cause, he would not be subject to tax. The second level of tax on a fiduciary who does not benefit from the transaction is to be 50 percent of the amount involved, where the fiduciary refuses to agree to part, or all, of the correction required to make the trust whole. Both the first- and second-level taxes on a fiduciary who does not benefit from the transaction are limited to $10,000 (for each tax) with respect to cash transactions.

The first-level tax is owed for each taxable year (or part of a year) in the period that begins with the date when the prohibited transac-

[97] tion occurs and ends on the earlier of the date of correction or the date of mailing of a deficiency notice for the first level tax (under section 6212 of the Code). The first-level tax (except in the case of a fiduciary who does not benefit from the transaction) is imposed automatically without regard to whether the violation was inadvertent.

If more than one person is liable for the prohibited transaction tax on parties in interest (or the tax on fiduciaries), they all are to be jointly and severally liable. For example, if the prohibited transaction involves $100.000, all parties in interest who participated in the transaction will be jointly and severally liable for the first-level tax of $5,000 (per year in the taxable period) and also jointly and severally liable for the second-level tax of $100,000.

The excise tax on a prohibited transaction is a function of the amount involved in the transaction. The bill provides that the amount involved is the greater of the fair market value of the property (including money) given or received in the transaction. However, with regard to services which are necessary to the operation of the plan and which generally may be paid for if the compensation is not excessive, the amount involved is the excess compensation. For the first-level tax, the amount involved in a prohibited transaction is valued as of the date of the transaction. However, for the second-level tax the amount involved is valued at the highest fair market value during the correction period. The higher valuation is used for the second-level tax so the person subject to tax will not delay returning the amount involved to the trust in order to earn income with this amount.

A prohibited transaction may be corrected to avoid the second-level tax at any time before the 90th day after the Internal Revenue Service mails a notice of deficiency with respect to the first-level tax. However, the 90-day period may be extended by any period within which a deficiency cannot be assessed (because of petitions to the Tax Court), and may also be extended for a period which the Internal Revenue Service determines is both reasonable and necessary to correct the prohibited transaction. To correct a prohibited transaction, the transaction must be undone to the extent possible, but in any case the final position of the trust must be no worse than it would have been if the prohibited transaction had not occurred. The higher valuation to be used in computing any second-level tax that might be applicable, is also the valuation to be used in correcting the transaction. In other words, correction requires that the trust receive the benefit of whatever bargain turns out to have been involved in the transaction.

Prohibited transactions and exceptions, in general.—The bill removes qualified trusts from the present arm's-length prohibited transaction rules, and in place of these limitations establishes a set of comprehensive definitions of the prohibited transactions that apply to qualified trusts. Generally, the committee bill defines as prohibited transactions the same type of transactions that constitute prohibited self-dealings with regard to private foundations, with modifications that are appropriate in the employee benefit trust area. As with private foundations, the bill prohibits both direct and indirect dealings of the types specified.

Sale, exchange, or leasing of property.—Under the bill, the sale, exchange, or leasing of any property between the trust and a party

[98] in interest (with the exceptions noted subsequently) is a prohibited transaction. Under this rule, the transaction is prohibited whether or not the property involved is owned by the trust or the party in interest, and the prohibited transaction includes sales, etc., from the party in interest to the trust and also from the trust to the party in interest. Additionally, following the private foundation rules, a transfer of property by a party in interest to a trust is treated as a sale or exchange if the property is subject to a mortgage or similar lien which the party in interest placed on the property within 10 years of the transfer to the trust, or if the trust assumes a mortgage or similar lien placed on the property prior to transfer. This rule prevents circumvention of the prohibition on sale by mortgaging the property before a transfer to the trust.

Loans.—The bill also prohibits all lending of money or other extension of credit between the trust and a party in interest but with the exceptions noted below. The committee recognizes that at times a trust may need financial aid and a party in interest may be the only person willing, or able, to provide that aid. The committee believes that the problem of need and the problem of practical administration in this case can be reconciled where an independent third party makes the loan and the interested party guarantees the loan. Therefore, the bill provides that an interested party may guarantee a loan to a qualified trust if a reasonable rate of interest is charged. In this way, there will be an independent lender to keep the interest rate from being too low (which would avoid the contribution limits), and the trust will have an interest in keeping the interest rate from being too high (which could drain money from the trust to the detriment of the employees). The committee contemplates that a party in interest may guarantee a loan to the trust only where the loan is made by a person who is independent of and not related to the party in interest (or fiduciary), and that the party in interest (or fiduciary) must not provide the lender any direct or indirect consideration for making the loan other than the guarantee.

Following current practice, the bill also allows a loan by the trust to a participant or beneficiary to the extent of the vested accrued benefit of the borrower. To be permitted, such loans must be available to all participants and beneficiaries on a nondiscriminatory basis, and must be made in accord with specific provisions in the plan governing such loans. In addition, a reasonable interest rate must be charged and the loan must be adequately secured. However, it is intended that loans to persons who have been, at any time within 3 years before the loan is made, or while the loan is outstanding, owner-employees or proprietary employees under the plan are not available under this exception; otherwise, the prohibition of premature distributions to such persons could be circumvented.

It is intended that prohibited loans include the acquisition by the trust of a debt instrument (such as a bond or note) which is an obligation of a party in interest. (However, the transition rules, described below, establish special rules regarding certain debt instruments held by the trust on August 21, 1973.) Similarly, the committee intends that it would be a prohibited transaction (in effect, a loan by the trust to the employer) if the employer funds his contributions to the trust with his own debt obligations.

[99] *Furnishing goods, services, and facilities.*—The committee bill also prohibits the furnishing of goods, services, and facilities between the trust and parties in interest. However, a party in interest may furnish goods, services, and facilities to a trust if this is necessary for the operation of the plan and the compensation paid is not excessive.

However, since a substantial portion of a trust's activity is usually investment of assets, the committee intends that "personal service" not include the activities of a broker, for this activity can give rise to substantial conflicts of interest (e.g., "churning" of assets).

Also, a trust may furnish goods, services, or facilities to a party in interest if the terms on which the goods, etc., are offered are no more favorable than the terms on which they are made available to the general public.

Transfer or use of trust income or assets.—The bill prohibits the transfer of any trust income or assets to, or for the benefit of, a party in interest. It also prohibits the use of trust income or assets by or for the benefit of any party in interest. As in other situations, this prohibited transaction may occur even though there has been no transfer of money or property between the trust and any party in interest. For example, securities purchases or sales by the trust in order to manipulate the prices of the securities to the advantage of a party in interest constitute "a use by, or for the benefit of, a party in interest of any income or assets of the trust."

To prevent discrimination against fiduciaries and parties in interest, the bill permits these persons to receive any benefits to which they are entitled as participants or beneficiaries in the plan.

Payment of compensation.—The bill also generally prohibits payment of compensation, or payment or reimbursement of expenses, by a trust to any party in interest. However, this prohibition does not apply to the payment of compensation, or payment or reimbursement of expenses, by the plan to a fiduciary or other party in interest for personal services which are reasonable and necessary to the plan, if the compensation for payment or reimbursement is not excessive. To prevent double payment, this exception does not apply with regard to a fiduciary who is receiving full-time pay from a party in interest whose employees or members participate in the qualified plan. Also, in accord with present law, it is intended this exception will not apply to payments to owner-employees (or proprietary employees) or to certain of their relatives or to corporations controlled by them.

Transactions primarily involving conflicts of interest and fiduciaries.—The committee bill generally prohibits a fiduciary from dealing with the income or assets of a trust in his own interest or for his own account. However, this does not prohibit the fiduciary from dealings where he has an account in the employee benefit trust and the dealings apply to all trust accounts without discrimination.

The bill also prohibits fiduciaries from receiving consideration in connection with a transaction involving the trust from any party who deals with the trust. This prevents, e.g., kickbacks to a fiduciary.

Transfer of assets outside the United States.—In order to prevent "run-away assets", the bill prohibits any assets of the trust from being held, deposited, or invested outside the United States unless the assets remain within the jurisdiction of a United States district court, except as authorized by the Internal Revenue Service under regulations.

[100] Any such exceptions should be made only where, as to categories of circumstances, it is clear that neither the interests of the trust participants and beneficiaries, nor the interests of the United States in protecting the integrity of its taxing and regulatory and pension guaranty systems would be likely to be jeopardized by the trust assets being outside the United States.

Acquisition of securities of the employer.—The committee bill generally prohibits employee benefit plans from acquiring stock or other securities of the employer. This is provided because generally investment in an employer's securities subjects plan participants to a double risk of loss. If an employer has severe financial reverses, his employees may not only lose their jobs (and the employer's contributions for their retirement may substantially decrease), but also they may suffer a loss from decreases in the securities' value and dividends. Also, if the trust is permitted to invest in securities of the employer, the fiduciary may well be subject to great pressure to time the purchases and sales so as to improve the market in those securities, whether or not the interests of protecting retirement benefits of plan participants may be adversely affected..

However, the bill provides a special rule for profit-sharing plans because the concept of these plans is that employees should share in profits through dividends and appreciation as well as through employer contributions out of profits. As a result it is not to be a violation of this securities-of-the-employer rule for a profit-sharing plan to invest all or any part of its assets in securities of the employer if the securities are readily tradable in an established securities market. However, where the securities are not tradable on an established market, then no more than 10 percent of the profit-sharing trust's assets is to consist of the employer's securities. This limit is needed because of the greater difficulty in selling such securities and therefore the greater risk involved in this situation.

Moreover, the bill does not limit acquisition of employer's stock by stock bonus plans, since limitations in these cases would be inconsistent with the nature of these plans.

An employer's securities includes the securities of any controlled group of corporations (as defined in section 1563(a) of the Code) of which the employer is a member. The prohibition applies not only to the purchase of securities, but also to acquisition in other ways, such as acquisition on default of a loan where stock was security for the loan (this latter example is to apply only where the stock was made security for the loan after August 21, 1973).

The 10-percent test, applicable in the case of profit-sharing plans where the securities are not tradable on an established securities market, is to be applied at the time the securities are acquired. Consequently, if the 10-percent test is met at the time of acquisition, ownership of employer securities is not to be prohibited at a later time when the securities may represent more than 10 percent of the trust assets (e.g., because of a change in the values of the assets of the trust).

The committee bill does not change present law which provides, for qualified trusts, that trust funds may not be used for any purpose other than for the exclusive benefit of the employees or their beneficiaries. Under administrative rulings, an investment generally meets

[101] the "exclusive benefit" requirement if its cost does not exceed fair market value, a fair return is received, sufficient liquidity is maintained, and the safeguards and diversity adhered to by a prudent investor are present. The exclusive benefit rule currently applies to investment in an employer's securities and it is intended that the rule continue to so apply.

The committee bill also does not prohibit a plan from acquiring shares in a regulated investment company (defined under section 851 of the code) which holds or acquires securities of the employer as a regular part of its investment program. However, where the mutual fund acquires securities of the employer as part of the arrangement under which the employer acquires shares in the mutual fund, this exception is not to apply.

Investments that jeopardize income or assets.—The bill also treats as a prohibited transaction investments which jeopardize the income or assets of the trust. This is similar to the rule that private foundations must invest in a manner that does not jeopardize the carrying out of their exempt purposes. It is expected that, under this rule, investment standards will be established for employee-benefit trusts that are similar to the investment standards which have been established for private foundations. In this case also it is not intended that a "legal list" of investments for pension trusts be established. Of course, the prohibited transaction provisions do not prevent an employer, on termination of his plan, from recovering assets not needed to pay plan benefits. Because of this the Internal Revenue Service should take care that this jeopardy rule is administered with due regard to the interests of present and future participants and beneficiaries. If termination is contemplated, it should be clear that investments are not being made or maintained with the interests of potential remaindermen in mind in any case where this is in conflict with the interests of the participants or beneficiaries.

Miscellaneous exceptions from prohibited transaction rules.—In the interests of making the prohibited transaction rules work in as practical a manner as possible, certain exceptions are provided to them. One of these exceptions provides that a transaction (such as an exchange) between a trust and a party in interest pursuant to a corporate adjustment, such as a liquidation, merger, redemption, or recapitalization is not to be a prohibited transaction if all the securities of the class held by the trust are subject to the same terms. However, a redemption in which only the stock held by the trust plan is redeemed would have to serve a bona fide business purpose.

Recognizing current practice, the bill also does not prohibit a person from serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

In addition, the bill provides that plans subject to the prohibited transaction rules are not to include funds held by certain insurance carriers, funds held by an investment company subject to the Investment Company Act of 1940, or plans administered by Federal or State governments or by any agency or instrumentality of these governments.

Transition rules for prohibited transactions.—To prevent undue hardship, the committee bill provides transition rules for situations where employee benefit trusts are now engaging in activities which

[102] do not violate current law but which would be prohibited transactions under the bill.

One of the transition rules permits the leasing or joint use of property involving a trust and a party in interest under a binding contract in effect on August 21, 1973 (or pursuant to renewals of the contract), to continue for 10 years beyond that date, until August 22, 1983. For this transition rule to apply, the lease or joint use must remain at least as favorable to the trust as an arm's-length transaction with an unrelated party, and must not otherwise be a prohibited transaction under present law. A similar 10-year transition rule applies to loans or other extensions of credit under a binding contract in effect on August 21, 1973 (and renewals thereof), where the loan remains as favorable as an arm's-length transaction and is not prohibited under present law.

Under the general rule in the bill, a trust may not generally acquire or hold a bond or other evidence of indebtedness issued by a party in interest, since it would be a prohibited loan. However, if on August 21, 1973, the trust holds any bonds, debentures, notes, certificates, or other evidence of indebtedness which were issued by a corporation and that have interest coupons or are in registered form, and the holding of these debt obligations is not prohibited under present law, then the trust may continue to hold those bonds, without time limit. However, to the extent the bonds are disposed of by the trust, they cannot be reacquired and held under these transition rules.

In order to avoid disruption of markets where a pension plan already holds employer securities (or where a profit-sharing plan subject to the 10-percent limit discussed above, holds more than that limit), the bill does not require divestiture of present holdings of those securities. For this purpose, additional shares acquired as a result of a stock split or stock dividend are to be treated as securities already held. However, exercise of a right to acquire securities (e.g., through conversion of a convertible security), is not to be permitted. If a trust subject to these limitations disposes of some of its present holdings, it may not thereafter acquire new securities of the employer, unless that acquisition is permitted under the general rules (as distinguished from this transitional provision). For example, a pension trust would not be permitted to reacquire present holdings of employer securities after it had sold them; a 10-percent profit-sharing trust would not be permitted to reacquire present holdings of employer securities after it had sold them, unless it could do so within the 10-percent limit. Present holdings, for these purposes, are holdings as of August 21, 1973, the date the committee bill is reported.

The bill allows a trust to sell property, at arm's-length terms, to a party in interest where the property is now under a lease or joint use which qualifies for the 10-year transition rule described above. Sales of this type must occur before August 22, 1983. A transitional rule of this type is provided because it appears that such leases are not uncommon, and in such cases often a party in interest is the best available buyer.

Definitions used in prohibited transaction provisions.—The committee bill contains a number of definitions of terms used in describing the operation of the prohibited transaction provisions. These are described below.

[103] The committee bill defines "fiduciary" as any person who exercises any power of control, management, or disposition with respect to any moneys or other property of the plan, has authority or responsibility to exercise these powers, or is a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for the plan (as described in sec. 7701(a)(6)). Under this definition, fiduciaries include officers and directors of a trust, members of the trust's investment committee, and persons who select these individuals. Consequently, the definition includes persons who have authority and responsibility with respect to the transaction in question, regardless of their formal title.

The bill's definition of a "party in interest" includes the following general categories: (1) managers (and employees) of the plan, (2) persons providing benefit plan services to the plan, (3) the employer and its officers, directors, and highly compensated employees, and controlling or controlled parties, or parties under common control, (4) employee organizations (e.g., labor unions, including the national and international unions where a plan covers any local) with members covered by the plan, and officers and directors of those organizations and (5) fiduciaries who benefit other than in their capacity as plan fiduciaries from the particular prohibited transaction. Additionally, certain relatives and certain partners of parties in interest are treated as parties in interest.

It is intended that "benefit plan services" include investment advisory, actuarial, legal, accounting, computer and bookkeeping, and other similar services necessary for plan operations. Additionally, attribution rules for ownership of stock are provided which are similar to the attribution rules under the private foundation self-dealing rules. Also, in addition, the bill provides that an open-end mutual fund, the mutual fund's investment advisers, and the mutual fund's principal underwriters are not to be considered as plan fiduciaries or parties in interest merely because an employee benefit trust purchases shares in the mutual fund. Mutual funds are currently subject to substantial restrictions on transactions with affiliated persons under the Investment Company Act of 1940, and also it appears that unintended results might occur (such as preventing a trust from redeeming its mutual fund shares) if mutual funds were not excluded from these definitions.

Civil actions.—The committee recognizes that there are breaches of fiduciary responsibility which may not appropriately be subjected to an excise tax either because the amount involved in the transaction is difficult to determine, or because formal injunctive action may be necessary or desirable. Also, the committee recognizes that many persons have a direct interest in seeing that trustees do not breach their fiduciary responsibilities. Consequently, in addition to establishing an excise tax on prohibited transactions, the committee bill strengthens the enforcement of fiduciary duties by providing that individual participants and beneficiaries may bring civil actions in State or Federal courts to redress or prevent fiduciary breaches. Additionally, the bill provides that the Secretary of Labor may enforce breaches of fiduciary duty through civil actions in Federal court.

In providing for enforcement by the Secretary of Labor, the committee bill is similar to the 1969 Tax Reform Act which included pro-

[104] visions to strengthen the ability of State attorneys general to enforce the self-dealing rules regarding private foundations. However, since State attorneys general usually do not have the same common law responsibility to oversee employee benefit trusts as they do private foundations, it was believed that the Secretary of Labor was generally the more appropriate Government official in whom to vest enforcement powers.

Under the bill, civil actions to enforce fiduciary duties generally may be brought with regard to any employee benefit plan which maintains a fund of money or other assets in connection with the plan, and is established or maintained by an employer engaged in or affecting interstate commerce or by an employee organization representing employees so engaged. However, plans established by Federal or State governments or agencies or instrumentalities of these governments are excluded, as are workmen's compensation and unemployment compensation disability insurance plans and plans of churches (in accordance with their exception from the insurance provisions, as described above). Employee benefit plans include plans which provide for retirement, medical, surgical, hospital care, sickness, accident, disability, death or unemployment benefits. These plans also include profit-sharing plans and plans with a trust fund subject to the Labor Management Relations Act of 1947 (sec. 302(c) of that act).

A fiduciary is subject to civil action for breach of fiduciary duty if the plan meets these definitions, regardless of the legal form of the plan. The definition of fiduciaries subject to civil actions includes the same types of persons as the definition of fiduciaries who are subject to the prohibited transaction rules under the excise tax, described above. (However, the plan need not be a qualified plan for tax purposes for a person to be a fiduciary subject to civil action.)

The fiduciary duties which may be enforced through civil actions include the transactions which are prohibited transactions (in the above discussion on prohibited transactions, prevented by excise taxes), and include other fiduciary responsibilities as well. If a fiduciary engages in a transaction which is a prohibited transaction subject to the excise tax, or which would be prohibited and subject to tax if the plan were qualified under the tax laws, the fiduciary's misconduct may be redressed (or prevented) by civil action. In addition, the bill provides that a fiduciary must not jeopardize the income or assets of a plan. Also, a fiduciary must not represent any other party dealing with the plan or act on behalf of a party adverse to the plan or its participants or beneficiaries. Breaches of these duties also may be remedied (or prevented) by civil action.

The bill also provides that fiduciaries must act solely in the interests of the participants and their beneficiaries, and in accordance with the documents and instruments governing the plan (if consistent with the bill). These rules now govern plans qualified under the tax laws and, through the civil action provisions, are extended to other plans of employers which affect commerce (or plans of employee organizations whose members affect commerce).

It is intended that under the rule which prohibits a fiduciary from jeopardizing the income or assets of a plan, fiduciaries will be subject to the usual trustees' duties such as (but not limited to) the duty to

[105] keep and render clear and accurate accounts, take and keep control of the plan property, protect the plan property from loss and damage, enforce claims of the plan and defend actions against the plan (unless it is reasonable not to do so), and keep plan property separate from other property. It is intended that the investment standard that must be met by a fiduciary is to be the standard established by the prohibited transaction rule discussed above which prohibits investments that jeopardize the income or assets of a trust.

The bill also prohibits a person who has been convicted of a number of specified crimes from acting as a manager, fiduciary, employee, or consultant to an employee benefit plan for 5 years after conviction or after imprisonment. Any willful violation of this prohibition is subject to a penalty of $10,000 and 1 year imprisonment; the same penalty is applicable to anyone who knowingly permits another person to violate this prohibition. Upon an administrative hearing and after giving notice to prosecuting officials, the Board of Parole of the Department of Justice may remove the restriction on serving with a plan if the Board finds that this would not be contrary to the purpose of the bill. The Board's determination will be final.

Under the bill, the Secretary of Labor and participants and beneficiaries of a plan may bring civil actions for any appropriate legal or equitable relief to redress or restrain a violation of fiduciary duties. The bill specifically makes a fiduciary who breaches any of the specified duties personally liable; the fiduciary must make good any losses which the plan sustained from the breach and must restore to the plan any profits which he made using plan assets. However, a fiduciary is only personally liable where he knew, or would have known if he exercised reasonable diligence, that his act or failure to act constituted a breach of his responsibility. The bill also provides that fiduciaries have a duty to prevent their co-fiduciaries from breaching a fiduciary responsibility and must compel a redress of a breach. However, if the co-fiduciary objects in writing to the specific action and files a copy of the objection with the Secretary of Labor, he will not be liable for any act (or failure to act) of another fiduciary. Furthermore, the bill specifically prohibits exculpatory clauses.

The bill also makes a party in interest who participates in a prohibited transaction (or a transaction which would have been a prohibited transaction if the plan were qualified under the tax laws) personally liable for any losses sustained by the plan and for any profits made through using plan assets. A party in interest is so liable only if he knew that the transaction was prohibited or would have known after exercising reasonable diligence. This liability is appropriate because in these situations often the party in interest is a major beneficiary of a fiduciary breach; in addition, this liability is in accord with the excise tax liability discussed above regarding prohibited transactions. Fiduciaries and parties in interest who are liable on account of a breach of duty in which they both participated are to be jointly and severally liable.

Appropriate equitable relief may be granted in a civil action. For example, injunctions may be granted to prevent a violation of fiduciary duty, and a constructive trust may be imposed on the plan assets, if needed to protect the participants and beneficiaries. Also, the bill

[106] specifically provides that a fiduciary may be removed through civil action brought by the Secretary or participants or beneficiaries if he has violated any of the specified fiduciary obligations, or is serving in violation of the criminal conviction provisions. (The Attorney General also may bring an action to remove in the latter case.) It is expected that a fiduciary (other than one serving in violation of the criminal conviction provisions) may be removed for repeated or substantial violations of his responsibilities, and that upon removal the court may, in its discretion, appoint someone to serve until a fiduciary is properly chosen in accordance with the plan.

The bill provides that participants and beneficiaries may bring civil actions to redress a breach of fiduciary responsibility in any State or Federal court of competent jurisdiction. Actions by participants and beneficiaries brought in Federal district court are subject to the $10.000 jurisdictional requirements (28 U.S.C. sec. 1331). (However, the $10.000 limit does not apply to actions brought by the Secretary of Labor or the Attorney General.) Where participants and beneficiaries bring a civil action, the Secretary of Labor must be served with a copy of the complaint or petition, and the Secretary may intervene in the action and remove an action from a State court to a Federal district court. Removal is available only when the Secretary could have brought the action initially.

The bill provides that participants or beneficiaries may bring class actions under certain circumstances. Further, in an action by participants or beneficiaries, a court may allow reasonable attorney's fees and costs and may require the plaintiff to post security for payment of these fees and costs. Liberal venue and service provisions are established for actions brought in Federal district court.

If the fiduciary breach is disclosed in a report filed with the Secretary of Labor, civil action may be brought no later than 3 years after the report is filed. In other cases, an action may be brought within 3 years after the plaintiff knows or has reason to know of the violation, but no action may be brought more than 10 years after the transaction occurred. Additionally, where there is a willfully false or fraudulent statement, misrepresentation, concealment or failure to disclose a material fact to the Secretary of Labor, action may be brought within 10 years of the violation.

Effective date

The effective date of the fiduciary responsibility provision is January 1, 1975.

Revenue effect

The fiduciary responsibility provisions are not expected to have any significant effect on the revenues.

H. Administration and Enforcement

(Secs. 101 and 102, 601, 602, and 641 of the bill, and secs. 4974, 7476, 7477, and 7802 of the Code)

The committee bill relies heavily on the tax laws in order to secure compliance with the new requirements that it imposes on employee

[107] pension, profit-sharing and stock bonus plans. The bill, in providing new standards of coverage, vesting, funding and fiduciary responsibility, continues the administration of these provisions in the Internal Revenue Service.

Many aspects of compliance have been discussed in conjunction with the various substantative provisions described in the bill. This includes, for example, the new excise taxes imposed with respect to underfunding and those imposed in connection with transactions which are prohibited to qualified plans.

In a number of other ways, however, efforts have been made to improve the provisions of existing law. The provisions of this type discussed here are the new office set up in the Internal Revenue Service to administer the new standards in this bill as well as those of existing law, together with the audit fee tax designed to provide for this administration. In addition, the bill deals with the problem raised as to the absence under existing law of a judicial review for letters of determination as to the qualification status of plans. Procedures are also set out whereby employees can question the qualification of plans. Finally, the bill establishes procedures in the Department of Labor for an administrative review of employee claims as to their rights under qualified plans.

1. INTERNAL REVENUE SERVICE

Present law

Under present law, the national office of the Internal Revenue Service is organized on a general activity basis rather than a tax or subject basis.[1] At the present time, there are six Assistant Commissioners of Internal Revenue in the national office whose activities are broken into the following categories: collection and taxpayer service, compliance (including auditing), inspection (internal security), planning and research, technical (rulings) and administration housekeeping). Similarly, the field offices of the Service are organized on a similar line. Within each of these broad categories there are Service units whose jurisdictional breakdown is by subject matter under examination. For example, the Miscellaneous and Special Provisions Tax Division under the Office of Assistant Commissioner (Technical) contains a Pension Trust Branch and an Exempt Organization Branch. However, various other aspects of national office employee benefit plan and tax exempt organization administration are under the Office of Assistant Commissioner, Accounts Collection and Taxpayer Service and the Office of Assistant Commissioner, Compliance.

General reasons for change

Concern has been expressed in the case of the administration of employee benefit plans (and also tax exempt organizations) as to whether the Internal Revenue Service with its primary concern with the collection of revenues is giving sufficient consideration to the purposes for which these organizations are exempt. Many believe that the

[1] Reorganization Plan No. 1 of 1952 which went into effect on March 15, 1952. For a description of the present organization of the Internal Revenue Service, see Statement of Organization and Functions (C.B. 1970–1, 442).

[108] present organization of the Service causes it to subordinate concern for the protection of the interests of plan participants (or the educational, charitable, etc., purposes for which the exemptions are provided).

On the other hand, the enormous growth in retirement plans during the last third of a century has proceeded largely under the tax regulations of the Internal Revenue Service. Moreover, clearly the greatest single protection for rank and file employees during this time has been the Internal Revenue Service's administration of the provision denying any special tax treatment for contributions or benefits discriminating in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. The thrust of this provision is to require broader substantial participation in the plans than would be provided but for the Service's administration of the statute.

At the same time, it must be recognized that the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of exemption provisions. Similar concern has been expressed in the past over the Service's administration of the provisions of the tax law relating to exempt organizations.

The committee believes that in the employee benefit plan and tax exempt organization area it should be easier to emphasize the basic objectives involved if the activities relating to these plans and exempt organizations were more closely coordinated, if the activities in these areas relating to auditing, rulings, etc. whether in the field or in the national office are brought together and if the top direction for these activities also has specialized in them. For the reasons outlined, the bill establishes a separate office in the Internal Revenue Service, headed by an Assistant Commissioner for Employee Plans and Exempt Organizations to deal primarily with plans that are (or claim to be) qualified under section 401 of the code and organizations that are (or claim to be) exempt from income taxes under section 501(a) of the code. This includes pension, profit-sharing and stock bonus trusts and plans, religious, educational, charitable, organizations and foundations as well as the various other exempt organizations described in section 501(c) of the code. Similar units are to be established in the various regional and district offices. In addition, the committee has decided to earmark half of the 4-percent private foundations excise tax on investment income as well as the proceeds from a new audit-fee excise tax for the funding of these new offices.

Explanation of provisions

Office of Assistant Commissioner, Employee Plans and Exempt Organizations.—The bill establishes within the Internal Revenue Service a new office of Assistant Commissioner to be known as the Office of Assistant Commissioner, Employee Plans and Exempt Organizations. This office is to have the supervision and direction of the basic activities of the Internal Revenue Service in connection with pensions, etc. plans (governed by secs. 401 through 414 of the code) and tax exempt organizations (exempt from tax under

[109] sec. 501(a) of the code). The bill authorizes the prescribing of the activities this office is to be responsible for in connection with organizations exempt from tax (under sec. 501(a) of the code) and plans to which the special tax benefits of the deferred compensation provisions of the tax laws (secs. 401 through 414 of the code).

In connection with deferred compensation plans it is intended that this office will be made responsible for, among other things, the question as to the qualification of the plan and the related trust and the exemption from tax of the trust. It also is intended that questions as to the deductibility of contributions to a plan, the taxability of a beneficiary of an employees' trust and the taxation of employee annuities be included in the jurisdiction of this office. In addition, it is planned that this office would have responsibility over the minimum standards relating to funding of the plan and the excise tax for underfunding, including the enrollment and reports of actuaries. The new rules relating to prohibited transactions also come within the activities it is intended should be administered by this office.

In connection with organizations exempt from tax (under sec. 501(a) of the code) it is intended that this office have the responsibilities as to an organization's exempt qualification, the taxes on unrelated business income of an organization exempt from tax, and the rules relating to the private foundation provisions of the Internal Revenue Code.

To carry out the provisions of this bill, it is intended that the principal activities referred to above will be transferred from the various Assistant Commissioners' offices to the new Office of the Assistant Commissioner (Employee Plans and Exempt Organizations). With these transfers it is intended that the Assistant Commissioner (Employee Plans and Exempt Organizations), under the direction and supervision of the Secretary, or his delegate, will have the authority to direct national and field office policy in connection with the basic activities of the Service relating to employee plans and exempt organizations.

Salaries.—The bill provides that the Assistant Commissioner (Employees Plans and Exempt Organizations) is to be classified at a GS–18 level and is in addition to the number of positions authorized by present law (sec. 5109 of Title 5 of the U.S. Code). Present law also is amended (sec. 5108 of Title 5 of the U.S. Code) to provide that in addition to any positions already provided (and without regard to any other restriction of present law) there are to be a total of 20 new positions in the Internal Revenue Service in levels GS–16 and GS–17. These increases are to become effective on the date of the enactment of the bill.

Authorization of appropriations.—The responsibilities and functions allocated to this new office are to be funded by separate appropriations, authorization for which is made in this bill. For this purpose, the bill authorizes that the revenue from the annual $1 audit-fee tax imposed on the employer for each plan participant (sec. 4974) plus one-half of the revenues from the 4 percent excise tax on foundation investment income (sec. 4940) is authorized to be appropriated to this office for purposes of carrying out the functions of the office.

[110] The investment income tax on foundations currently is yielding $56 million. This suggests that given the present level, $28 million would be authorized for the new office from this source. It is estimated, based upon the present number of covered pension participants, that $30 million will be collected from the new $1 audit fee tax. Thus, based upon present levels of revenue and participants the revenue provided for the new office is expected to amount to $58 million. Presently the costs of administering the provisions of the tax law relating to exempt organizations is about $20 million and the cost of administering the provisions relating to employee plans is about $22 million. This suggests a total of $42 million, but with the new activities provided in the case of pension plans and the expanded requirements under the 1969 Act with respect to exempt organizations, it is anticipated that significantly more revenue than this will be required to carry out these functions in the future.

Because the authorization for the new office is to be based upon estimates of collections from the two taxes referred to above, it is necessary to have collection data available for purposes of this authorization. As a result, the bill provides that generally the amount of the authorization is to be based upon collections for the second preceding fiscal year. Since the audit fee tax is a new tax first going into effect in the calendar year 1974, the collections from this tax will be first realized in the last half of fiscal year 1974, i.e., the first six months of calendar year 1974. This means that collections for the second preceding year with respect to this portion of the revenue of the new office will not be available before the fiscal year 1976. As a result, as a substitute for the audit fee tax in the years 1974 through 1976, the bill authorizes $35 million a year for the new office. This is in addition to the authorization of half of the collections from the foundation investment income tax.

The funds provided by these two taxes which are authorized for the new office in the Internal Revenue Service are to be used only for activities delegated to this new office and may not be transferred or used by the Internal Revenue Service in any other manner.

Effective date

These provisions are to be effective as of the date of enactment of the bill.

Revenue effect

It is not believed that this provision will have any revenue effect (but, for revenue raised by the audit-fee tax, see below.)

2. EXCISE TAX FOR AUDITING

Present law

As indicated above, the present annual cost of administering employee benefit plans subject to the special tax provisions of the Internal Revenue Code is about $22 million. With the increased costs arising from the expanded duties it is estimated that additional costs will in the near future raise this total to about $35 million. Under present law no audit fees or taxes are paid with respect to a qualified employee plan in order to cover the costs of the Internal Revenue Service in administering qualified employee plans.

[111] *General reasons for change*

The committee's bill (sec. 101) has established a new Office of Assistant Commissioner for Employee Plans and Exempt Organizations to administer the qualified employee plan provisions and the exempt organization provisions of the code. Under present law, private foundations pay a 4 percent excise tax on their investment income (sec. 4940) half of which under the provision described above is to be used to meet the administration of the exempt organization provisions and other costs of the new office. In contrast, qualified employee plans do not presently contribute funds for the administration of the provisions of the tax law relating to their qualified status. The committee believes that qualified employee plans like exempt organizations should contribute to the cost of their administration. Accordingly, the committee has decided to impose a $1 audit fee excise tax on the employer for each plan participant in a qualified employee plan. As indicated in the provisions described above, the revenue from the $1 audit fee is to be authorized to be used to meet the portion of the joint cost of the new Office of Assistant Commissioner, Employee Plans and Exempt Organizations, which is attributable to pension plans.

Explanation of provisions

The bill provides that for the calendar year beginning on January 1, 1974, and subsequent years an excise tax is imposed of $1 per participant under an employer pension, profit-sharing, or stock bonus plan (described in sec. 401(a)), or an annuity plan (described in sec-403(a)), or a bond purchase plan (described in sec. 405(a)). The $1 tax imposed is to be paid by the employer of each participant under a qualified plan.

For purposes of administration and collection of this tax the employment tax provisions (subtitle C) of the code are to be applicable. Thus, the audit fee tax becomes the liability of the employer when contributions are first made during a calendar year by, or on behalf of, an employee to a qualified employee plan. However, contrary to the employment taxes, the $1 audit fee excise tax is to be deductible as a trade or business expense (i.e., sec. 3502 does not apply).

The tax imposed under this provision is not to apply to participants under a plan of an agency or instrumentality of the United States, a State or political subdivision. For purposes of this provision a plan established by the employer includes a plan established by a predecessor of the employer.

To be a participant, an individual must be actively employed by the employer at any time during the calendar year. Further, the individual must be entitled to have amounts contributed to or under a qualified plan on his behalf by the employer (or to make contributions to the plan) and must not currently be receiving benefits under the qualified plan (that is, is not a retiree).

The Treasury Department is authorized to prescribe such regulations as may be necessary to carry out the provisions imposing the $1 excise tax.

Effective date

The $1 excise tax is to be applicable to calendar years beginning after December 31, 1973.

[112] *Revenue effect*

The enactment of this provision is expected to produce approximately $30 million of excise taxes at 1973 levels of employment.

3. TAX COURT DETERMINATIONS

Present law

Plans which meet the requirements of the Internal Revenue Code (that is, are exclusively for the benefit of employees, are nondiscriminatory in regard to coverage and benefits. do not engage in prohibited self-dealing transactions and meet certain other qualifications) receive special tax treatment designed to foster their growth. It is not necessary, in order to receive this special tax treatment, that a prior determination be obtained from the Internal Revenue Service as to the qualification of a plan. However, to assist employers in their development of plans or plan amendments, the Internal Revenue Service issues determination letters indicating whether or not proposed plans or amendments qualify for the special tax treatment. As a practical matter, since taxpayers generally want assurance in advance that their plans or amendments will qualify, in most cases they obtain prior determinations from the Internal Revenue Service before adopting a plan or modification. Such a determination relates both to the qualification of the plan (sec. 401 of the Code) and the tax-exempt status of the related trust (sec. 501 of the Code).

Under the Internal Revenue Service's published procedures, this generally takes the form of a determination letter issued by a district director. The district director may request technical advice from the national office on issues arising from a request for a determination letter. Also, the applicant may request national office consideration of the matter if the district director does not act within 30 days from notice of intent to make such a request, or acts adversely.

Standards are set as to the type of situation in which the national office will entertain a request for consideration of a case. It will, for example, consider a case where the contemplated district office action is in conflict with a determination made in a similar case in the same, or another, district. The procedure provides for a conference in the national office, if it is requested by the applicant.

General reasons for change

In most cases an employer is ultimately able to obtain national office consideration of a request for a determination by means of a request for technical advice by a district director or by appeal to the national office of a district director's determination or failure to make a determination. In some cases, the Service has refused to make a determination with respect to the status of a plan and related trust. In either case, however, the employer has exhausted his remedies after the action by the national office.

As a practical matter, there is no effective appeal from a Service determination (or refusal to make a determination) that a proposed pension plan fails to qualify for the special tax benefits. In these cases, although there may be a real controversy between the employer and the Service, present law permits the employer to go to court only after he has made contributions to the plan, deducted them, and had

[113] those deductions disallowed. The long time period and the related uncertainty, coupled with the threat of the ultimate loss of the tax deduction, almost always causes the employer to go along with the Service, even if he disagrees with the Service's position. In addition, the determination letter procedure does not permit employees, or their unions, to question the qualification of plans.

The committee believes that both employers and employees should have a right to court adjudication in the situations described above. The bill deals with the problem by providing that, in the event of an unfavorable determination (or failure to make a determination), the employer may ask the Tax Court for a declaratory judgment as to the status of a new plan, a plan amendment or a plan to be terminated. In addition, the committee has decided that interested employees should be allowed to participate in the consideration by the Service of an employer's request for a determination and any controversy connected with it. An employee who intervenes in the Service's determination procedure is to be entitled to receive a copy of the determination issued by the Service in connection with the proceeding. If the employee questions a Service determination with respect to the qualification of a particular plan, he may petition the Tax Court to issue a declaratory judgment as to the status of the plan.

The committee believes that this procedure is desirable because it will permit all interested parties to the controversy (the Government, the trustee, the employer, and his employees) to have an opportunity to participate in the administrative determination of the matter and to have an opportunity to contest the Service determination of the matter.[2]

While the committee decision permits employers and their employees to petition the Tax Court for a declaratory judgment in connection with a new plan, a plan amendment, or a plan termination, the committee also expects the Service to establish procedures whereby interested parties (including employees regardless of whether they are plan participants or plan beneficiaries) may question the continued qualification of a plan and a related trust and obtain a determination from the Service. In such a case, it is believed that the Service should afford the employer and other interested parties an opportunity to be heard before issuing a determination letter with respect to the plan and related trust. If the Service ultimately concludes that a plan is no longer qualified, then the Service is to proceed in the usual manner by notice of deficiency. Of course, the Service while concluding that the plan remains qualified could conclude that there has been a violation of a fiduciary obligation, and the Service would then proceed by imposition of the excise tax.

While this new procedure is being made available to parties who desire to use it, there is no requirement that a party use this new procedure to determine the status of a plan. Further, there is no requirement, as a condition for qualification, that a request for a determination be made.

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[2] The present Service procedure provides that appeals from a district director are to be considered by the national office in Washington, D.C., and as a result, if a party wishes to make an oral presentation, he must incur the cost of travel. The Service has instituted a regional appeals procedure in connection with the status of an organization exempt by reason of section 501(c)(3) and it is hoped that the Service will institute a similar appeals procedure for employee benefit plan determinations.

[114] *Explanation of provisions*

In general.—The bill provides that the United States Tax Court is to have jurisdiction to hear and enter judgments with respect to controversies as to the qualification of an employee plan which has been established by an employer. The plans for which the Tax Court may enter a declaratory judgment are pension, profit-sharing, and stock bonus plans (described in sec. 401(a)), annuity plans (described in sec. 403 (a)), and bond purchase plans (described in sec. 405(a)). A declaratory judgment issued by the Tax Court is to be treated as the final decision of the court and is to be appealable to the U.S. Court of Appeals.

The Tax Court is to have jurisdiction to declare whether a plan is, or is not, a qualified plan, but in this judgment is not to determine whether any proposed action is a prohibited transaction (sec. 4973). The Court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new matter which the Service may wish to introduce at the time of the trial. The Tax Court decision, however, is to be based upon a redetermination of the Service's determination and not by a general examination of the provisions of the plan or related trust. The judgment is to be binding upon the parties to the case based upon the facts as presented to the Court in the case for the year or years involved. This, of course, does not forclose future action if an examination of the operations of the plan indicates that the plan does not in operation meet the requirements for qualification.

The parties entitled to petition the Tax Court for a declaratory judgment under this provision in general are the trustee of a plan, a taxpayer seeking to take a deduction for contributions to a plan or trust, or an employee of the taxpayer.

Exhaustion of administrative remedies required.—For a petitioner to receive a declaratory judgment from the Tax Court under this provision, he must demonstrate to the court that he has exhausted all administrative remedies which are available to him within the Internal Revenue Service. Thus, in the case of an employer (or a plan trustee) he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination by a district office to the national office of the Internal Revenue Service, or has requested or obtained through the district director technical advice of the national office. To exhaust his administrative remedies a party must satisfy all procedural requirements of the Service. For example, the Service may decline to make a determination if an employer fails to supply the Service with the necessary information on which to make a determination. In addition, the Service should decline to make a determination if it is not satisfied that the employer has taken reasonable steps to notify all employees who might have an interest in the action on request for a determination.

In addition to exhausting administrative remedies, an employer must have placed a plan into effect prior to the petition of the Tax Court for a declaratory judgment. However, a new plan is to be treated as being in effect even if it includes a provision that the funds con-

[115] tributed to it by the employer and employee may be refunded in the event that the plan is not found to be a qualified plan by the Service or the Tax Court. In the event that the contributions are refunded, all deductions for contributions would be disallowed and all income derived by the trust would be includable in income by the person who receives the payment. In the case of a plan amendment or plan termination, the proposed action by the employer or plan trustee also may be put into effect on a conditional basis.

While the Service presently does not provide any procedure for employee objection to proposed determinations concerning the qualification of a plan, it is anticipated that the Service will adopt procedures similar to those procedures provided for employers making the request for the determination. These procedures would permit employees who have an interest in the requirements necessary for the plan to qualify to participate in the administrative determination of whether a plan is entitled to qualified status. An employee must exhaust these remedies before petitioning the Tax Court for a declaratory judgment. If there has been a failure to provide an employee with adequate notice of a request for a determination, then he need only exhaust those administrative remedies that are available to him at the time he receives adequate notice.

Tax Court Commissioners.—In order to provide the court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the Commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide.

Right to petition Tax Court.—The right to petition the Tax Court for a declaratory judgment is to arise only out of cases involving requests for a determination with respect to a new plan, an amendment to an existing qualified plan, or a termination of an existing qualified plan. The request for a determination must be communicated by the employer (or plan trustee) to the employees at the time that a request for a determination is made to the Service. This apprises the employees of their rights, or lack of rights, under the plan and permits them to participate in the proceedings with the Service and enter an objection to any proposed determination.

An employer (or a trustee of a plan) may bring an action for a declaratory judgment in connection with a pension, profit-sharing, stock bonus, annuity, or bond purchase plan if he has submitted to the Service a request for a determination as to the qualified status of a new plan or the continued qualified status of a plan that has been amended or the status of a plan which has been terminated. If the action is brought by the employer or trustee, any employee who had intervened in the proceedings before the Service is to be allowed to intervene in the Tax Court proceedings.

An employee may bring an action for a declaratory judgment if his employer or the trustee of his employer's plan obtained a determination from the Service that is adverse to the employee. A determination may be adverse to an employee, for example, if he is excluded from the group of employees covered by the plan or if his vesting or benefits are not as favorable as he claims they need to be in order to

[116] satisfy the nondiscrimination provisions of the tax law. To bring the action an individual must have been an employee of the employer during the period for which he is questioning the qualification of the plan. In any suit by an employee for a declaratory judgment his employer or the trustee of the plan is to be allowed to intervene.

Time for bringing action.—In general, the petition to the Tax Court for a declaratory judgment must be filed within 90 days after the date on which the Commissioner sends by certified or registered mail his final determination in response to an employer or trustee's request for a determination. Generally, the event causing the period to begin to run is to be a notification by the national office of a refusal to hear an appeal from a district director's determination, or of a notice of a decision with respect to an appeal from a district director's determination. Alternatively, the event may be a notice by the district director of a response by the national office for technical advice. To give interested parties an additional period of time in which to make determinations or file documents, the bill provides that the period for filing a petition may be extended for such additional period as may be needed if agreed to by the Service and the party making the request for a determination.

Generally, the Commissioner is to have 270 days within which to make a final determination. As explained above, however, this period may be extended by consent for whatever period is agreed to by the Commissioner and the party making the request for a determination.

If the Service fails to make a final determination within the specified period of time (including any extensions of time), the employer or trustee may bring his action for a declaratory judgment within 90 days after the expiration of the 270-day period or such longer period for which an extension had been agreed.

Burden of proof.—The normal rules of burden of proof and evidence for the Tax Court are to be applicable in declaratory judgment cases. The burden of proof is on the petitioner with respect to any ground which was set forth in the determination in a manner which informs the petitioner of the reasons for the Service's action. The burden of proof is on the Service with respect to any reason which was not set forth by the Service as a reason for denial of qualification. If the case involves a request for a declaratory judgment where the Service did not make a determination, the burden of proof is to be on the Service for any ground on which it relies in the declaratory judgment proceeding. If an employee disagrees with the Service's determination that a plan is qualified, the burden of proof is on the employee to show that the plan is not qualified.

Effective date

The amendments providing for petitioning of the Tax Court to issue declaratory judgments is to take effect on January 1, 1975.

4. DETERMINATION OF EMPLOYEE RIGHTS

Present law

Under present law, retirement plan participants do not have any right under Federal law to access to an inexpensive forum for having their pension rights declared. In the case of those plans which do not

[117] provide for some form of grievance or arbitration procedure, the plan participants generally only have an opportunity to obtain redress of their grievances in State or local courts.

General reasons for change

The committee believes that all workers and plan beneficiaries should have the opportunity to resolve any controversy over their retirement benefits under qualified plans in an inexpensive and expeditious manner. Hardships have been encountered in the past by workers who are unable to plan for their retirement because of the uncertainty of their benefits and by beneficiaries who have lost benefits to which they were entitled. Accordingly, the committee has decided to provide that controversies as to retirement benefits are to be heard by the Department of Labor.

The procedures provided by this section of the bill are provided as alternatives to existing procedures that may be available to plan participants or beneficiaries. Nor are these procedures intended to override the provision of any collective bargaining agreement or similar agreement which sets out procedures for employees in redressing their grievances.

Explanation of provisions

The bill provides a procedure whereby a plan participant or beneficiary may request the Secretary of Labor to hear and decide disputes as to the present or future entitlement of a plan participant or beneficiary to benefits under a plan which is (or was) qualified under the Internal Revenue Code. For this purpose, a qualified plan is a pension, profit-sharing, or stock bonus plan (described in sec. 401(a) of the code), an annuity plan (described in sec. 403(a) of the code), or a bond purchase plan (described in sec. 405(a) of the code).

To be a participant, an individual must be actively employed by the employer at any time during the calendar year. Further, the individual must be entitled to have amounts contributed to or under a qualified plan on his behalf by the employer (or to make contributions to the plan) and must not currently be receiving benefits under the qualified plan (that is, is not a retiree). A plan beneficiary generally is an individual who is receiving (or claims a right to receive) benefits under a qualified plan.

Upon the application of a plan participant or beneficiary for a determination of his retirement rights the Secretary of Labor is to notify the administrator of the plan under which the applicant is requesting that his rights be declared. The Secretary is to notify the plan administrator of the matters complained of and the relief requested by the applicant, and to hold a proceeding at such time and place and in such manner as to permit the plan participant or beneficiary to be present and to present his case to the Secretary.

The Secretary is to attempt to secure voluntary compliance with any decision he makes with respect to an applicant's retirement rights, but he has the power to issue an order directing the plan administrator to comply with the terms of any decision. In the case of a refusal to comply with a decision of the Secretary, the Secretary may petition any U.S. District Court within the jurisdiction of the proceedings to issue an order requiring compliance.

[118] In any hearing conducted by the Secretary under this proceeding the Secretary is to have the authority to require attendance and to permit examination of witnesses and the production of books, papers, and documents (secs. 49 and 50 of the Federal Trade Commission Act). Under this provision the Secretary also is authorized to examine and copy any documentary evidence of any corporation which is a party to the proceedings and to have the power to require by subpoena the attendance and testimony of witnesses and the production of documentary evidence relating to any matter relative to the proceedings. Other procedures and practices common in administrative determinations of this type are also provided for. It is expected that the procedures adopted by the Secretary will be conducted with a minimum of formality and without requiring a printed record in all cases. It is believed if this procedure is followed, the hearings can be conducted in an expeditious and inexpensive manner.

Any decision made by the Secretary determining the pension benefits of an applicant may be appealed to any United States District Court within the jurisdiction of which the proceeding was held. The provisions of Chapter 7 of Title 5 of the United States Code (relating to judicial review) are to apply to any such appeal and on appeal the facts upon which the decision was based are subject to a trial de novo by the reviewing court.

Effective date

The provisions of this section are to take effect and apply to applications for determinations made on or after January 1, 1975.

I. Limitation on Contributions

(Secs. 702, 704, and 706 of the bill and secs. 72, 401, 404, 412, 414, 1379, and 6691 of the Code)

Present law

Under present law, different rules are provided for employer and employee contributions in the case of plans for self-employed individuals (H.R. 10 plans), plans of "regular" corporations, and plans of electing small business corporations (subchapter S).[1] These are described below.

H.R. 10 plans.—The amount of deductible contributions to an H.R. 10 plan on behalf of a self-employed person cannot exceed the lesser of 10 percent of his earned income[2] or $2,500 (sec. 404(e)). In addition, nondeductible contributions may be made in certain cases, but these contributions on behalf of owner-employees may not exceed the lesser of 10 percent of earned income or $2,500. Allowable voluntary contributions by employees of self-employed individuals must be at least proportionate to allowable voluntary contributions for self-employed (sec. 401(e)(1)(B)(ii)).

[1] All the types of plans must, in addition to the rules described below, meet the general reasonable compensation tests (sec. 162). The statute does not specify limitations on the benefits which may be paid under a qualified pension plan. However, in Rev. Rul. 72–3, 1972–1 CB. 105, the Internal Revenue Service ruled that pension benefits from a qualifid pension plan are intended as a substitute for compensation, and that in general a plan which provides benefits in excess of an employee's compensation is therefore not qualified.

[2] "Earned income" is generally defined as being equivalent to "net earnings from self-employment"—the kind of income that may be subject to self-employment taxes in lieu of FICA taxes (secs. 401(c)(2) and 1402).

[119] *"Regular" corporate plans.*—In the case of a "regular" corporate plan there are no limitations on how much may be contributed by the employer. There are, however, limitations on the amount of the contribution that is deductible. Different limitations apply to profit-sharing and stock bonus plans and to pension plans.

In the case of profit-sharing or stock bonus plans, the amount of the contribution that is allowable as a deduction is not to exceed in the aggregate 15 percent of compensation to employees covered under the plan. Contributions in excess of the 15-percent limitation may be carried over to future years. In addition, within certain limits, to the extent that an employer does not make the full 15-percent contribution in one year he may increase the amount of his deductible contribution in a future year.

In the case of pension plans, the amount of the contribution that is deductible is not to exceed 5 percent of the compensation to employees covered under the plan, plus the amount of the contribution in excess of 5 percent of compensation to the extent necessary to fund normal pension costs and remaining past service costs of all employees under the plan as a level amount or as a level percent of compensation. In the alternative, the taxpayer may compute the limit on his deductible contributions by limiting his deduction to his normal cost for the plan plus 10 percent of the past service cost of the plan (sec. 404(a)). In practice, these limitations have very little effect in limiting contributions to regular corporate pension plans.

Where an employer contributes to two or more retirement plans which are governed by different limits on deductions (pension, profit-sharing or stock bonus, or employee annuities), the total amount annually deductible under all the plans cannot be more than 25 percent of compensation otherwise earned by the plan beneficiaries. If any excess is contributed, it may be deducted in the following year; the maximum deduction in the following year (for carryover and current contributions together) is 30 percent of compensation. A carryover is available for additional excess contributions which are deductible in the succeeding taxable years in order of time.

Subchapter S plans.—The limitations on the deductibility of contributions to a subchapter S corporation plan are the same as those in "regular" corporate plans. However, a shareholder-employee (an employee who owns more than 5 percent of the outstanding stock of such a corporation) must include in his gross income the amount by which the deductible contributions paid on his behalf exceeds the lesser of 10 percent of his compensation or $2,500 (sec. 1379(b)).

Professional corporations.—Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. Consequently, their contributions to retirement plans were limited by the rules governing self-employed persons. In recent years, however, all States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate

[120] employees. The Treasury Department, in the so-called Kintner regulations, held that professional corporations were not taxable as corporations. A number of court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

General reasons for change

Many self-employed people, especially professionals, feel that they are discriminated against as compared with corporate executives and proprietary employees of corporations in regard to the tax treatment of retirement savings. This is because, at present, there is no comprehensive limit on the amounts the corporate employer can contribute on behalf of its executives and proprietary employees. Self-employed persons, on the other hand, are subject to the contribution limits described above.

In addition, many of the self-employed argue that, as a result of these contribution limits, it is difficult for them to provide adequately for their retirement, particularly as many professionals have a limited number of years of peak earnings, in which it is comparatively easy to set something aside. It is also argued that the $2,500 limit is no longer appropriate, since in the approximately 10 years since H.R. 10 was first enacted, there has been a substantial inflation factor in the economy. Furthermore, it is contended that the present law in the retirement plan area creates an artificial incentive for the incorporation of businesses which more traditionally, and perhaps more appropriately, have been conducted in unincorporated form. For all of these reasons, the committee believes that a substantial increase in deductible contributions for self-employed individuals is justified at the present time. Under the committee bill, the present limits would generally be increased to 15 percent of earned income, up to a maximum deduction of $7,500 per annum.

At the same time, it is clear to the committee that the formation of professional corporations, a practice which has proliferated enormously in recent years, has had the effect of circumventing the limitations which Congress intended to impose on deductible contributions by persons who are essentially, in most respects, self-employed. In many corporate plans a much larger percentage of the contributions and benefits go to "rank and file" employees than is the case with regard to most H.R. 10 plans. In such corporate plans, if large contributions are made for executives, then the antidiscrimination provisions of present law (sec. 401(a)(4)) require that proportionate contributions be made on behalf of rank and file employees. Not only does this "financial drag" effect tend to impose practical restrictions on the size of contributions made for the highest level employees, but it also means that, if large contributions are made for this group, then lower level employees will also benefit. Thus, it appears that many corporate plans are subject to practical limitations which do not apply in the case of self-employed plans. The absence of such practical limitations is the reason that it has been thought necessary to impose legal limitations upon self-employed plans.

However, it appears to the committee that the current method of limitations does not apply equally to all situations where "financial

[121] drag" is very small or nonexistent. Also, the committee feels that the present system discriminates in favor of those who choose to incorporate, and against those who do business in the more traditional partnership form. Similarly, other small businesses in corporate form are treated differently for pension plan purposes depending whether or not they are under subchapter S, and without regard to whether most of the benefits under the retirement plan go to rank and file employees.

The committee bill would correct this situation by putting the regulation of retirement benefits on a realistic basis, applying limitations where they are appropriate, whereas the current system depends too greatly on the form of business operation. Thus, under the committee bill, limitations on contributions would be imposed not only on self-employed plans, as under present law, but also on proprietary employees holding a two percent or greater interest in an incorporated business, but only where all such persons, in the aggregate, have more than a 25-percent interest in benefits under the plan.

Explanation of provisions

The committee bill increases the maximum deductible contribution on behalf of self-employed persons to the lesser of $7,500, or 15 percent of earned income. (A similar, although not identical, rule is applied in the case of defined benefit pension plans.) However, no more than the first $100,000 of earned income may be taken into account in applying the percentage limits. The $100,000 ceiling on the earned income rate base means that a self-employed person with more than $100,000 income will have to contribute at a rate of a least 7½ percent on behalf of his employees if he wishes to take the full $7,500 deduction on his own behalf (in order to comply with the antidiscrimination requirements).[3] A self-employed person earning more than $100,000 who wishes to contribute $5,000 for himself will have to contribute at least 5 percent on behalf of his employees.

The committee bill also extends the application of these provisions to plans for the benefit of "proprietary employees." In general, a "proprietary employee" would be any individual owning either directly, or through attribution rules (those prescribed in sec. 1563(e)), at least 2 percent of the total combined voting stock of the corporation, or 2 percent of the total value of all shares of stock in the corporation. However, the provision does not apply unless all proprietary employees who are active participants, as a class, have more than 25 percent of the total account balances for active participants under a defined contribution plan (such as a money purchase plan), or in other cases have more than 25 percent of the present value of all accrued benefits under the plan (whether or not vested) for active plan participants.[4] The committee believes that this approach will place the treatment of corporate plans on a more realistic and equitable basis—where most of the benefits under the plan are for individuals who are not proprietary employees, the contribution ceiling will not apply, but

[3] The limitations on nondeductible contributions on behalf of owner-employees in a self-employed plan is not increased, however.

[4] In a case where a corporation has two or more plans, an individual will be a proprietary employee for purposes of all the plans, if the more than 25 percent test is met with respect to any of the plans.

[122] where a substantial portion of the plan benefits are for proprietary employees, the ceiling will apply.

The new rules are also to apply in the case of subchapter S corporations. Under the committee bill, section 1379 is repealed. However, subchapter S corporations would remain subject to limitations under the same rules applicable to other corporations. Thus, if more than 25 percent of the benefits under the plan were for individuals who each held at least 2 percent of the stock in the corporation, these stockholders would be considered to be proprietary employees, and would be subject to the 15 percent—$7,500 limitation. But if less than 25 percent of the benefits were for these individuals, these limitations would not apply.

As is the case under present law with respect to an owner-employee, a proprietary employee (or a group of two or more proprietary employees) who controls more than one business would be required under the bill to group together all controlled business activities for the purpose of determining whether all employees of the proprietary employee are covered by a retirement plan on a nondiscriminatory basis, and also for the purpose of assuring that the limitations on contributions are not exceeded. As a result of this requirement, a proprietary employee could not make contributions under two or more retirement plans, which, when totaled together exceeded $7,500. This provision ensures that a proprietary employee may not exceed the limitations on deductible contributions by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his business and set up a retirement plan in one business where, for example, he is the only employee.

The bill also provides that—like an H.R. 10 owner-employee under present law—an individual who is a proprietary employee in a business (whether or not he controls the business), and is also a proprietary employee in another business which he controls, may not be covered under the plan of the first business unless he has established a plan for the employees of the business which he controls. The plan for the business which he controls must provide contributions and benefits for employees which are at least as favorable as the contributions and benefits provided for him under the plan of the first business.

The rules outlined above also apply in cases where an individual is an owner-employee in one firm and a proprietary employee in a second business.

Defined benefit plans—limitation on benefits.—The committee bill also contains a provision, which applies in the case of all defined benefit plans (including corporate plans without proprietary employees), generally limiting the annual benefits which can be paid out under these plans (as of age 65) to 100 percent of the participant's average compensation from the employer during his highest 3 consecutive years of earnings. A pension is essentially a substitute for earning power during the retirement years and the committee believes that no qualified pension plan should pay defined benefits which are higher than an employee's average earnings during his highest 3 years. It is the understanding of the committee that this provision is consistent with present law (Rev. Rul. 72-3, 1972-1 C.B. 105) and by this provision the committee only intends to clarify and make more explicit present law.

[123] The plan could, however, provide for a cost of living adjustment over and above the 100 percent limit. However, benefits paid in the event of early retirement would have to be scaled down from the 100 percent of salary level on an actuarial basis. In general, in the case of any defined benefit pension plan which does not pay benefits in the form of a straight life annuity, commencing at age 65, or which provides ancillary benefits, the 100 percent limitation would have to be adjusted in accordance with regulations.[5] In the case of a contributory plan, upward adjustments in the benefit schedule would be permitted in accordance with regulations, to reflect the fact that part of the annuity had been purchased with the employee's own after-tax dollars.

In the case of an employee who is a participant in both a defined benefit pension plan and a money purchase pension plan, the maximum 100 percent of salary benefit under the defined benefit pension plan would be reduced under the committee bill by multiplying 100 percent of the participant's average compensation by a fraction, the numerator of which is the percentage of compensation contributed under the money purchase plan, and the denominator of which is 20. (Under another provision of the committee bill, 20 percent would be the maximum tax-excludable contribution under a money purchase plan.)

For example, if an employee had an average high-three-year salary of $20,000, and a 10 percent of salary contribution had been made on his behalf to a money purchase plan, his maximum yearly benefit under the defined benefit pension plan could not exceed $10,000 (10/20ths of $20,000). This would prevent the situation where an employee might seek to circumvent the limitations on benefits under a defined benefit plan, or on tax-excludable contributions under a money-purchase plan, by setting up two different types of plans for himself. (In cases where the rate of contributions to a money purchase plan fluctuated over the career of the employee, or were made for certain years when he was a participant under the defined benefit plan, but not for others, appropriate adjustments to this formula will be made in accordance with regulations.)

As a further adjustment, in the case of an employee who participates in a defined benefit plan for less than 10 years, the defined benefit otherwise allowable in accordance with the rules described above is to be reduced by multiplying the otherwise allowable benefit by a fraction, the numerator of which is the proprietary employee's years of active participation in the plan, and the denominator of which is 10. For example, if an individual who was an active participant for 3 years under the plan had an average high-three years salary of $50,000 (and no other adjustments were required) his maximum benefit could not exceed 3/10ths of $50,000, or $15,000 per annum.

This would prevent a situation where an individual might receive an extremely high pension, even though he had only a few years of active service under a plan.

Defined benefit plans for proprietary employee corporations.—At present, many small corporate plans are defined benefit plans, although

[5] The committee expects that the adjustment for ancillary benefits will be substantially equivalent to the adjustment now provided under present law for a plan which is integrated with social security.

[124] most self-employed plans are defined contribution plans because of the limitations on contributions imposed on self-employed persons under present law. The committee was concerned that in extending the contribution limits to certain proprietory employee corporate plans, the committee bill might inadvertently take away, as a practical matter, the option of having defined benefit plans from these corporations. As a result, the committee bill contains a formula (which under the bill may also be used by self-employed individuals) which would allow proprietary employees, in effect, to translate the 15 percent—$7,500 limitations on contributions, to which they would otherwise be subject, into limitations on benefits which they could receive under a defined benefit plan. (Of course, all employees of all corporations, and all self-employed individuals, remain subject to the 100 percent of salary limitation, discussed above.)

Under the formula, the basic benefit for the employee (that is, a straight life annuity commencing at the later of age 65 or 5 years from the time the participant's current period of participation began, with no ancillary benefits) is not to exceed the amount of the employee's compensation which is covered under the plan (up to a maximum of $50,000) times the percentage shown on the following table.

Age at participation	*Percentage*
30 or less	6.5
35	5.4
40	4.4
45	3.6
50	3.0
55	2.5
60 or over	2.0

The percentages in early years are higher to reflect the fact that contributions made during these time periods earn interest for a longer period prior to retirement than contributions made in later years. The Secretary or his delegate is to have authority to prescribe regulations in cases of plans which provide something other than the "basic benefit." Also, the regulations are to specify percentages for individuals who become participants at ages other than those shown on the table. In addition, the Secretary or his delegate is given authority to prescribe new percentages, to be used in years beginning after December 31, 1977, based on changes in money rates and mortality tables occurring after 1973.

To illustrate how this formula would work, assume that a self-employed person enters a defined benefit plan at age 30, and participates in the plan for 5 years, with income covered under the plan of $20,000 per annum. At age 35, he leaves the plan, but at age 50, he again becomes a participant. For the first 5 years his covered income is $30,000 per year, then $40,000 for the next 5 years, and finally $50,000 for the last five years prior to his retirement.

The calculation would work as follows:

Age	Compensation per year	Rate	Benefit earned per year	Total benefit
30–35	$20,000	6.5	$1,300	$6,500
50–55	30,000	3.0	900	4,500
55–60	40,000	3.0	1,200	6,000
60–65	50,000	3.0	1,500	7,500
Total				24,500

[125] Thus, the maximum benefit which could be paid to the individual under the plan in the form of a single life annuity commencing at age 65 with no ancillary benefits would be $24,500 per year.

The committee bill also provides that for purposes of the antidiscrimination rules, the maximum amount of compensation which is to be taken into account is to be $100,000. (This is the same ceiling provided in connection with contributions to a money purchase plan.) For example, if a self-employed person established a defined benefit plan for himself at age 50 (where a 3 percent rate would apply) and earned $100,000 per year, benefits under the plan for his employees could be earned at the rate of 1.5 percent of covered compensation, and the plan would not be considered to be discriminatory. In other words, the maximum benefit which could accrue per year for the self-employed person would be 3 percent of $50,000, or $1,500, which is equivalent to 1.5 percent on a $100,000 base. Thus, the self-employed person would be permitted to make contributions which would purchase a 1.5 percent benefit for his employees. However, even if the self-employed person's earnings were $200,000, benefits earned for the employees under the plan could not drop below the 1.5 percent rate.

Limitations on contributions to money purchase plans.—The committee bill also contains a provision which would limit tax excludable contributions under a money-purchase plan. Cases have been found where the stockholders of small corporations invest very substantial percentages of their income in what is, in effect, a deferred compensation arrangement. As discussed above, the Internal Revenue Service has ruled (Rev. Rul. 72–3, 1972–1 C.B. 105) that a pension is essentially a substitute for earning power during the retirement years and that, in general, a pension plan does not qualify in cases where the pension benefit is more than the employee's highest average salary. The committee agrees with this interpretation of present law, but the 100-percent-of-salary limitation is difficult to apply in the case of money purchase plans because the amount of the pension benefit which will ultimately be received cannot be determined with precision. Thus, the committee bill, as a corollary to the 100-percent-of-salary limitation for defined benefit plans, also contains a provision that tax excludable contributions to a money purchase or other defined contribution plan cannot exceed 20 percent of the employee's compensation. Any additional contributions on behalf of the employee must be included in income by him.[6]

To enforce these provisions, employers or pension plan custodians would be required to report to the Service, in accordance with regulations, whenever contributions in excess of the 20 percent limitation had been made, and a penalty ($10 a day up to a $5,000 maximum) would be imposed for each instance of unexcused failure to comply with these reporting requirements.

Any amount included in gross income under this provision would be considered as part of the employee's investment in the contract for purposes of computing the taxable amount of a distribution from the plan to the employee. However, these contributions would be considered to be made by the employer for purposes of qualification of the

[6] The only exception would be in the situation where a contribution was made by the employer at a 20 percent rate (or less) for his employees, but the contribution happened to exceed 20 percent of the employee's actual compensation due, for instance, to a termination of employment.

[126] plan. If the employee's rights under the plan should terminate before tax excludable payments under the plan equaled the amounts included in gross income under this provision, a tax deduction would be allowed equal to the unrecovered contributions.

Integration rules for plans benefiting proprietary employees.— Under present law, any H.R. 10 plan which benefits owner-employees is subject to certain additional rules with respect to integration. If more than one-third of the contributions under the plan are made on behalf of owner-employees, the plan is not permitted to integrate with social security. On the other hand, if less than one-third of the contributions are made for owner-employees, and the owner-employee treats the self-employment taxes which he pays as contributions on his own behalf under the plan, the plan may integrate by treating the employer's social security contributions on behalf of his employees as contributions made under the plan (sec. 401(d)(6)). By contrast, a qualified employer plan may integrate by treating social security benefits as benefits provided under the plan (within certain limits).

Under the committee bill, essentially these same provisions would be applied in the case of plans for proprietary employees. Otherwise, it was apparent to the committee that professionals and others would still have a substantial artificial tax incentive to incorporate rather than to do business in more traditional forms. In addition, it seemed reasonable that the same general considerations which led the committee to conclude that it was desirable to extend the limitations on contributions to certain corporate plans, also suggest that employees of those corporations should have the extra protection against erosion of their pensions through integration that the special rules afford.

Therefore, under the committee bill, it is provided, in general, that in any plan for the benefit of proprietary employees, the plan may not integrate if more than one-third of the account balances or accrued benefits under the plan are for the benefit of individuals each of whom holds 10 percent or more of the stock in the corporation. Other proprietary employee plans may integrate, but only on the same basis as an owner-employee plan could integrate (that is, by treating social security taxes paid for the employees as contributions paid on their behalf under the plan).

At the same time, the commitee recognizes that there are many small corporate plans, already in existence, which now use integration, and which might be seriously affected if the rules in this area were to be altered too abruptly.

The committee bill provides a transitional rule, under which any proprietary employee plan which was in existence on July 24, 1973, may continue to integrate (in plan years beginning before January 1, 1980) at the same level of integration (if any) as was in effect under the plan on July 24, 1973, but the level of integration may not increase. (For example, when the social security rate base rises, the plan must still continue to integrate at the old level.) However, any self-employed plan which elects to convert to a defined benefit basis (using the table and formula described above) and any new proprietary plan, created after July 24, 1973, which elects a defined benefit approach, may not integrate. Also, any proprietary plan in existence on July 24, 1973,

[127] which shifts from a defined contribution plan to a defined plan may not integrate.

Other special rules for proprietary employee plans.—The committee bill also extends certain other provisions which apply to H.R. 10 plans under present law to plans for the benefit of proprietary employees as well. For example, payments under a qualified pension plan to a proprietary employee would have to begin by the time he attained age 70½, and the employee's account would have to be paid out at least ratably over the life of the employee or the lives of the employee and his spouse (sec. 401(a)(9)). Also, if a proprietary employee should die before his entire interest in the plan had been distributed to him, the plan would generally be required to distribute that interest, or purchase an annuity for his beneficiaries, within 5 years after his death (sec. 401(d)(7)).

Also, excess contributions on behalf of any proprietary employee would have to be prohibited by the plan (although, as under present law, nondeductible employee contributions could be made by a proprietary employee, up to $2,500 per year, in plans where such contributions may be made by employees who are not proprietors) (secs. 401(d)(5) (A) and (B), and 401(e)(1)). Any excess contributions which were made inadvertently would have to be repaid by the plan to the corporation within 6 months after mailing of notice of the overcontribution by the Internal Revenue Service (secs. 401(d)(8)(A) and 401(e)(2)(C)).

Also, death benefits paid by a qualified plan to a proprietary employee would not qualify for the $5,000 death benefit exclusion for purposes of the Federal income tax (sec. 101). Proprietary employees (and individuals who had been proprietary employees at any time within 5 years prior to the distribution) would be treated the same as self-employed persons for purposes of the rules with respect to the income tax treatment of lump-sum distributions (sec. 72(n)).

In addition, if a proprietary employee borrows money, pledging his interest in the pension plan as security, the portion pledged as security shall be treated as a distribution under the pension plan to the employee (sec. 72(m)(4)). The purpose of this rule is to prevent the employee from engaging in an arbitrage type of transaction, in which he makes a tax deductible contribution to the pension, which also earns tax-free interest, then gets the money out of the plan, in effect, by means of a loan secured by his portion of the plan assets, and also receives a tax deduction for the amount of interest paid on the loan (subject to certain limitations on excess investment interest (sec. 163(d)).

Time for making contributions.—Under present law, contributions to a self-employed plan must be made by the end of the taxable year in order to be deductible for that year. Often this can create difficulties for the self-employed person, who may not have at hand all the information necessary for him to determine how much he is permitted to contribute on his own behalf. In order to meet this problem, the committee bill provides that tax deductible contributions to self-employed plans (and all other qualified plans) may be made at any time up to the point when the Federal income tax return (corporate or individual, as the case may be) for that year is due (including any exten-

[128] sion). This rule should provide the additional time necessary for the individuals involved to make the required calculations and determine the amount of the maximum deductible contribution which is permitted for the taxable year in question.

Custodial Accounts.—Under present law, a custodial account may be treated as a qualified trust, but only if the custodian is a bank, and the investments are made solely in the stock of regulated investment companies, or solely in annuity, endowment, or life insurance contracts (and certain other conditions are met) (sec. 401(f)). The committee believes that present law is too restrictive in this respect and the committee bill would allow the custodian of the account to be someone other than a bank, provided, however, that the custodian would have to establish, to the satisfaction of the Internal Revenue Service, that it would manage the assets of the account in a manner consistent with the intention of the tax law. (For example, it would have to be shown that no premature distribution prior to age 59½ would be made to owner-employees.) Also, a formal custodial account would no longer be necessary under the bill. Any similar arrangement having appropriate safeguards could be used if approved by the Secretary.

Also, the committee bill would provide that someone other than the trustee or custodian, including the employer, can have authority to control the investments of the plan account, either by directing the investment policy of the plan, or by exercising a veto power.

Generally, the requirement of the bill would be satisfied in a situation, where, for example, a regulated investment company or other investment advisor might make investment decisions with respect to the assets of the account, but an independent third party, which might be a bank or some other responsible institution, would administer the plan, and handle distributions. The committee is desirous of affording extra flexibility in this area, and reducing the cost of pension plan administration, but it also wishes to preserve the safeguard of a plan administrator which is independent with respect to the employer.

Withdrawal of voluntary contributions by owner-employees.—Under present law, amounts received from a retirement plan before retirement are tax free to all participants other than owner-employees to the extent of all nondeductible contributions made to the plan by the participants. Thus, all participants other than owner-employees may, if the plan permits it, withdraw their voluntary contributions prior to retirement. The committee bill would extend this same treatment to owner-employees.

Effective date

Generally, these provisions would take effect in plan years beginning after December 31, 1973. However, in the case of proprietary employee plans in existence on July 24, 1973, that will be made subject under the bill to certain rules and limitations which, under present law, apply only in the case of owner-employee plans, the committee believes that a transitional period is necessary to allow time for plan amendments. Thus, proprietary plans in existence on July 24, 1973, will generally be made subject to the contribution limits for plan years beginning after December 31, 1974. Extension of H.R. 10 owner-employee plan restrictions to proprietary employee plans in

[129] existence on July 24, 1973, will also generally take effect in plan years beginning after December 31, 1974. In addition, proprietary employee plans which were integrated on July 24, 1973 may continue as integrated plans, but may not increase the level of integration.

The repeal of the special subchapter S limitation (sec. 1379) is effective for plan years beginning after December 31, 1973, and subchapter S corporations will then become subject to corporate rules (including the rules on proprietary employee plans) in this area.

The treatment of proprietary employees as self-employed persons for purposes of the death benefit income tax exclusion (sec. 101) and the rules on lump-sum distributions (sec. 72(n)) will apply to taxable years beginning after December 31, 1973.

The amended rules, with respect to custodial accounts apply to plan years beginning after December 31, 1973.

Revenue effect

By increasing the maximum amount that self-employed persons will be allowed to deduct as contributions under H.R. 10 plans to 15 percent of earned income up to $7,500 a year, an increased revenue loss is estimated that will amount to $175 million annually. The provision in the bill that allows individuals who are not covered presently by pension plans to deduct up to $1,000 a year as contributions to personal retirement plans will reduce revenues by an estimated $270 million a year. A revenue gain of $125 million is estimated to be the result of the provision that applies to certain proprietary employees of corporations the same limitations on deductible pension contributions that apply to self-employed individuals under H.R. 10 plans. The net result of these three provisions that are designed to equalize tax treatment under pension plans is a revenue loss of $320 million. These estimates assume 1973 levels of income and employment.

J. Employee Savings for Retirement

(Secs. 701 and 706 of the bill and secs. 72, 219, 408, 409, and 4960 of the Code)

Present law

Generally, an employee is not allowed a deduction for amounts which he contributes from his own funds to a retirement plan. There is no provision for an employee to establish his own retirement plan with tax-free dollars. Also, while an employer's qualified plan may allow employees to contribute their own funds to the plan,[1] no deduction is allowed for these contributions (except to the extent that tax excludable contributions made in connection with salary reduction plans, described below, may be viewed as employee contributions). However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.[2]

In the case of a salary reduction plan, however, in the past employees have been permitted to exclude from income amounts contributed by

[1] Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation. I.R.S. Publication 778, p. 14 (Feb. 1972).

[2] At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person; no deduction was allowed for half of the contribution (presumably, the half "contributed by" the self-employed person). This limitation (sec. 404(a)(10)) was repealed for taxable years after December 31, 1967.

[130] their employers to a pension or profit-sharing plan, even where the source of these amounts is the employees' agreement to take salary reductions or forego salary increases. If the plan met certain nondiscrimination requirements, the Internal Revenue Service in the past had taken the position in rulings that, under certain circumstances, the amount of the salary reduction would be treated as an employer contribution to a qualified pension plan, not taxable to the employee (until benefits were received from the plan). The maximum amount that could be so treated was 6 percent of compensation.[3]

On December 6, 1972, however, the Service issued proposed regulations (37 Fed. Reg. No. 235, p. 25938) which would change this result in the case of qualified pension plans by providing that amounts contributed by an employer to such plans in return for a reduction in the employee's total compensation, or in lieu of an increase in such compensation, will be considered to have been contributed by the employee and consequently will be taxable income to the employee.[4] Public hearings have been held on these proposed regulations but regulations in final form have not yet been issued.

General reasons for change

While in the case of many millions of employees provision is made for their retirement out of tax-free dollars by their participation in qualified retirement plans, many other employees do not have the opportunity to participate in qualified plans. Often plans are not available because an employer is not willing to incur the cost of contributing to a retirement plan. This may be so even though the employees would be willing to contribute their own funds for this purpose. The employees not covered under a qualified plan who, as a result, are not able to set anything aside for their retirement out of after-tax dollars, are further disadvantaged by the fact that in their case earnings on their retirement savings are subject to tax, and grow more slowly than the tax sheltered earnings on contributions to a qualified plan.

The committee bill deals with this problem by making available a special deduction for amounts set aside for retirement by employees who are not covered under a qualified plan (including an H.R. 10 plan), a government plan, or a tax exempt organization annuity plan (sec. 403(b)). Individuals in this status, in computing their income tax, will be permitted to deduct up to $1,000 a year for contributions to an individual retirement account. The earnings on this amount will also be tax free. As in the case of H.R. 10 plans, the amounts set aside plus the earnings become taxable to the individual generally after he has

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[3] In the case of employees of tax-exempt charitable, educational, religious, etc., organizations and employees of public educational institutions, a specific statutory provision provides for employer contributions of up to 20 percent of compensation, times years of service, reduced by amounts previously contributed by the employer for annuity contracts on a tax excluded basis to the employee (sec. 403(b)). The regulations under the statute allow the employer contributions to be made under these salary reduction plans. Antidiscrimination provisions that apply generally to qualified plans do not apply to those tax sheltered annuities. The committee bill does not affect the tax treatment of these contributions.

[4] The proposed regulations would not affect the tax treatment of contributions to certain qualified profit-sharing plans, where the contributed amounts are distributable only after a period of deferment, presumably because the Federal tax treatment of this type of plan has been established by a long-standing series of revenue rulings. (Rev. Rul. 56-497, 1956-2 C.B. 284; Rev. Rul. 63-180, 1963-2 C.B. 189; Rev. Rul. 68-89, 1968-1 C.B. 402.)

[131] reached retirement age, when he receives benefits from the account. In addition, as a way of gradually converting retirement accounts of this type into qualified retirement plans, the bill provides that employers can (but are not required to) provide part or all of the $1,000 retirement savings for employees.

Explanation of provisions

In general.—Under the committee bill, any individual who was not covered during a year as an active participant in a qualified retirement plan, or a government plan (whether or not qualified), or a section 403(b) annuity plan,[5] is to be permitted a deduction of up to $1,000 a year from earned income for contributions to a personal retirement account. In order to provide the widest possible scope for the provision, the committee bill provides that the deduction in this case is to be from gross income, and as a result can be taken even by those taxpayers who do not itemize the rest of their deductions. This is designed to assure every employee, or self-employed person, the opportunity to set aside at least some retirement savings on a tax sheltered basis. Earnings on these contributions would also be tax free (until actually distributed to the employee as benefits from the account).

In the case of a married couple, each spouse may establish his or her separate retirement savings account and the $1,000 limitation is to be applied separately to the earned income of each spouse. For example, a married woman with only a limited amount of earned income from part-time employment would be enabled, under the committee bill, to set this aside for her own retirement. (For this purpose, earned income is to be attributed to the person earning the income without regard to any State community property laws.) This provision permits an individual to set something aside for his or her own retirement based on his or her own earned income.

Under the bill, the employee can establish his own retirement savings account, or the retirement savings can be made through the medium of contributions by an employer (either in the form of additional compensation provided by the employer or a salary reduction plan) if there is no qualified, government or exempt organization plan which covers the employees in question. In other words, if the employer does not have a qualified plan, or if he has such a plan but it does not cover certain employees, the employer can establish a retirement savings account of up to $1,000 for each of these employees. Any employees not covered under the employer plan (including those excluded from participation due to length of service requirements, or because of age) can be covered under an employer-sponsored retirement account, or alternatively, these individuals can establish their own individual retirement accounts. The committee believes, however, that it is important to preserve the employer-sponsored retirement account as an option, because it may be easier administratively for the employer to set up individual retirement accounts for his employees than for each employee to have to set up his own account. In addition such an employer-sponsored plan is likely to grow into a qualified pension or profit-sharing plan.

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[5] If contributions were made on behalf of an individual under a plan during the taxable year, he would generally be considered an active participant for that year.

[132] Where individual retirement accounts are set up by the employer, the aggregate tax excludable contributions and tax deductible contributions by the employee (which are to be accounted for separately in the records of the account) are not to exceed $1,000 per year.[6] Of course, all benefits under the salary reduction plan are to be immediately vested, since the contributions, in effect, either represent compensation to the employee or come from his own funds.

It is the intention of the committee that where an employer has both a qualified plan and employer-sponsored retirement accounts, that the qualified plan must meet the nondiscrimination standards without regard to the individual retirement accounts.

Since the deduction for contributions to individual retirement accounts is to be available to the self-employed as well as employees, the committee bill will also benefit people such as jockeys, who in years of low earnings are limited in what they can contribute to an H.R. 10 plan by the percentage-of-income limitation (15 percent under the bill). However, since there is no such limitation on contributions for personal retirement savings, an individual could, if he chose, contribute all of his earned income to a qualified retirement account, up to the $1,000 ceiling. Moreover, a self-employed person, such as a jockey, might, if he chose, participate in an H.R. 10 plan in certain years, and make contributions to an individual retirement account in other years so long as he does not actively participate in both types of plans in the same year.

Requirements for an individual retirement account.—An individual who wishes to establish an individual retirement account (instead of participating in an employer-sponsored retirement account) would have to maintain, under the provisions of a written governing instrument, a separate accounting of his contributions, the earnings on them, and the distributions made either to the individual involved or to his beneficiaries.[7] The balance in the account could, for example, be invested in insurance annuity contracts, in a common trust fund managed by a bank, in a savings account with a savings and loan institution or a credit union, or in stock of a mutual fund. However, in any case, the funds must be held by a bank or other person who establishes to the satisfaction of the Service that the manner in which it will hold the balance in the account is consistent with the intention of the new provision. The funds might be held in a trust, a custodial account, or any similar arrangement approved by the Secretary of the Treasury.

The bill also contains a number of other provisions designed to ensure that the accounts will be used for retirement savings, many of which are similar to requirements which are already in the law with respect to H.R. 10 plans.

One of these requirements relates to excess contributions. The written governing instrument is to provide that no contributions in excess of

[6] Any amount deductible or excludable under these provisions is not to be considered to be part of the employee's investment in the contract for purposes of computing the taxable part of the distribution, since all of the contributions would be made, in effect, with tax-free dollars. If contributions in excess of these limits are made, the employer is not to receive a deduction for the excess contribution, and all excess would have to be repaid to the employer.

[7] However, in the case of a married individual in a community property State, the committee bill would allow the establishment of an individual retirement account, even though contributions to the account were treated as community property under the State law.

[133] the deductible limit can be made to the plan. Any excess contributions inadvertently made would have to be refunded to the individual with interest within 6 months after notice of the excess contribution was sent by the Internal Revenue Service. If the excess contributions were not repaid, the account would be disqualified for that year and all succeeding taxable years. In this case, the individual would also be required to take into income the assets of the account (valued as of the first day of the taxable year in which the account became disqualified), reduced by any contributions in the account for the current year (for which deductions are denied).

In addition, if it is found that the excess contributions are made willfully, the taxpayer's interest in all individual retirement accounts is to be distributed to him and he is not to be permitted to establish another retirement account for a period of five years (in the same way that owner-employees are subject to similar penalties for excess contributions to H.R. 10 plans).

An example of an excess contribution which would not be willful might occur where the employee made a $1,000 contribution to a retirement account believing at that time he would be eligible to receive the deduction for this amount. Later in the year, however, the employee might become ineligible because he changed jobs and became a participant in a government or qualified pension plan. Under these circumstances, the employee would receive no deduction for the contribution to the qualified retirement account, and the proper procedure, in order to preserve the qualified status of the account, would be to request repayment of the excess contribution.

Generally, an individual would only be permitted to receive a deduction for contributions to one individual retirement account in any one taxable year. However, the bill provides an exception to cover the situation where the employee entered or left employment during the year with an employer who contributed to his qualified retirement account. For example, under these circumstances, an employee would be permitted to contribute $200 to an account which he established, and then, upon entering his new employment, the employee and employer together could contribute up to $800 on a tax-free basis to an account established by the employer.

In addition to the rules on excess contributions, the written instrument is also required to provide that no distributions can be made to the individual prior to age 59½, except in the event of death or disability. On the other hand, under the bill, the plan is required to begin distributions when the individual attains the age of 70½, and distributions then have to be made at least on a ratable basis over the life expectancy of the individual, or the individual and his spouse. After age 70½, an excise tax of 10 percent a year is imposed on any amounts in the individual's account in excess of the amounts to be ratably distributed. Also, under the committee bill, no tax deductible contributions could be made to the account after the individual attains the age of 70½. By these provisions the committee hopes to encourage the use of the proceeds of these accounts for retirement purposes.

If the individual establishing the account should die before his entire interest in the account has been distributed to him, the governing instrument is generally to require that the undistributed assets be

[134] distributed, or applied to the purchase of an annuity for his beneficiaries, within 5 years after his death. However, this rule does not apply if distributions began prior to his death, and the account was to be completely distributed over a period not exceeding the life expectancy of the individual and his spouse (measured as of the time when distributions from the account began).

In addition, if the assets of the account are invested in an insurance contract, the governing instrument must provide that any refunds of premiums are to be held by the insurance company and applied toward the payment of future premiums or the purchase of additional benefits within the current taxable year or the next succeeding year.

Premature distributions.—Premature distributions frustrate the intention of saving for retirement, and the committee bill, to prevent this from happening, imposes a penalty tax. If a premature distribution from the account is made before the individual attains the age of 59½, the distribution is subjected to a penalty tax of 30 percent.[8] This is in addition to any other income taxes payable on this distribution, and would not be offset by any tax credits (other than the refundable credits for overwithholding, overpayment of tax, and the gasoline tax credit). Also, this tax would not be treated as reducing the individual's tax liability under the minimum tax provisions (sec. 56).

The penalty tax is not to apply in the event of death or disability. However, the committee expects that the Internal Revenue Service will require that the custodian must receive proof of disability before making distributions under the disability provision. Generally it is intended that the proof be the same as where the individual applies for disability payments under social security.

The penalty tax also is not applied in the case of a refund of excess contributions which were not willful.[9]

Taxation of beneficiaries.—Generally, the proceeds of an individual retirement account are to be taxable to the individual when distributed. Since the contributions to the account will be made with tax free dollars, the employee's basis in the account will be zero.

The amounts distributed to the individual are not to be eligible for capital gains treatment, and the special averaging rules applicable to lump sum distributions (under sec. 72) are not to be available. This should encourage the individual to take down the amounts ratably over the period of his retirement. However, the individual would be permitted to use the general averaging rules (sec. 1301).

If any individual borrows money, pledging his interest in the retirement account as security, the portion pledged as security is to be treated as a distribution from the retirement account to the individual. This treatment also is consistent with the committee's intention to encourage retirement savings, since in this case if the employee had already pledged his retirement account as security for a loan, he has no funds left for retirement. For the same reasons, any contribution to an individual retirement account, or any income of the account, applied to the purchase of life insurance protection under any retirement

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[8] The distribution would not, however, be subject to the penalty provided under section 72(m)(5) for premature distributions to owner-employees.

[9] For example, some qualified and government plans permit an employee to elect to participate if he makes employee contributions. In some instances, the employee with some years of service already to his credit may join the plan retroactively, by means of makeup contributions. If an employee should join a qualified plan on this retroactive basis, his individual retirement accounts for those retroactive years would no longer be qualified. Thus, he would have to take the previously deducted contributions into income for that year, but no penalty tax would be payable.

[135] income, endowment, or other life insurance contract also will constitute income to the individual.

For purposes of the estate and gift taxes the amounts in individual retirement accounts are not to be excluded from tax (secs. 2039(c) and 2517). This too is consistent with the committee's intent that the funds be spent during the individual's period of retirement.

Rollovers.—To permit flexibility with respect to the investment of an individual retirement account, the bill provides that money or property may be distributed from an individual retirement account, without payment of tax, provided this same money or property is reinvested by the individual within 60 days in another qualifying individual retirement account. The transfer may be desired because the individual desires to shift his investments, for example, from, or to, an annuity contract, a mutual fund, a savings account or perhaps to a Government bond (described below). To prevent too much shifting of investments under this provision, the committee bill provides that this rollover can only be used once every three years. Also, before releasing the account, the committee anticipates that the custodian will be required by the Internal Revenue Service to receive a declaration of intention from the individual as to the proposed reinvestment (except in the case of an individual who was entitled to receive a distribution because of his retirement at age 59½, or because of disability). The custodian is also to be required to notify the Service that a distribution of assets from the account had been made.

Qualified retirement bonds.—In addition to the various types of investment described above in which an individual retirement account can be placed, the bill also provides that these amounts may be invested annually in a retirement bond, to be issued by the government. The bonds are to be issued under the Second Liberty Bond Act and provide for the accumulation of interest until the time of redemption. In conformity with the general provisions for individual retirement accounts, the bill provides that the bonds generally can only be cashed after the individual has reached the age of 59½ years, or if he becomes disabled. If he dies, the bonds could be redeemed by his estate.

There would be one further exception to cover the case of an individual who purchased the bonds, believing that he would be eligible for the deduction for that year, only to discover later that he was not eligible. For example, an individual might purchase the bond early in the year, and later become a participant under a qualified retirement plan sponsored by his employer. To meet this situation, the committee bill provides that the bond may be redeemed at any time within 12 months of its purchase without penalty (and without payment of interest).[10] This provision could also be used by individuals who purchased the bond, but discovered within a year that they needed the money for other purposes. In this case the Internal Revenue Service would be notified that the bond had been redeemed and, therefore, would be on notice that no deduction should be allowed because of its purchase.

Consistent with the general rules for individual retirement accounts, the bill provides that the bonds are to cease to bear interest when the

[10] If the bond was not cashed within the 12 month grace period, the individual would still not receive the deduction, in those cases where he was not eligible for it. However, when he cashed in the bond at retirement age, the proceeds of the bond would constitute income to him (since his basis in the bond would be zero under the committee bill).

[136] individual reaches age 70½. In addition, during that year the individual is also required to take any of these bonds he is still holding into income, even if he does not cash them in. It is anticipated that these rules will be set forth on the face or back of the bonds.

Also, for similar reasons, the committee bill provides that bonds are to cease to bear interest not later than five years after the death of the individual in whose name the bonds have been issued.

The bonds are to be issued in the name of the individual who purchases them for his retirement and are not to be transferrable, under any circumstances, except to his executor in the event of his death (or to a trustee for his benefit in the event he became incompetent to manage his own affairs). For example, the bonds could not be pledged for the payment of debts, and could not be assigned to a trustee in bankruptcy. Also, the bonds could not be awarded to the individual's spouse as the result of a divorce settlement.

When the bonds are redeemed, the full proceeds of the bonds, including any interest earned on them, is to be treated as ordinary income to the individual, whose basis in the bonds would be zero.[11] However, if the individual chose to do so, he could treat this income under the general averaging provisions of the tax law (sec. 1301 et seq.).

Other rules.—To safeguard the individual retirement accounts, the committee bill imposes certain additional rules with respect to fiduciary standards and reporting. Under these provisions, the qualified retirement account is to be treated as an owner-employee plan for purposes of the rules with respect to the excise tax on prohibited transactions (sec. 551 of the bill and sec. 4973 of the code) and also for purposes of the provisions relating to returns of information by exempt organizations (sec. 6033) and fiduciary returns required to be filed in connection with certain trusts, annuity and bond purchase plans (sec. 6047). In addition, the rules with respect to unrelated business income (sec. 511) also are to apply to these accounts.

A special rule is also provided in the case of divorce settlements. Under present law, if an asset of an individual is transferred pursuant to a divorce settlement, the individual is deemed to realize gain on the difference between his basis in the asset and its fair market value at the time of the transfer (if the asset has appreciated). The committee believes that this is not a desirable result with respect to individual retirement accounts. As a result, under the committee bill, if an individual retirement account should be transferred to the individual's spouse pursuant to a divorce decree, or settlement agreement, this transfer is not to be taxable under the bill. Thereafter, the account would be maintained for the benefit of the spouse, and only the spouse could make further contributions to the account.

Six percent salary reduction plans.—The committee bill also clarifies the law with respect to the tax treatment of 6 percent salary reduction plans. As discussed above, until recently, the Internal Revenue Service had taken the position that amounts contributed to a qualified retirement plan on a salary-reduction basis could, under certain conditions, be considered as tax excludable employer contributions to the plan.

[11] A limited exception to this rule is provided in the case of an individual who redeems bonds after age 59½, and reinvests the proceeds within 60 days in another qualified retirement account. This form of "rollover" from one type of qualified retirement account to another is permitted under the committee bill on a tax-free basis in order to provide flexibility of investment. Prior to age 59½, there could be a rollover from an individual retirement account to the purchase of bonds, but not vice-versa, because the bonds could not be cashed.

[137] Under the committee bill, this treatment is continued with respect to contributions to a qualified pension or profit-sharing plan made prior to January 1, 1974. Thereafter, as is already true under present law, in the case of employee contributions under the Federal Civil Service Plan, or similar government plans, contributions which are really employee contributions (whether required to be made or made at the individual option of the employee in return for a reduction in his basic or regular compensation, or in lieu of an increase in such compensation) are to be treated as such and will no longer be excludable from income by the employee. The only modification in this rule is that where an individual is not covered by a qualified plan, a government plan, or a sec. 403(b) annuity plan, employer contributions of up to $1,000 per annum can be made to an individual retirement savings account under a salary reduction arrangement. Income earned on amounts contributed under a salary reduction plan prior to 1974 would for the future remain tax exempt as also would the earnings on these amounts.

Section 403(b) annuity plans.—Under present law, the proceeds of a section 403(b) annuity plan, for the benefit of teachers or employees of tax-exempt organizations, may be invested only in insurance contracts. The committee believes that it would be desirable to provide more flexibility in this area and, accordingly, the committee bill provides that the assets of these accounts may also be invested in mutual funds, under appropriate custodial restrictions.

Retirement income credit.—A conforming amendment provides that amounts distributed from an individual retirement account, or the proceeds of qualified retirement bonds, are to be treated as retirement income for purposes of the retirement income credit. As a result, this form of retirement income will form part of the base for determining the credit, in the same manner as other forms of taxable retirement income do under present law.

Net operating loss provisions.—The bill provides that any individual retirement account contributions by individuals which are deductible are to be treated as personal expenses and not as trade or business expenses of the individual for purposes of the net operating loss provisions. As a result, contributions to a qualified retirement account may not be used to create or increase a net operating loss. This is consistent with the treatment afforded contributions under H.R. 10 plans.

Effective date

These provisions will apply with respect to taxable years beginning after December 31, 1973.

Revenue effect

It is estimated that these provisions (at 1973 levels of income) will result in a revenue loss of $170 million in 1974, rising to $270 million.

K. Lump-Sum Distributions

(Sec. 703 of the bill and secs. 72, 402, and 403 of the Code)

Present law

Retirement benefits generally are taxed as ordinary income under the annuity rules (sec. 72) when the amounts are distributed, to the extent they do not represent a recovery of the amounts contrib-

[138] uted by the employee. However, an exception to this general rule under the law in effect before the Tax Reform Act of 1969 provided that if an employee's total accrued benefits were distributed or paid in a lump-sum distribution from a qualified plan within one taxable year on account of death or other separation from service (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than as ordinary income.

The capital gains treatment accorded these lump-sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than other compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of $50,000, particularly in view of the fact that a number of lump-sum distributions of over $800,000 have been made.

To correct this problem, the Tax Reform Act of 1969 provided that part of a lump-sum distribution received from a qualified employee's trust within one taxable year on account of death or other separation from the service (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. The ordinary income treatment applies to the taxable portion of the distribution (i.e., the total distribution less the employee's contribution) which exceeds the sum of the benefits accrued during plan years beginning before 1970, and the portion of the benefits accrued thereafter which does not consist of employer contributions (sec. 402(a)(5) and 403(a)(2)(c)).

The 1969 Act provided a special limitation in the form of a seven-year "forward" averaging formula which applies to the portion of the lump-sum distribution treated as ordinary income. An employee (or beneficiary) is eligible for the special 7-year forward averaging provision if the distribution is made on account of death or other separation from service (or death after separation from service)[1] and, in the case of receipt by an employee, if he has been a participant in the plan for 5 or more taxable years before the taxable year in which the distribution is made.

Reasons for change

The Treasury has had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the precise breakdown between ordinary income and capital gain in a lump-sum distribution. It has also had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the amount of tax imposed on account of the "ordinary income" element of post-1969 lump-sum distributions. Recently, the Treasury withdrew its earlier proposed regulations on the second point and substituted new ones which, in general, would produce lower tax liabilities than those determined under the earlier set of proposed regulations. The new regulations would produce lower tax liabilities than under current long-term capital gain rates in many cases, and this could mean that they would result in revenue losses, rather than revenue gains, in comparison to the law which would have applied in the absence of any special action with respect to this provision in the Tax Reform Act of 1969.

[1] Self-employed taxpayers, on the other hand, continue to be eligible for their special 5-year forward averaging only on lump-sum distributions received on account of death, disability as defined in sec. 72(m)(7) of the Code, or if received after age 59½ and, in the case of receipt by an employee, after at least 5 years of participation.

[139] More important, the new proposed regulations appear to share with the old proposed regulations the problem of excessive complexity. It is frequently maintained that lump-sum distributees are unable to compute their taxes, and that accountants and tax lawyers have been refusing to attempt the computations.

To eliminate undue complexity but maintain the revenue at least as high as that which would result under the proposed regulations under the 1969 Act provision, the committee chose to introduce a new and simplified method of computing the tax due on lump-sum distributions. The substance of the 1969 change in the tax treatment would be preserved, however. Under the bill, all pre–1974 portions of lump-sum distributions would be taxed as capital gain, rather than as ordinary income. The effect of the January 1, 1974, cutoff date under this bill is to provide long-term capital gains treatment for that portion of future distributions that relates to years after 1969 and before 1974; under the 1969 Act, portions of the distributions allocable to those years would have been taxed as ordinary income.

Under the simplified computational rules, ordinary income portions of lump-sum distributions from qualified plans are to continue to benefit from special "forward" averaging. The portion of the distribution representing pre-1974 value is to receive capital gains treatment, as stated above. The portion of the distribution attributable to post-1973 value in excess of the employee contributions is to be subject to tax as though it were ordinary income of the taxpayer, but his only income, and with 15-year averaging.

This ordinary income treatment for the post-1973 value of the lump-sum distribution is computed completely separately from the taxpayer's other income. This separate computation is used because it was found that taxpayers were, in effect, being treated quite differently depending upon the presence or absence of other income in the year of distribution—something which they sometimes had in their power to control. The 15-year averaging is provided in order to give roughly the equivalent of what the tax would be were the individual to live 15 years after retirement and receive his interest in the plan over that period. In this case, a tax is computed on $\frac{1}{15}$th of the distribution computed as if the taxpayer had no other income or deductions. After the tax is computed, the result is multiplied by 15, and this amount is then added to the employee's tax liability on his other income. His tax liability on this other income takes into account not only his tax on wages, salary, or investment income, etc., but also the capital gains tax on the portion of the lump-sum distribution attributable to pre-1974 value. The tax liability on this other income does not in any way, however, take into account the portion of the lump sum distribution treated as ordinary income.

In making the ordinary income computation on the post-1973 value, a special minimum distribution allowance is provided to insure that the tax on relatively small lump-sum distributions will generally be not more than it would be under present law. This allowance is phased out for lump-sum distributions over $20,000.

A major problem with the rule arrived at under the 1969 Act was the difficulty in determining the value of the distribution attributable to years before 1970 for which capital gains treatment was continued by that Act. To meet that problem, the committee bill provides that where a lump-sum distribution relates to active participation

[140] which began before 1974 and ended after that time, the distribution is to be apportioned between the pre-1974 participation (eligible for capital gains treatment) and post-1973 participation (treated as ordinary income under a separate 15-year averaging computation) on the basis of the amount of time in which the employee was an active participant in each period. This method will significantly simplify the computation previously required.

Table 1 presents a comparison showing the average effective tax rates applicable for taxpayers in various situations and with various amounts of lump-sum distributions, with the methods of computing post-1973 taxable value as capital gain, under present law (with the proposed regulations), and under the committee bill.

TABLE 1.—COMPARISON OF INCOME TAX TREATMENT OF LUMP SUM DISTRIBUTIONS UNDER THE COMMITTEE BILL WITH CAPITAL GAINS TREATMENT AND WITH THE TREATMENT PROVIDED IN 1969 (AS SHOWN BY PROPOSED REGULATIONS)

Assumed adjusted gross income, other than lump sum [1] distribution	Assumed lump sum distribution [2]	Average effective income tax rates (percent)		
		Capital gains treatment (1973 law) [3]	1969 treatment as shown by proposed regulations [4]	Rates which apply under Finance Committee bill when all but employee contributions are ordinary income
$5,000	$2,500	7.4	5.1	7.0
	5,000	7.7	5.3	7.0
	10,000	7.4	5.6	7.0
	50,000	8.5	10.6	15.4
	60,000	8.7	11.3	16.6
	100,000	10.6	13.2	19.1
$10,000	5,000	8.1	5.7	7.0
	10,000	9.2	5.9	7.0
	20,000	9.5	8.9	7.1
	50,000	10.4	12.0	15.4
	100,000	12.2	15.4	19.1
	200,000	15.8	19.5	22.6
$25,000	12,500	15.6	11.5	7.0
	25,000	15.7	13.9	9.3
	50,000	16.7	16.1	15.4
	125,000	18.8	20.0	20.1
	250,000	22.3	23.2	24.3
	500,000	25.6	27.2	32.9
$50,000	25,000	24.6	19.6	9.3
	50,000	24.8	21.0	15.4
	100,000	25.5	22.2	19.1
	250,000	27.0	25.2	24.3
	500,000	29.1	28.4	32.9
	1,000,000	31.2	32.5	46.0
$100,000	50,000	25.0	30.1	15.4
	100,000	28.2	31.4	19.1
	200,000	30.7	33.8	22.6
	500,000	32.0	37.0	32.9
	1,000,000	33.8	38.8	46.0
	2,000,000	35.1	43.9	57.3

[1] Income other than lump sum distributions consists of income taxed at ordinary rates and which is not subject to either the maximum tax on earned income or the minimum tax on items of tax preference. To avoid problems of maximum tax on earned income, ordinary income in excess of $50,000 is considered as coming from sources other than earnings. Taxable income is computed from AGI by deducting the larger of the standard deduction or itemized deductions equivalent to 15 percent of AGI and from personal exemptions of $750 each. Taxpayer is considered to be married and filing a joint return. No additional itemized deductions are considered to accrue to the taxpayer due to the receipt of lump sum distribution.

[2] Net of taxpayer's basis.

[3] 50 percent inclusion of capital gains in AGI. Taxpayer is eligible for either alternative tax of 25 percent on 1st $50,000 of capital gains or normal 5 year income averaging. Four prior year base period income is assumed to be the same as taxable income excluding distribution for the current year, except for $5,000 AGI class which is assumed to have a base of $1,462.50 and the $10,000 AGI class which is assumed to have a base of $5,850.

[4] 70 percent of distribution assumed to be capital gains; 30 percent ordinary income.

[141] *Explanation of provisions*

Under the simplified computation of the tax on lump-sum distributions, the post–1973 portion of a distribution is to be taxed as ordinary income (but with 15-year "forward" averaging), thus maintaining the recognition in the Tax Reform Act of 1969 that the taxable portions of these distributions are basically deferred compensation, and generally should be taxed as is other compensation; that is as ordinary income. Fifteen-year averaging is provided to recognize the fact that the distribution represents compensation which generally is received spread out over the taxpayer's life beginning with the time he retires. The fifteen-year averaging insofar as the size of the tax is concerned achieves this result. It is believed that it would be unfair to use the high tax rate that would be applicable if the distribution were treated as received wholly in one year. As a result of the averaging, the distribution would be taxed roughly as if it were received in 15 equal parts in 15 years. The decision to tax this income separately from all other income (to the extent it is not treated as pre-1974 income eligible for capital gains treatment) was made on the basis that most distributees will have little or no other taxable income in the years following their retirement.

The portion of the distribution attributable to pre-1974 service is to be taxed as capital gain and taxed along with any other income the taxpayer may receive. For this income, the committee believed it was appropriate to preserve the pre-1969 treatment (at current capital gains rates) to the fullest extent possible. The portion which constitutes a return of employee contributions continues to be nontaxable as a return of basis.

Under the computation, the capital gain portion is included in the amount of the taxable distribution prior to the deduction of the minimum distribution allowance and the application of the 15-year averaging rule. After a total tax is determined under the 15-year averaging rule, the tax on the ordinary income element is the portion of that total tax determined according to that portion of the plan participant's total time in the plan that was spent after 1973. The capital gain is added to the taxpayer's other income and the combined amount (minus regular deductions, exclusions, etc.) is taxed under usual rules. (See the examples at the end of this *Explanation of provisions* section.)

A further simplification from prior law in the computation is the determination of the amounts to be attributed to pre-1974 employment (capital gain taxation) and to post-1973 employment (15-year averaging with ordinary income taxation). That attribution is to be made on the basis of the amount of time in which the distributee was an active participant in each period. Thus, if a distributee was an active participant from January 1, 1971, through December 31, 1980, three-tenths of the taxable portion of his distribution would be taxed as capital gain while seven-tenths would be taxed as ordinary income and averaged over 15 years.

In order to treat all distributees equally, all computations of the tax on the 15-year averaging ordinary income portion are to be made on

[142] the basis of the tax schedule for unmarried individuals.[2] In addition, community property laws are to be ignored for these purposes. Thus, a distributee in a community property State is to compute his tax on the basis that the entire amount of the distribution is his income.

The committee recognized that excessive computational problems would arise if separate computations were made where a plan participant had accrued some of the value of his lump-sum distribution over the years as a rank-and-file employee, while accruing another portion as a self-employed individual or as a proprietary employee.[3]

To avoid undue complexity in these cases the committee bill provides that the five-year averaging available for self-employed persons and proprietary employees is to be used for the entire distribution if the number of years spent by that person while he participated as a self-employed person or proprietary employee exceeds 50 percent of the total time he was a participant in the plan. If not, the 15-year averaging rule is to apply.

In the 15-year averaging computation, a minimum distribution allowance is to be allowed to reduce the amount of the distribution subject to tax. In this computation, the amount of the taxable distribution (the total distribution less the distributee's basis) is to be reduced by the minimum distribution allowance before the tax is computed. The minimum distribution allowance is one-half of the first $20,000 of the distribution. This allowance is to be phased out at the rate of $1 for every $5 by which the distribution exceeds $20,000. Thus, the entire allowance would be eliminated for distributions of $70,000 or more.

It was recognized that a tax avoidance possibility would exist if a taxpayer were able to apply separate 15-year averaging computations to distributions received in different tax years. For that reason, although it is believed that few will have to use the provision, the bill provides for a 5-year "lookback", under which distributions made during the previous 5 years are included in the 15-year averaging computation for the purpose of determining the tax on the second distribution. When the total tax is determined, the amount of the tax liability on the earlier distribution or distributions is subtracted, and the remainder is the tax on the second distribution.

All distributions made within the previous 5 years to the same distributee, whether or not with respect to the same plan and whether or not with respect to the same participant, are to be subject to this 5-year lookback.[4]

Earlier distributions (or purchases of annuities) for the spouse of the distributee are not to be included under the lookback rule. Each spouse is to have his or her distributions taxed under a separate computation.

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[2] Distributees, in computing the tax on their other income (including the capital gain element of the distribution) may use any appropriate tax schedule. They are not restricted to the schedule for unmarried individuals. They may also use, when appropriate, the regular five-year averaging method for the tax on their other income (including the capital gains portion of the distribution). The regular five-year averaging rule is provided under present law for cases in which taxable income in any taxable year increases markedly from taxable income in prior years.

[3] In general terms, a proprietary employee is an employee with a two percent ownership interest in a business having a plan in which the accrued benefits of such proprietary employees have an aggregate total exceeding 25 percent of the accrued benefits from employer contributions.

[4] A lump-sum distribution is made a reportable event, under the bill, in the provisions for plan termination insurance. (As a result, under appropriate circumstances, the plan might be terminated.) For purposes of providing a time limit to the lookback rule, the five years is determined from the time the distribution is reported to the insurance corporation.

[143] The computation is to take into account any annuity purchased for the plan participant in the year of distribution or in the previous five years. For purposes of the computation, the amount included with the taxable portion of the distribution is the cash surrender value of the annuity. The value of the annuity is to be added to the value of the other property distributed and a tax is calculated on the sum. From that is to be subtracted the tax calculated on the value of the annuity alone (using the minimum distribution allowance applicable to the total). The remainder is to be used in calculating the tax on the taxable (nonannuity) portion of the distribution. No changes are made with respect to the treatment of distributions of employer securities, as such.

Examples of tax computations involving lump-sum distributions.—The tax computations involved in lump-sum distributions can be shown by the following two examples, the first involving a distribution in 1975 and the second a distribution in 1976 which also involves the lookback provision.

First example.—On December 31, 1975, A (who was not self-employed or a proprietary employee) retires and receives a lump-sum distribution of $50,000 from a qualified plan. A has been participating in the plan since January 1, 1966. The plan is noncontributory. A is married; both A and his wife are over 65. Their only other income is A's salary of $15,000 and his salary from a second job ($5,000). Their itemized deductions are $3,000. Their avearge base period income for the preceding four years (1971 through 1974) is $14,000.

The tax on the portion of the distribution which is not treated as a long-term capital gain is computed as follows:

Net distribution		$50,000
Less: minimum distribution allowance: 50 percent of first $20,000	10,000	
Reduced by: 20 percent of net distribution in excess of $20,000	6,000	
		4,000
Distribution less allowance		46,000

The tax on 1/15th of the distribution less allowance computed from the tax rate schedule for single taxpayers is $512.67.

Multiply this amount by 15: $7,690.05.

Then, multiply by the fraction,

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}}=\frac{2}{10}=0.2$$

which yields $1,538.01.

Thus, the tax on the ordinary income portion of the distribution is $1,538.01.

The amount of the distribution taxed as a long-term capital gain is the amount of the net distribution multiplied by the fraction,

$$\frac{\text{Years of participation before 1974}}{\text{Total years of participation}}=\frac{8}{10}=0.8$$

Net distribution	50,000
Capital gains element	40,000

[144] The capital gains element is taxed along with other income (exclusive of the ordinary income element) in the normal way. The tax on the taxable income of $34,000 ($15,000 salary from first job, plus $5,000 from second job, plus $40,000 capital gains element of lump-sum distribution, less $20,000 capital gains exclusion, less $3,000 itemized deductions, less four times $750 personal exemptions) is calculated using the tax rate schedule for married taxpayers filing joint returns. In this case the alternative tax on capital gains is not available, but the regular five-year income averaging provisions are.

Ordinary tax	$9, 500. 00
Tax—Using regular income averaging	[1] 8, 348. 00

[1] As indicated above, average base period income is $14,000.

Selecting the tax computation method which yields the smallest amount of tax, A uses the regular 5-year income averaging method and has a tax of $8,348.00.

Finally A combines the tax on the capital gains portion of the distribution and his salary, with the tax on the ordinary income portion of the distribution:

Tax on salary and capital gains portion of distribution	$8, 348. 00
Tax on ordinary income portion of distribution	1, 538. 01
Total 1975 income tax	9, 886. 01

Second example.—On December 31, 1976, A retires from his second job and receives from that employer a nontransferable annuity contract, the cash value of which is $6,000, and a lump sum distribution of $4,000 financed solely by the employer. A had participated in the plan since January 1, 1967. Mr. and Mrs. A's only other income is A's salary of $5,000 and interest of $3,000 on the prior lump sum distribution of $50,000. They have itemized deductions of $2,100. Mr. and Mrs. A's 1976 tax is computed as follows:

First, compute the tax on the portion of the distribution which is not treated as a long-term capital gain and which is taxed separately.

Step 1:

1976 cash distribution		$4, 000
1976 annuity contract		6, 000
Prior year distribution		50, 000
		60, 000
Less: Minimum distribution allowance: 50 percent of first $20,000	$10, 000	
Reduced by: 20 percent of net distribution in excess of $20,000	$8, 000	
		2, 000
		58, 000

Fifteen times the tax on one-fifteenth of $58,000 (from the rate schedule for single taxpayers) is $9,970.05.

[145] *Step 2:*

1976 annuity	$6,000
Minimum distribution allowance from step No. 1	2,000
	4,000

Fifteen times the tax on one-fifteenth of $4,000 is $559.95.

Step 3:

$9,970.05 − $559.95 = $9,410.10

Step 4:

Determine ordinary income and capital gains elements of A's distribution and his prior year distribution. The ordinary income element of A's latest distribution is determined by multiplying $4,000 by:

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}}=\frac{3}{10}=0.3$$

Thus, A's ordinary income element is $1,200. $10,000 of Mr. A's prior distribution of $50,000 was ordinary income.

Thus, the tax on the ordinary income element is the fraction of the tax from Step 3 which the ordinary income elements of the 1976 and prior year distributions bear to the entire distributions.

$$\frac{(\$1{,}200+\$10{,}000)}{(\$4{,}000+\$50{,}000)}\times\$9{,}410.10=\$1{,}951.72$$

Step 5:

The tax on the ordinary income element of A's 1975 distribution from their 1975 income tax return was $1,538.01. Subtracting that from the tax calculated in Step 4 yields the tax on the ordinary income element of A's latest distribution:

$1,951.72 − $1,538.01 = $413.71

Second, compute the tax on all other income, including the capital gains portion of the distribution.

Step 6:

In Step 4, the ordinary income element of the distribution was calculated as $1,200. Therefore, the long-term capital gains element is:

$4,000.00 − $1,200.00 = $2,800.00

Step 7:

The capital gains element is taxed along with other income in the ordinary manner.

Capital gains element	$2,800
Less: 50% of net long-term capital gain	1,400
	1,400
Salary	5,000
Interest	3,000
Adjusted gross income	9,400
Less: Itemized deductions	2,100
Less: Personal exemptions (4 x $750)	3,000
Taxable income	4,300

[146] The tax on $4,300 from the rate schedule for married taxpayers filing joint returns is $677.00. The A's income does not make them eligible for either the regular five year income averaging or the alternative tax on capital gains.

Third, combine the taxes computed above.

Step 8:

Tax on capital gains portion of distribution and on other income	$677.00
Tax on ordinary income portion of distribution	413.71
Total 1976 income tax	1,090.71

Effective date

The effective date of the lump-sum distribution provisions of the bill is January 1, 1974.

This early date was chosen to eliminate at the earliest practical date the problems and confusion that result from attempting to compute tax on lump-sum distributions under current law. As previously stated, current law provides that the pre-1970 value of lump-sum distributions (and a portion of the post-1969 value) is to receive the capital gain treatment.

Revenue effect

The revised tax treatment of lump-sum distributions from qualified plans is expected to result in relatively small increases in revenue over the next few years since the bulk of the lump-sum distributions in these years will be attributable to pre-1974 years. However, after a transition period, this provision is expected to result in annual revenue gains amounting to $35 million a year based on 1973 levels of income.

L. Miscellaneous Provisions

1. *Right to elect a survivor annuity (sec. 261 of the bill and sec. 401 of the Code).*

Under present law, there is no requirement that a qualified retirement plan must offer the option of a survivor annuity. This can result in a hardship where an individual primarily dependent on his pension as a source of retirement income is unable to make adequate provision for his spouse's retirement years, should he predecease her. To correct this situation, the committee provision requires that a joint and survivor annuity be offered as an option with respect to any benefit under a qualified retirement plan which is payable as an annuity. If the option is exercised, and a survivor annuity is elected, the participant's own annuity may be reduced, so that the value of the joint and survivor annuity and the value of the annuity the participant would have been entitled to receive had the option not been exercised are actuarially equivalent.

This provision generally applies to plan years beginning after the date of enactment. However, in the case of a plan in existence on the date of enactment, the provision applies to plan years beginning after December 31, 1975.

[147] 2. *5 percent deduction limitation (sec. 706(d) of the bill and sec. 404 (a)(1) of the Code).*

Contributions to a pension plan are deductible under three alternative provisions, the "5 percent" method which allows deductions to be taken for contributions not in excess of 5 percent of the annual compensation of the covered employees (sec. 404(a)(1)(A) of the code), the "level cost" method (sec. 404(a)(1)(B) of the code), and the "normal cost" method (sec. 404(a)(1)(C) of the code).

Unlike the "level cost" method and the "normal cost" method, the 5-percent limitation on contributions is often unrelated to the funding needs of the pension plan, for it frequently is not determined by the level of benefits provided by the plan. Consequently, the 5-percent method has allowed employers to contribute and deduct more than is reasonably needed to fund a pension plan.

The bill repeals the 5-percent deduction limitation (sec. 404(a)(1)(A) of the code). Thus, deductible contributions under a qualified pension plan are to be limited under either the "level cost" or the "normal cost" methods.

3. *Retroactive remedial changes to qualified plans (sec. 706(h) of the bill and sec. 401 of the Code).*

Employers may now retroactively cure defects in employee benefit plans (which do not meet the requirements for tax qualification) by making remedial amendments by the 15th day of the third month after the end of the taxable year of the employer in which a plan is newly established. Retroactive remedial changes however may not be made with respect to plan amendments.

The time allowed for remedial changes may be too short for a plan to be cured to qualify as of the year in which it is established. This occurs because many plans are established at the end of the year and thus only 2½ months are available to cure a plan. Additionally, plan amendments (which may be as significant as newly established plans) may not be retroactively cured. As a result of these limitations, plans may not be qualified, to the detriment of employers and employees.

The committee bill provides that retroactive remedial amendments may be adopted to cure a plan regardless of whether failure occurs on establishing a new plan or because of an amendment of an existing plan. The bill also extends the time to adopt a retroactive remedial amendment to the time (including extensions) for filing the employer's return for the taxable year for which the plan or amendment was put into effect, or to a later time designated by the Service. It is expected that the regulations will provide for extension for reasonable cause, such as the filing of a bona fide request for a determination by the Service that a plan or plan amendment is qualified.

4. *Reporting and publication of returns (sec. 706(i) of the bill and secs. 6040, 6103, and 6104 of the Code).*

In order that many of the new rules governing qualified plans may be enforced, new reporting and publication requirements are needed.

The bill restates present law by requiring employers (or plan administrators) who establish or maintain deferred compensation plans

[148] to file annual information returns. In addition, the bill extends this requirement to individuals who establish individual retirement accounts (described in section 408 of the Code, as added by the bill) and individual bond purchase plans (described in section 409 of the Code, as added by the bill). Also, to enable the Internal Revenue Service to enforce the limits on contributions to individual retirement accounts, the bill requires additional information from persons who pay wages to individuals covered under qualified plans.

The bill makes certain information returns open to inspection by proper officers of the Pension Benefit Guaranty Corporation, in order that the Corporation can properly administer the insurance program. In addition, the bill opens to public inspection applications for a determination that a plan is qualified and that the trust under the plan is exempt, except for plans where the employer has less than 26 employees; annual returns with respect to qualified plans are also open to public inspection. These rules enable plan participants and beneficiaries to easily obtain the full information needed to enforce their plan rights, pursuant to the new rules established in the bill. With respect to plans of smaller employers, this information will be available only to participants and beneficiaries from the employer and the Service; this limitation is established because of the more confidential nature of small business.

The bill establishes a penalty for failure to file annual returns (under sec. 6040 and sec. 6047 of the code); the penalty will be $10 for each day that a return is late, up to a maximum penalty of $5,000 for any one failure to file. However, this penalty will not be owed if failure to file is shown to be due to reasonable cause.

V. EFFECT ON THE REVENUES OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of this bill. The committee estimates that the bill will on balance reduce direct tax revenues by $237 million a year over the long run. This figure includes an estimated $48 million of annual receipts from two new taxes imposed by the bill (the audit fee tax and the tax to finance plan termination insurance). However, deductions taken by employers for their payment of these two new taxes will offset these receipts by $23.4 million a year.

In addition, because it increases employer contributions to qualified plans and hence tax deductions, the minimum vesting standard adopted by the bill involves an estimated annual long-run revenue loss, which could range from $130 million to $265 million, but which is probably closer to $130 million. The minimum funding standards imposed by the bill also result in a modest reduction in revenue as a result of larger tax deductions for contributions to qualified plans.

The administration of the more comprehensive requirements for qualified plans adopted by the bill will add an estimated $13 million a year over the next five years to the present cost of administration of the provisions relating to such plans by the Internal Revenue Service. This additional cost of administration is financed out of the proceeds of the audit fee tax provided by the bill.

[149] The Treasury Department agrees with this statement. Part III of this report contains a more detailed statement of the revenue effect of the bill.

VI. VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with section 133 of the Legislative Reorganization Act, as amended, the following statement is made relative to the vote of the committee on reporting the bill. This bill was ordered favorably reported by the committee without a roll call vote and without objection.

VII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

[151] VIII. ADDITIONAL VIEWS OF MR. HARTKE

Today over 34 million working men and women are subject to great inequities in the private pension system. These inequities cause the intolerable situation in which only one out of ten employees enrolled in pension plans will ever receive benefits. It is fortunate that the Senate Finance Committee has reported out a bill on the private pension system. It is unfortunate that their proposal falls short of a viable and comprehensive reform. The committee is taking steps in the right direction at a time when large strides are necessary.

Over the past 9 years, I have introduced a number of proposals aimed at providing a degree of security for the millions of workers enrolled in pension plans. Beginning with termination insurance legislation and now with the inclusive Federal Pension Plans Protection Act (S. 1858), which I introduced this year. I have been motivated by the conviction that every working man and woman in this country deserves the dignity and security of adequate means of support for his or her retirement years. I am greatly distressed that so many people still consider pensions a form of insurance in which most must lose so that some may gain. The committee proposal seems based on this concept. In rejecting this notion, I maintain that a pension should not be a game of chance.

Some may be satisfied with the committee's minimal proposals on vesting, funding, portability and termination insurance. I am not content. The committee solutions aid only a few, leaving millions who need adequate and secure pension coverage wanting. Let me specifically explain my points of difference with the committee.

I. Administration and Enforcement

A. THE COMMITTEE PROPOSAL

Principle responsibility would be placed in the Treasury Department. The Secretaries of Labor, Treasury and Commerce would be the trustees of the termination insurance program and the voluntary central portability program, and the Secretary of Treasury would be the managing trustee.

B. OBJECTIONS

While I agree that the Treasury Department should be responsible for enforcement of the provisions of the bill, I believe that the Labor Department should be the principle agency for administration. Rather than playing political games over questions of committee jurisdiction, our principle concern should be safeguarding the rights of workers. I do not believe that the principal administration of this bill should be given to an agency whose primary interest is tax collection.

C. THE HARTKE APPROACH

[152] Under my proposal, the Secretary of Labor would administer the vesting standards and termination insurance program. The Treasury Department would administer funding standards and would be responsible for the enforcement of the bill. The Labor Department is charged historically with the protection of workers' rights and collects and analyzes annual information on assets, costs, and actuarial liabilities under the Pension and Welfare Plans Disclosure Act.

II. PARTICIPATION

A. THE COMMITTEE'S PROPOSAL

A qualified pension plan would require, as a condition of eligibility, service of no more than 1 year, or attainment of age 30, whichever occurs later.

B. OBJECTIONS

Most workers begin their jobs in their late teen years or early twenties. A fair and equitable reform should not exclude these early years of service. Age 30 is too late a date for participation because it delays the acquisition of vesting rights.

In many cases the committee's proposal is only slightly more progressive than the administration's vesting standards—the so-called "rule of 50," i.e. a worker gains 50 percent vesting when his age and years of participation equal 50, and 10 percent additional each year thereafter. (See table below under vesting.) Under the committee proposal a worker who started at age 20 would have to work 15 years until age 35 before he attained his full vested rights. The committee proposal would make attainment of full vested rights difficult or impossible for millions of part-time and part-year workers. Examples of these groups of workers excluded by the committee bill are given below under vesting.

C. THE HARTKE APPROACH

Pension benefits should not be considered an exclusive privilege of the fortunate few; rather they should be made a right for all. My reasonable approach provides for a more quickly attainable eligibility; participation would commence after a period of service no longer than 2 years or age 25, whichever occurs later.

III. VESTING

A. THE COMMITTEE'S PROPOSAL

A qualified plan must provide at least 25 percent vesting after 5 years participation, 5 percent additional vesting for each of the next 5 years, and 10 percent each year for the next 5 years thereafter. This formula would provide for at least 25 percent vesting after 5 years participation, 50 percent after 10 years and 100 percent after 15 years.

B. OBJECTIONS

[153] Progressive vesting rights are the heart of pension reform. Weak vesting clauses make for ineffectual and superficial pension legislation. The committee's proposal gives the illusion of reform without the substance. The vesting provisions are extremely weak and inadequate. Such a scheme would discriminate against women, seasonal workers, and workers in mobile or faltering industries. A recent Senate Labor Subcommittee study found that, for plans requiring 10 years participation or less for vesting, 78 percent of those separated did not qualify for benefits. Under these same conditions, the committee proposal would provide 50 percent vesting after 10 years participation for only 22 percent of those who separate. I do not consider such an approach acceptable.

Achieving vested rights for women is also difficult under the committee's proposal. Most women work at a job for shorter periods than men, and often work part-time or part-year. The committee has made no provision for part-time or part-year work. While men in manufacturing have a median of 14.3 years of service, women in their later years, have only 8.3 years of service. And in retailing, women over 45 had an average of 4.9 years. As a result, a woman would achieve only 40 percent of her vested rights. This is not a decent retirement benefit.

A moderately good benefit will give $5 a month for each year of credited service. A normal retirement for a woman would be 8 years of credited service or $40 a month. But the committee's proposal would provide only 40 percent of this or $16 a month—less than $4 a week. And that benefit is subject to erosion by inflation between the time it vests and the time it becomes payable.

Aerospace is an example of a faltering industry in which many plants have shut down and many more will shut down in the future. A recent study found that 80 percent of the employees in this industry had completed fewer than 10 years of service. At the very best, the committee's proposal would provide 50 percent vesting for these workers—too minimal a standard.

With no provision for part-year work, it will be virtually impossible for the seasonal worker to attain vested rights. Many cumulative years of service will add up to nothing in retirement.

The committee vesting proposal would provide for little or no benefits for the majority of workers in this country. It ignores the overwhelming evidence which demonstrates that the weaker the vesting requirements, the less likely it is that the participant will ever receive his needed pension benefits.

C. THE HARTKE APPROACH

I propose that 100 percent vesting be achieved after only 5 years of service. These more progressive rules on vesting will open the way for more frequent job changes, increases in work satisfaction, a more mobile and a more effective labor force. We owe this to the working

[154] men and women of this country. In order to demonstrate graphically the superiority of the Hartke approach, I submit the following table:

VESTING TABLE

Age	Percent vested committee proposal	Percent vested administration proposal	Percent vested Hartke proposal
20	0	0	0
25	0	0	100
30	50	0	100
35	100	0	100
40	100	50	100
45	100	100	100

The table shows what would happen to a worker beginning his job at age 20. Under the committee proposal, this worker would not qualify for participation until the age of 30. After 10 years of work he would be only 50 percent vested. This worker would be 35 before he was fully vested under the committee bill, 45 under the Administration's bill; *but* only *25* under the Hartke proposal.

IV. Funding

A. THE COMMITTEE'S PROPOSAL

The committee agreed to a minimum funding standard which requires the payment of current or normal pension costs and the level payment, or amortization, over a 30 year period of unfunded accrued liabilities, without regard to whether such past service liabilities are vested or unvested. A plan amendment resulting in a 5 percent increase in unfunded past service cost existing at the time of the amendment is to be regarded as a "substantial" increase in unfunded past service costs which may be treated as a new plan and funded over 30 years.

B. OBJECTIONS

Inadequate funding is the primary reason that thousands of workers yearly lose their benefits when a plan terminates. In 1964, when the Studebaker plant in South Bend, Indiana, shut down, over 8,500 employees lost their pensions because there was not enough money to fund them. *The Committee's bill would not have prevented this tragedy.* Studebaker had a 30 year funding schedule. Tragedies like the Studebaker case occur every year and in all parts of the country. Only strong funding requirements will prevent them from occurring.

C. THE HARTKE APPROACH

My proposal would require past service liabilities to be funded over a 25 year period, and substantial increases in liabilities due to amendments would also be funded over 25 years.

[155]

V. Termination Insurance

A. THE COMMITTEE'S PROPOSAL

Vested rights of participants would be insured up to a maximum of 50 percent of the average monthly wage over the past 5 years and not to exceed $750 a month. For the first 3 years, the termination insurance would be financed by a 50 cents per capita payment for each participant in the pension plan. After such time, premiums would be set at a level based on cost experience.

B. OBJECTIONS

On the average, 20,000 workers a year are affected by pension failures. The participants hit hardest by these closeouts are those between the ages of 40 and 60. This group is usually paid little or nothing in pension benefits for many years of service.

I am gratified that the Committee's proposal would establish an insurance program to protect these thousands of workers, but I am disappointed that the proposal would provide such inadequate benefits. Fifty percent of expected benefits is simply not an adequate means of support for the average worker. When a worker enrolls in a pension plan he has the right to expect adequate benefits regardless of whether the plan folds, whether his department is phased out, whether his company goes out of business or merges with a larger unit.

C. THE HARTKE APPROACH

My plan would insure vested benefits to a maximum of 80 percent of the highest average wage over a 5 year period or $500 a month, whichever is less. The insurance premium rate would be no higher than 0.5 percent of unfunded liabilities.

VI. Portability

A. THE COMMITTEE'S PROPOSAL

A voluntary central portability fund would be established as a private corporation under the trusteeship of the Secretaries of Labor, Commerce and Treasury, with the Secretary of Treasury being the managing trustee. If the employer and employee both agree, the departing employee could transfer his vested benefits to the fund.

B. OBJECTIONS

Voluntary portability will do very little for the employee. There is little reason to expect that an employer would give away dollars to a departing employee which he could give to a retiring employee who remains with his company. The trusteeship of the fund by three Secretaries causes needless confusion and duplication of effort. It is

[156] much simpler and more reasonable that the Secretary of Labor alone be the managing trustee of the fund.

C. THE HARTKE APPROACH

I will propose the establishment of a compulsory portability fund into which an employee's vested benefits would automatically be transferred. The employer would have a maximum of 5 years to pay these vested benefits into the portability fund.

The private sector should be given an initial opportunity of at least 18 months to develop plans for the organization of a portability fund. If they fail to act, the Secretary of Labor would establish the plans for portability funds. I strongly believe that these efforts should be made to keep pension monies within the private sector.

The central portability fund should also have the option of offering basic plans of pension coverage to companies that do not have any. Such plans would be limited to employers with 300 employees or less. This service would be particularly beneficial to smaller companies who cannot afford the high costs of establishing and operating pension programs. We must make a strong effort to expand the private pension industry to cover the millions of Americans not presently enrolled.

VII. CONCLUSION

These are among the changes to the committee's proposal which I propose to bring real reform to the private pension system in this Nation. I emphasize that we should not accept any illusions of reform but rather we should have the courage to help the 34 million working men and women who are enrolled in pension plans. When the Senate begins debate on pension reform, I intend to initiate a full discussion of the issues which I have raised in this statement.

VANCE HARTKE.

[157] IX. SUPPLEMENTAL VIEWS OF MR. CURTIS

This legislation is important to our private pension programs in the United States. It carries many provisions which I advocate and endorse. I am especially interested in the provisions which make it possible for an individual not covered by a company pension or an H.R. 10 pension to set aside for his own retirement and have the tax advantages that other plans have. This is a matter that I have worked for for many years.

In general, I would have preferred to have had the enactment of my own bill, S. 1631, which was supported by the Administration. The provisions of that bill are more acceptable in several respects including the issue of professional corporations.

CARL T. CURTIS.

House Report No. 93-807[1]

2d Session

[Bracketed numerals indicate official report page numbers.]

FEBRUARY 21, 1974.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. Ullman, from the Committee on Ways and Means, submitted the following

REPORT

together with

SUPPLEMENTAL VIEWS

[To accompany H.R. 12855]

The Committee on Ways and Means, to whom was referred the bill (H.R. 12855), to amend the Internal Revenue Code of 1954 to provide pension reform, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. INTRODUCTION AND SUMMARY

H.R. 12855, as reported by the Committee on Ways and Means, deals with the tax aspects of making pension, profit sharing, and stock bonus plans fairer and more effective in providing retirement income for employees who have spent their careers in useful and socially productive work.

Your committee, in reporting this bill, anticipates that it will, in the House action, become a part of a broader bill dealing with retirement plans generally. It is expected that this bill will be combined with H.R. 12906, to be reported by the Committee on Education and Labor. This bill and the bill reported by the Committee on Education and Labor, are expected to jointly deal with participation, vesting, and funding with respect to pension plans. In these areas, this bill has been worked out in close coordination with the version of the bill expected from the Committee on Education and Labor to be sure that the general standards provided in these three areas are the same. Because of the expected coordination between your committee's bill and that of the Education and Labor Committee, no action is taken in this bill to deal with the general subjects of fiduciary standards, plan termination insurance, and reporting and disclosure, which are dealt with in H.R. 12906.

This bill deals only with qualified plans and provides for enforcement with respect to retirement plans through the Internal Revenue

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[1] This House Report supersedes House Report 93-779 published in Cumulative Bulletin 1974-3.

[2] Service, while the bill from the Committee on Education and Labor is expected to deal with both qualified and nonqualified plans and provide for enforcement through the Department of Labor. Because of the coordination and effort involved, it is not expected that this dual jurisdiction in these three areas will present problems. Not only have the standards in the two bills been coordinated, but also provisions have been made for joint regulations in areas where problems might otherwise arise.

In the areas of participation, vesting, and funding it is important for the Committee on Ways and Means to have a part in setting the standards involved since for plans qualifying under these standards there are significant tax advantages. At the same time, guidelines established for retirement plans also are of significance to a committee charged with the jurisdiction of labor laws. Although provision is made for dual enforcement in these two areas by the Internal Revenue Service and the Department of Labor, it is anticipated that these agencies will coordinate their efforts so as not to duplicate enforcement efforts.

This bill encourages provisions for the retirement needs of many millions of individuals. At the same time, the committee recognizes that private retirement plans are voluntary on the part of employers, and, therefore, it has weighed carefully the additional costs to the employers and minimized these costs to the extent consistent with minimum standards for retirement benefits.

In broad outline, the bill is designed—

(1) to increase the number of individuals participating in retirement plans;

(2) to make sure that those who do participate in such plans do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the plan to accumulate and retain sufficient funds to meet its obligations; and

(3) to make the tax laws relating to such plans fairer by providing greater equality of treatment under such plans for the different taxpaying groups involved.

This bill also goes a long way toward equalizing the tax treatment of those in different lines of work. In the case of the self-employed, it makes a threefold increase in the deductible amount which can be set aside for retirement. At the same time, it provides limits on the contributions or benefits for individuals covered by qualified plans. The bill also provides deductions for a modest retirement savings set-aside for those who are not covered by any existing plans.

The bill continues to rely primarily on the tax laws to secure needed improvements in pension and related plans. In general, it retains the tax incentives granted under present law for the purpose of encouraging the establishment of plans which contain socially desirable provisions. However, it also improves the effectiveness of these tax incentives by extending or increasing them in certain cases where this is warranted and by pruning them where they have given rise to problems.

Present tax treatment of qualified plans

Present law encourages employers to establish retirement plans for their employees by granting favorable tax treatment where plans qual-

[3] ify by meeting nondiscrimination and other rules set forth in the Internal Revenue Code. Such qualified plans must cover a specified percentage of employees or cover employees under a classification found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees. Similarly, the contributions to such plans or the benefits paid out by them cannot discriminate in favor of such employees.

The favorable tax treatment granted qualified plans is substantial. Employers, within certain limits, are permitted to deduct contributions made to these plans for covered employees whether or not their interests are vested; earnings on the plan's assets are exempt from tax; and covered employees defer payment of tax on employer contributions made on their behalf until they actually receive the benefits, generally after retirement when their incomes and hence applicable tax rates tend to be lower.

The private pension system has shown substantial development under the present tax rules. Estimates of the coverage of private pension plans range from 23 million to 30 million employees for 1972 and 42 million employees are expected to be covered by 1980 without any change in law. Similarly, in 1970 about $14 billion was contributed to pension plans by employees and employers and 4.7 million beneficiaries received $7.4 billion in pension payments. Moreover, pension plan assets amounted to $150 billion (book value) in 1972 and are expected to reach $225 billion by 1980.

Problem areas

While the achievements of private retirement plans are substantial, a number of serious problems have become apparent. Those dealt with by this bill can be briefly outlined as follows:

Inadequate coverage.—Despite the rapid growth in pension coverage, about one-half of all employees in private nonagricultural employment are still not covered. Moreover, many plans have overly restrictive age and service requirements for participation, resulting in the exclusion of many employees.

Inadequate vesting.—Present law generally does not require an employee plan to give a covered employee vested rights to benefits—that is, the right to receive benefits if he leaves or loses his job before retirement age. Many private pension plans do provide vested rights to benefits before retirement, but as a general rule, employees do not acquire vested rights until they have served a fairly long time with the firm and/or are relatively mature. As a result, even employees with substantial periods of service may not acquire rights to pension benefits upon separation from employment.

Inadequate funding.—A significant number of pension plans are not adequately funded—that is, they are not accumulating sufficient assets to pay benefits in the future to covered employees. Under the present minimum funding requirements, contributions to qualified plans must be at least large enough to pay the normal costs (the pension liabilities created in the current year) plus the interest on unfunded accrued liabilities attributable to the past service of the covered employees. However, this minimum funding requirement is

[4] not adequate because it does not require the unfunded accrued liabilities for past service to be amortized.

Discrimination against individuals not covered by pension plans.—Individuals who are outside of qualified pension plans have no opportunity to set aside income for their own retirement under the favorable tax treatment accorded to individuals covered by such plans. These individuals must save for their retirement from income after tax and must pay tax currently on the income earned by their retirement savings.

Unjustifiable differences in tax treatment of corporate owner-employees and self-employed individuals under qualified plans.—At present, in practice there is almost no practical limit on the amount of pension contributions that corporations can make to qualified plans on behalf of corporate employees. This has resulted in abuse situations in which extremely large pension benefits have been financed for corporate employees in part at the expense of the general taxpaying public, as a result of the favorable tax treatment that is accorded.

The fact that pension contributions on behalf of corporate employees are in practice not subject to control has also given rise to claims of discrimination on the part of self-employed persons. Pension contributions made by self-employed persons on their own behalf are limited to 10 percent of earned income up to $2,500 a year under present law. These limits also have had the undesirable effect of inducing many individuals, including professional people, who would normally carry on their activities as sole proprietors or partners, to convert their activities to the corporate form almost entirely to secure the greater tax advantages associated with corporate plans.

Provisions of the bill

The bill deals with these problems in many different ways. The principal provisions of the bill are summarized below.

1. *Minimum Participation Standards.*—Generally, an employee cannot be excluded from a plan on account of age or service if the employee is at least 25 years old and has had at least one year of service. The one-year of service requirement may be extended to 3 years if immediate vesting is provided.

2. *Minimum Vesting Standards.*—Three alternative minimum vesting standards are provided. The first of these provides for at least 25 percent vesting at the end of the fifth year of covered service. Thereafter the vesting percentage is increased by 5 percent a year until a level of 50 percent is reached at the end of the tenth year. Following this, vesting increases at the rate of 10 percent a year until 100 percent vesting is reached at the end of the 15th year.

The second vesting standard under the bill is 100 percent vesting at the end of ten years of covered service.

The third vesting standard is the so-called rule of 45. Under this standard, there must be 50 percent vesting when the sum of the age of the individual and the number of years of covered service equal 45 (provided there is at least 5 years of service). An additional 10 per-

[5] cent per year is then required to be vested in each of the next 5 years of service.

These vesting rules are phased in over a five-year period beginning, in the case of existing plans, in 1976.

3. *Minimum Funding Standards.*—Normal costs are to be funded currently. Costs attributable to already-existing liabilities are to be amortized over a 40-year period. Liabilities under plan amendments and new plans generally are to be amortized over a 30-year period, except that in the case of multiemployer plans the amortization period is to be 40 years (in this latter case the Secretary of Labor can extend this for a further period of 10 years). Experience gains and losses are to be amortized over 15 years generally, but in the case of multiemployer plans over a period of 20 years (in this last case the period can be extended an additional ten years by the Secretary of Labor). These experience gains and losses generally will only be required to be recomputed every three years. The above funding standards are based upon accrued liabilities.

If funding requirements are higher under a second general standard which is based on accrued "vested" liabilities, this standard is to apply in lieu of the rules set forth above. Under this standard, accrued vested liabilities are determined, as also are the value of the plan's assets. Where the former exceeds the latter, the contribution for that year must be sufficient to cover the level annual payment required to amortize the difference in 20 years. A determination for a new 20-year amortization period is made in each of the succeeding years.

Where any of the requirements set forth above present hardship under a plan (and certain standards are met), the Secretary of the Treasury can permit variances spreading the current liability in this case over a 15-year period.

4. *Special Variance for Multiemployer Plans.*—In the case of multiemployer plans where the Secretary of Labor finds that the vesting and funding provisions seriously endanger the continuation of a plan, he can authorize exceptions to the vesting and funding standards described above.

5. *Government Plans.*—The participation, vesting, and funding standards set forth above do not apply in the case of governmental plans. In the case of these plans, the same standards continue to apply as under present law. Studies are to be made by the Ways and Means Committee and the Education and Labor Committee as to the need for change in these areas in the future.

6. *Joint and Survivor Annuities.*—Qualified plans in the future that provide annuities are to provide for them as joint and survivor annuities (if the participant and his spouse have been married throughout the 5-year period ending on the annuity starting date) unless the employee elects out of such treatment.

7. *Effective Dates for Participation, Vesting, and Funding.*—Generally the participation, vesting, and funding provisions in the case of existing plans are to be effective as of January 1, 1976. In the case of new plans adopted after January 1, 1974, however, the participation, vesting, and funding provisions are to be effective as of the date

[6] of enactment. In the case of collective bargaining plans, the January 1, 1976, date is to be extended to January 1, 1977, or the expiration date of the current collective bargaining agreement (but not beyond January 1, 1981).

8. *Federal Procurement Contracts.*—In the case of employees working under contracts relating to federal procurement, construction, or research, the Secretary of Labor is directed to make a study as to procedures to encourage special provisions for engineers and others similarly situated who tend to change from one job to another, in order to provide them with more immediate vesting than is true in the case of employees generally. The study in this case is to be completed in a two-year period and regulations carrying out the study are to be put into effect at the end of the next year unless either House of the Congress within 90 days after the receipt of such proposed regulations votes against these regulations.

9. *Duties of Secretary of Health, Education, and Welfare.*—Whenever employees with vested rights leave their employment (prior to retirement), a statement as to their vested rights is to be given them by their employer. A copy of this statement is also to be transmitted through the Treasury Department to the Secretary of HEW. The Secretary of HEW will then inform the employee when he applies for social security benefits as to any statements of this type which an employer has given HEW. The department is not to be responsible for the accuracy of any such statements.

10. *Plan Termination Insurance and the Rules Relating to Fiduciaries.*—Although a program of plan termination insurance to protect the rights of covered employees is desirable, this bill makes no provision for such a program. Also, no change is made in this bill to tighten the rules relating to fiduciaries of qualified retirement plans which would also be desirable. This is because H.R. 12906, which is to be reported by the House Committee on Education and Labor, provides for a program of plan termination insurance and also provides for additional rules regarding fiduciary requirements which are designed to correct any existing abuses.

11. *Tax Court Procedure.*—Provision is made in the bill for the appeal from the determination of the Internal Revenue Service as to the initial qualification of pension plans or the effects of amendments proposed to pension plans. This is to be dealt with by a declaratory judgment procedure in the U.S. Tax Court.

12. *Establishment of Office of Assistant Commissioner.*—Provision is made for the establishment in the Internal Revenue Service of an office of Assistant Commissioner of Pensions and Exempt Organizations. This office is to provide a centralized group for unifying the tax treatment of pension plans throughout the country. Authorization is made for funds in the case of this office.

13. *Contributions on Behalf of Self-Employed Individuals.*—The limitations on deductions for self-employed individuals are to be increased from 10 percent of their self-employment income, not to exceed $2,500 up to 15 percent of their self-employment income, not to

[7] exceed \$7,500. A minimum of \$750 may be deducted in these cases without regard to the percentage limitation.

14. *Individual Retirement Accounts.*—Individuals not covered by qualified or government pension plans are to be permitted to take a deduction of up to 20 percent of their earned income not to exceed \$1,500. This amount may be set aside in a special custodial account with a bank, savings and loan, credit union, life insurance company or regulated investment company without tax consequences on the earnings on the balance in this account until such time as the individual draws down the amount. This amount cannot be drawn down without penalty before age 59½ (except in the case of death or disability) and the individual must begin drawing the amount down by age 70½ if penalty is to be avoided. An individual may establish the account directly himself or, alternatively, an employer or labor union may maintain accounts of this type for employees or members.

15. *Limitations on Benefits and Contributions.*—In the case of defined contribution plans (profit-sharing and money purchase pension plans), there may not be set aside with respect to an individual in a qualified plan in any year more than 25 percent of his compensation or \$25,000, whichever is the lesser.

In the case of defined benefit plans, the pension which may be paid with respect to any individual may not exceed 100 percent of his compensation in his high three years of employment or \$75,000, whichever is the lesser. (Both the \$25,000 amount and the \$75,000 amount referred to above are subject to cost-of-living allowances.) A "grandfather clause" provides that if an individual is eligible for more than a \$75,000 pension based upon his current compensation by taking into account his additional period of employment up to the time of his expected retirement, this amount may be paid despite the \$75,000 limitation.

If an employee is under both a defined benefit plan and a defined contribution plan, then an overall limit is applied to coordinate the two limits discussed above. In this case, the sum of (1) the percentage utilization of the maximum limit under the defined benefit plan and (2) the percentage utilization of the maximum limit under the defined contribution plan cannot exceed 140 percent. Amounts in excess of these limits may be provided under the plan, but may not be paid out of a qualified trust.

16. *Lump Sum Distributions.*—Lump sum distributions from qualified plans are to be treated as ordinary income subject to special 10-year averaging. This treatment is to apply to the post-1973 portion of such a distribution, with regular capital gain treatment available to the remaining portion (pre-1974) of the distribution. The distribution is to be apportioned between the income averaging part and the capital gains part on the basis of the employee's years of active participation in the plan after 1973 and his years before 1974.

17. *Salary Reduction Plans and Cash-or-Deferred-Profit-Sharing-Plans.*—Determination of the inclusion of income to an employee in

[8] the case of a salary reduction plan or a cash-or-deferred-profit-sharing plan is to be made on the basis of the way it would have been made before the Internal Revenue Service began the preparation of proposed regulations to change its administrative practices in this area. Those proposed regulations are to be withdrawn and no new regulations on this matter may be finally issued until after March 15, 1975.

18. *Revenue Effects*.—The tax provisions affecting retirement plans, which are in this bill, when fully effective, will result in an estimated net revenue loss of $460 million a year. An estimated revenue loss of $530 million a year is attributable to the provisions allowing individuals not covered by qualified plans to establish their own individual retirement plans and to the higher deduction limits for contributions by self employed people to H.R. 10 pension plans. This is offset by an estimated $70 million revenue gain attributable to the new tax treatment of lump sum distributions from qualified plans, and the provisions limiting contributions or benefits to qualified plans on behalf on any individual.

II. REASONS FOR THE BILL

One of the most important matters of public policy facing the nation today is how to assure that individuals who have spent their careers in useful and socially productive work will have adequate incomes to meet their needs when they retire. This legislation is concerned with improving the fairness and effectiveness of qualified retirement plans in their vital role of providing retirement income. In broad outline, the objective is to increase the number of individuals participating in employer-financed plans; to make sure to the greatest extent possible that those who do participate in such plans actually receive benefits and do not lose their benefits as a result of unduly restrictive forfeiture provisions or failure of the pension plan to accumulate and retain sufficient funds to meet its obligations; and to make the tax laws relating to qualified retirement plans fairer by providing greater equality of treatment under such plans for the different taxpayer groups concerned.

Essentially, your committee's bill represents a significant improvement in the tax treatment now applicable with respect to qualified retirement plans. Your committee regards the present legislation as part of an evolutionary process which keeps this basic framework but which builds on it new provisions which experience indicates are necessary for the proper functioning of these plans.

A fundamental aspect of present law, which the committee bill continues, is reliance on voluntary action by employers (and employees under contributory plans) for the establishment of qualified retirement plans. The committee bill also continues the approach in present law of encouraging the establishment of retirement plans which contain socially desirable provisions through the granting of tax induce-

[9] ments. In other words, under the new legislation as under the present law, no one is compelled to establish a retirement plan. However, if a retirement plan is to qualify for the favorable tax treatment, it will be required to comply with specified new requirements which are designed to improve the retirement system. Since the favorable tax treatment is quite substantial, presently involving a revenue loss of over $4 billion a year, it is anticipated that plans will have a strong inducement to comply with the new qualification rules and thereby become more effective in fulfilling their objective of providing retirement income.

The tax advantages associated with qualification under the Internal Revenue Code are substantial. Employers, within certain limits, are permitted to deduct contributions made to such plans on behalf of covered employees, whether or not the interests of covered employees are vested; earnings on the plan's assets are exempt from tax; and covered employees defer payment of tax on employer contributions made on their behalf until they actually receive the benefits, generally after retirement when their incomes and hence applicable tax rates tend to be lower.

THE ENCOURAGEMENT OF NONDISCRIMINATORY PLANS UNDER PRESENT LAW

As already indicated, our tax laws now provide substanital tax incentives for the establishment of nondiscriminatory retirement plans. In order to qualify as nondiscriminatory, a retirement plan must cover a specified percentage of employees [1] or cover employees under a classification found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees. Similarly, either the contributions to the plan or the benefits paid out by the plan must not discriminate in favor of officers, etc.

In adopting this legislation, your committee is aware of the achievements of the private pension system under the 1942 legislation. The private retirement system has grown rapidly over the past three decades. While the precise coverage of retirement plans is not known, estimates of the number of employees now covered by such plans range from 23 million to 30 million.[2] This compares with coverage of 4 million in 1940 and 9.8 million in 1950. (See Table 1.) By 1980, these retirement plans are expected to cover 42 million employees.[3]

[1] To qualify on this basis, the plan must cover 70 percent or more of all the employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are so eligible, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in any 1 week, and employees whose customary employment is for not more than 5 months in any calendar year (sec. 401(a)(3)(A)).

[2] Department of Health, Education and Welfare, Department of Labor and Treasury Department. Coverage and Vesting of Full-Time Employees under Private Retirement Plans; Findings from the April 1972 Survey, BLS Report No. 423, Sept. 1973.

[3] Public Policy and Private Pension Programs. A Report to the President on Private Employees Retirement Plans by the President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, January 1965, p. vi.

TABLE 1.—PRIVATE PENSION AND DEFERRED PROFIT-SHARING PLANS:[1] ESTIMATED COVERAGE, CONTRIBUTIONS, BENEFICIARIES, BENEFIT PAYMENTS, AND RESERVES, 1950, 1955, 1960–70

Year	Coverage[2] end of year (in thousands)			Employer contributions (in millions)			Employee contributions (in millions)			Number of beneficiaries, end of year (in thousands)			Amount of benefit payments (in millions)			Reserves, end of year (in billions)		
	Total	Insured	Noninsured	Total	Insured	Noninsured	Total	Insured	Noninsured	Total	Insured	Noninsured	Total[3]	Insured	Noninsured[3]	Total	Insured	Noninsured
1950	9,800	2,600	7,200	$1,750	$720	$1,030	$330	$200	$130	450	150	300	$370	$80	$290	$12.1	$5.6	$6.5
1955	15,400	3,800	11,600	3,280	1,100	2,180	560	280	280	980	290	690	850	180	670	27.5	11.3	16.1
1960	21,200	4,900	16,300	4,710	1,190	3,520	780	300	480	1,780	540	1,240	1,720	390	1,330	52.0	18.8	33.1
1961	22,200	5,100	17,100	4,830	1,180	3,650	780	290	490	1,910	570	1,340	1,970	450	1,520	57.8	20.2	37.5
1962	23,100	5,200	17,900	5,200	1,240	3,960	830	310	520	2,100	630	1,470	2,330	510	1,820	63.5	21.6	41.9
1963	23,800	5,400	18,400	5,560	1,390	4,170	860	300	560	2,280	690	1,590	2,590	570	2,020	69.9	23.3	46.6
1964	24,500	6,000	18,600	6,370	1,520	4,850	910	310	600	2,490	740	1,750	2,990	640	2,350	77.7	25.2	52.4
1965	25,300	6,200	19,100	7,370	1,770	5,600	990	320	670	2,750	790	1,960	3,520	720	2,800	86.5	27.3	59.2
1966	26,300	6,900	19,400	8,210	1,850	6,360	1,040	330	710	3,110	870	2,240	4,190	810	3,380	95.5	29.3	66.2
1967	27,500	7,700	19,800	9,050	2,010	7,040	1,130	340	790	3,410	930	2,480	4,790	910	3,880	106.2	31.9	74.2
1968	28,000	7,900	20,100	9,940	2,240	7,700	1,230	340	890	3,770	1,010	2,760	5,530	1,030	4,500	117.8	34.8	83.1
1969	29,000	8,700	20,300	11,520	3,030	8,490	1,360	350	1,010	4,180	1,070	3,110	6,450	1,160	5,290	127.8	37.2	90.6
1970	[4] 29,700	9,300	20,400	12,580	2,860	9,720	1,420	350	1,070	4,720	1,220	3,500	7,360	1,330	6,030	137.1	40.1	97.0

[1] Includes pay-as-you-go, multi-employer, and union-administered plans those of nonprofit organizations, and railroad plans supplementing the Federal railroad retirement program. Excludes pension plans for Federal, State, and local government employees as well as pension plans for the self-employed. Insured plans are underwritten by insurance companies; noninsured plans are, in general, funded through trustees.

[2] Excludes annuitants; employees under both insured and noninsured plans are included only once—under the insured plans.

[3] Includes refunds to employees and their survivors and lump-sums paid under deferred profit-sharing plans.

[4] Coverage for 1972 is estimated at 23,000,000 in Coverage and Vesting of Full-Time Employees under Private Retirement Plans: Findings from the April 1972 survey by the Departments of Health, Education, and Welfare and Labor. See BLS Rept. No. 42-3, September 1973. To the extent that this, 23,000,000 coverage figure is correct, the estimates of coverage shown in the above table are too high. Nonetheless, the coverage figures in the table may still be useful in giving an approximation of the relative increase in coverage over the past 2 decades or so.

Source: Compiled by the Office of the Actuary, Social Security Administration, from data furnished primarily by the Institute of Life Insurance and the Securities and Exchange Commission.

[11] The growth which has occurred is also evidenced in other ways. Between 1950 and 1970, total annual contributions made to retirement plans by employees and employers rose from about $2.1 billion to about $14 billion. In 1950, 450,000 beneficiaries received $370 million from retirement plans; in 1970, 4.7 million beneficiaries received $7.4 billion in pension payments. Moreover, retirement plan assets soared from $12.1 billion in 1940 to $150 billion in 1972 (book value) and are expected to reach $225 billion by 1980.[4]

PROBLEM AREAS

Despite the substantial achievements of retirement plans, it has become apparent that a number of problems have arisen which prevent many of these plans from achieving their full potential as a source for retirement income. These problem areas are outlined below.

Inadequate coverage.—Despite the rapid growth in retirement plan coverage in recent years to its 1970 level of from 23 to 30 million employees, somewhere in the vicinity of one-half of all employees in private, nonagricultural employment are still not covered by retirement plans. Retirement plans are still relatively rare among small business firms and in agriculture. Moreover, even where employees work for a firm with a retirement plan, the age and service requirements for participation in the plan may be overly restrictive, excluding many employees.

Discrimination against the self-employed and employees not covered by retirement plans.—Another problem area is that present law discriminates against employees not covered by retirement plans and against the self-employed. This is primarily because the personal retirement savings of individuals not covered by pension plans must be made out of after-tax income, while those covered by retirement plans are permitted to defer tax on their employer's retirement contributions. In addition, the earnings on the retirement savings of noncovered persons are subject to tax as earned, while the tax on earnings of pension funds is deferred until paid out as a retirement benefit.

Self-employed people also frequently maintain that they are discriminated against as compared with corporate executives and owner-managers of corporations in regard to the tax treatment of retirement savings. At present, there is no comprehensive limit on the amounts the employer can contribute on behalf of corporate executives and owner-managers of corporations; similarly, there is no statutory limit on the amount of pension benefits that the latter can receive—so long as those contributions or benefits do not discriminate in favor of employees who are shareholders, officers, supervisors, or highly paid and do not constitute unreasonable compensation. As a result of legislation enacted in 1962 and amended in subsequent years, self-employed people can establish retirement plans for themselves and their employees but their deductible contributions to such plans on their own behalf are limited to 10 percent of earned income up to $2,500 a year.

Inadequate vesting.—Present law generally does not require a retirement plan to give a covered employee vested rights to benefits—

[4] Table 1 and Securities and Exchange Commission, Private Noninsured Pension Funds, 1972, and A Report to the President on Private Employee Retirement Plans, *op. cit.*

[12] that is, the right to receive benefits even if he leaves or loses his job before retirement age.[5] Over two-thirds of the private retirement plans provide vested rights to retirement benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have accumulated a fairly long period of service with the firm and/or are relatively mature.

At present, only one of every three employees participating in employer-financed plans has a 50 percent or greater vested right to his accrued retirement benefits. Moreover, 58 percent of covered employees between the ages of fifty and sixty and 54 percent of covered employees 60 years of age and over do not have a qualified vested right to even 50 percent of their accrued retirement benefits.[6] As a result, even employees with substantial periods of service may lose retirement benefits on separation from employment. Extreme cases have been noted in which employees have lost retirement rights at advanced ages as a result of being discharged shortly before they would be eligible to retire. In addition, failure to vest more rapidly is charged with interfering with the mobility of labor, to the detriment of the economy.

Inadequate funding.—Another problem area is that a significant portion of present pension plans are not adequately funded—that is they are not accumulating sufficient assets to pay benefits in the future to covered employees. As a result, there is concern that many employees now covered by pension plans may not actually receive pensions when they retire because the funds will not be available to pay for those pensions.

In general, pension plans that are qualified under the Internal Revenue Code must meet certain minimum funding requirements by irrevocably setting aside funds in a trust or through the purchase of insurance contracts. Contributions to such plans must generally be at least large enough to pay the normal pension costs plus the interest on unfunded accrued liabilities which generally are attributable to the past service of the covered employees. However, this minimum funding requirement is not adequate because it is designed only to prevent the unfunded liabilities from growing larger and does not require any payment to reduce the amount of the outstanding unfunded liabilities, which may be substantial.

The available evidence suggests that many pension plans are adequately funded—but that a significant proportion of the plans have not been adequately funded. This is indicated, for example, by a survey made by the Senate Labor Subcommittee of 469 trustee-administered pension plans covering 7.1 million employees. In 1970, about one-third of the plans in the study covering one-third of the participants reported a ratio of assets to total accrued liabilities of 50 percent or less; while 7 percent of the plans covering 8 percent of the participants reported a ratio of assets to accrued liabilities of 25 percent or less. (See Table 2.)

[5] However, as noted below, vesting is required for employees under so-called H.R. 10 plans for owner-employees and may also be required in other cases to prevent the plan from having a discriminatory effect in operation, or upon plan termination or complete discontinuance of contributions.

[6] U.S. Treasury Department—Fact Sheet, Pension Reform Program, as reprinted in Material Relating to Administration Proposal Entitled the "Retirement Benefits Tax Act", Committee on Ways and Means, 93d Cong., 1st sess., p. 37, Table B.

[13] TABLE 2.—FUNDING OF PRIVATE PENSION PLANS: ASSETS AT MARKET VALUE, AS PERCENT OF PRESENT VALUE [1] OF TOTAL ACCRUED RETIREMENT BENEFITS, BY PLAN AND BY PARTICIPANT: AS OF 1970

	By plan		By participant	
	Number [2]	Percent	Number	Percent
Assets as percent of accrued benefits:				
25 percent or less	33	7	541,801	8
26 through 50	118	25	1,798,9[illegible]5	25
51 through 75	104	22	2,134,601	30
76 through 100	117	25	1,211,298	17
101 through 125	55	12	949,975	13
126 through 150	20	4	134,252	2
151 through 175	8	2	52,498	1
Over 175	14	3	275,835	4
Total	469	100	7,100,205	100

[1] Present value of accrued benefits is actuarially determined.
[2] Sample consists of 469 trustee-administered plans. Comparable data were not available for insured plans.

Note: The sum of individual items may not equal totals because of rounding.

Source: Senate Committee on Labor and Public Welfare Report on S. 3598, The Retirement Income Security for Employees Act of 1972, 92d Cong., 2d sess., p. 97.

In general, the older plans are better funded than the newer ones. Over one-half of the plans covered by the study which were 6 years old or less had an assets-liabilities ratio of 50 percent or less, while 35 percent of the plans in existence for 17 years to 21 years had such an assets-liabilities ratio.[7]

Loss of pension benefits due to plan terminations.—Concern has also been expressed over the possible loss of pension benefits as a result of termination of pension plans. The Studebaker case, which has been widely publicized, illustrates how pension benefits can be lost as a result of termination of a plan. When Studebaker closed its South Bend, Indiana, plant in 1964, the employees were separated and the pension plan was terminated. The plan provided fairly generous vested rights and the funding apparently would have been adequate had the firm remained in business and the plan continued in operation. However, at termination, the plan had not yet accumulated sufficient assets to meet all its obligations. As a result, full pension benefits were paid only to employees already retired and to employees age 60 or over with 10 years or more of service. Little or no benefits were paid to large numbers of other employees, many of whom had vested rights.

A joint study of the Treasury Department and the Department of Labor indicates that there were 1,227 plan terminations in 1972.[8] These terminations resulted in the loss of $49 million of benefits (present value) by 19,400 pension participants in 546 of the terminated plans. The average loss of benefits for participants amounted to $2,500. Participants losing benefits represented about eight one-hundredths of one percent of workers covered by pension plans. The data, of course, cover terminations occurring over a one-year period and may not be the typical experience.

Misuse of pension funds and disclosure of pension operations.—There also has been concern about the administration of pension plans. It has been charged that all too frequently pension funds have not been

[7] Senate Committee on Labor and Public Welfare report on S. 3598, The Retirement Income Security for Employees Act of 1972, 92d Cong., 2d sess., p. 98.
[8] Department of the Treasury and the Department of Labor Study of Pension Plan Terminations, 1972—Final Report, August 1973.

[14] used in the best interest of covered employees. There have been cases of extreme misuse of pension funds.

The Welfare and Pension Plans Disclosure Act, which is administered by the Labor Department, was adopted in 1958 to protect the interests of welfare and pension plan participants and beneficiaries by requiring disclosure of information regarding such plans. This Act requires the plan administrators to file with the Secretary of Labor and to send to participants upon written request a description and annual report of the plain. The Act was amended in 1962 to make theft, embezzlement, bribery, and kickbacks Federal crimes where these occur in connection with welfare and pension plans. The 1962 amendment also conferred limited investigatory and regulatory powers upon the Secretary of Labor. However, abuses in the administration of pension plans and in the handling of pension funds have continued.

The Internal Revenue Code (sec. 503(b)) seeks to prevent abuses in the use of funds held under qualified retirement plans by prohibiting qualified trusteed plans from engaging in certain specified prohibited transactions such as lending funds without adequate security and a reasonable rate of interest to the creator of the plan, his family, or corporations controlled by him. Other prohibited transactions include payment of excessive salaries, purchase of property for more than an adequate consideration, sale of property for less than an adequate consideration, or any other transactions which result in a substantial diversion of funds to such individuals. Special additional rules apply to payment of excessive salaries, purchase of property for more than an trusts benefitting owner-employees.

OBJECTIVES OF THE MAIN PROVISIONS OF THE BILL

Although there have been significant legislative changes since the present basic framework of the tax laws relating to pensions was first adopted—principally in allowing self-employed people to establish retirement plans for themselves and their employees and in requiring the disclosure of information regarding welfare and pension plans—it has been more than 30 years since these basic pension provisions were first adopted. It is time for new legislation to conform the pension provisions to the present day situation and to provide remedial action for the various problems that have arisen in the retirement plan area during the past three decades.

As indicated above, the present provisions of the Internal Revenue Code provide tax inducements for the adoption of nondiscriminatory plans and to a limited extent other objectives. These nondiscrimination provisions are retained, but the new legislation also requires retirement plans to conform to additional requirements in order to qualify for the favorable tax treatment under the Internal Revenue Code. In taking this action, the committee has been mindful of the need to construct the new requirements so that they will provide meaningful improvement in the various problem areas noted under the present law. At the same time, the committee is aware that under our voluntary pension system, the cost of financing pension plans is an important factor in determining whether any particular retirement plan will be adopted and in determining the benefit levels if a plan is adopted, and that

[15] unduly large increases in costs could impede the growth and improvement of the private retirement system. For this reason, in the case of those requirements which add to the cost of financing retirement plans, the committee has sought to adopt provisions which strike a balance between providing meaningful reform and keeping costs within reasonable limits.

Generally, it would appear that the wider or more comprehensive the coverage, vesting, and funding, the more desirable it is from the standpoint of national policy. However, since these plans are voluntary on the part of the employer and both the institution of new pension plans and increases in benefits depend upon employer willingness to establish or expand a plan, it is necessary to take into account additional costs from the standpoint of the employer. If employers respond to more comprehensive coverage, vesting and funding rules by decreasing benefits under existing plans or slowing the rate of formation of new plans, little if anything would be gained from the standpoint of securing broader use of employee pensions and related plans. At the same time, there are advantages in setting minimum standards in these areas both to serve as a guideline for employers in establishing or improving plans and also to prevent the promise of more in the form of pensions or related benefits than eventually is available.

Coverage.—One of the major objectives of the new legislation is to extend coverage under retirement plans more widely. For this reason, the committee bill sets minimum standards on the age and service requirements which can be used to exclude employees from participation in plans. Under the new rules, a qualified plan cannot require an employee to serve longer than one year or attain an age greater than 25 (whichever occurs later) as a condition of eligibility to participate in the plan. Thus, an employee who reaches age 25 and has at least a year of service would be eligible to participate (unless he is excluded for some reason other than age or service). However, a plan that provides vested rights immediately on participation will be permitted to set the participation requirements at no more than 3 years of service and age 25.

The Committee believes that these rules are reasonable. They provide a balance between the need to grant employees the right to participate in pension plans at a relatively early age so that they can begin to acquire pension rights and the need to avoid the administrative drawbacks that would be involved in granting coverage to immature and transient employees whose benefits would in any event be small. The participation rules also prevent potential avoidance of the vesting rules in the committee bill.

The bill also adopts a number of provisions which are carefully designed to make the minimum age and service requirements for participation work effectively. The Secretary of the Treasury or his delegate is given the authority to determine under regulations what constitutes a year of service for purposes of fulfilling the participation requirement in order to make the service requirement sufficiently flexible to meet the many varying situations which arise in different industries operating under different conditions of employment. At the same time, guidance is provided to those framing the regulations so as to

[16] minimize the possibilities of abuse. The bill, for example, provides that a qualified plan may not establish a service requirement for participation which has the practical effect of treating as a year of service an average period for all employees of more than 12 months or which excludes any employee who has more than 17 months of continuous service. In addition, the bill provides that a seasonal employee whose customary employment is for at least 5 months in a 12-month period is generally to be given credit for a year of service if he works his customary season months in a 12-month period.

The Secretary of the Treasury or his delegate is also given authority to prescribe by regulations different rules for determining a "year of service" for those industries whose normal work schedules are substantially different from those that are generally applicable. (For example, the regulations could, where consistent with the practice of an industry, permit 100 hours of employment to be treated as one month, or 1,000 hours of employment to be treated as one year.)

The bill also provides guidance to the Secretary or his delegate in issuing regulations in regard to the computation of the years of service of an employee who has a break in service. This is of significance since an employee will generally receive greater vested rights if all his periods of service with the employer are combined and treated as one period of service than if each period of service interrupted by a break is treated separately. This matter involves difficult issues. On the one hand, it appears desirable not to require service prior to the break to be merged with service after the break where the break in service is of substantial duration and the period of prior service is relatively short. This is because in such cases, the plan frequently will not have records regarding the employee's prior service and the administrative difficulties resulting from any requirement to merge service prior to the break with service after the break might make employers reluctant to rehire employees and yet at the same time would not provide substantial benefits for the latter. On the other hand, where the break in service is of relatively moderate duration, treating each period of service as a separate period could give rise to abuses by giving employers an inducement to discharge covered employees and then rehire them after a short time in order to reduce the cost of financing plan benefits. An additional consideration is that where an employee has acquired an attachment to the firm by serving a substantial number of years, and particularly where he has accumulated substantial vested rights to benefits, it seems reasonable that all his service including service prior to the break should be taken into consideration in determining his participation under the plan.

Your committee has resolved these issues by providing that where an employer rehires an employee who has had a break of service of at least one year after serving with the employer for less than 4 consecutive years, the plan will not be considered to be following an unreasonable procedure merely because it does not take into consideration his prior service. However, where a rehired employee had completed at least 4 consecutive years of service before the break, his prior years of service must be taken into consideration for purposes of computing his years of service unless the break is for 6 years or more. However, if a rehired employee acquired a nonforfeitable right to at least 50 per-

[17] cent of his accrued benefits derived from employer contributions prior to the service break, all his prior service must be taken into consideration in computing his years of service, regardless of the duration of the break.

Under plans which provide defined or specified benefits, it is more expensive for an employer to finance an equivalent retirement benefit for an older employee than for a young employee. To avoid making it more difficult for older workers to find employment, the bill permits plans which provide defined benefits to exclude from participation employees who begin employment within 5 years of the normal retirement age. This, for example, permits a defined benefit plan which provides for a normal retirement age of 65 to exclude an employee who begins work at the age of 60. Such exclusions are not permitted under money purchase pension plans or profit sharing plans. Under these plans, an employee is not promised any specified benefits, but instead is entitled only to the amount that is in his account (employer contributions, forfeitures, and employee contributions, adjustments for earnings, losses, and expenses) with the result that it is no more expensive for the employer to cover older employees than younger employees under such plans.

For purposes of satisfying the coverage rules of the Internal Revenue Code, a plan is permitted to exclude from participation employees covered by a collective bargaining agreement where the agreement does not provide that such employees are to be included in the plan and there is evidence that retirement benefits were the subject of good faith bargaining. This provision has two objectives: first, it recognizes that employees who are represented in collective bargaining agreements may prefer other forms of compensation, such as cash compensation, to coverage in a plan; and second, it makes it possible for employees who are not covered by a collective bargaining agreement to receive the advantages of coverage in a qualified plan where some employees of the same firm have elected through collective bargaining agreement not to be covered by the plan.[9] At present, it frequently is not feasible for the former employees to receive the advantages of a qualified plan because the very fact that the employees covered by the collective bargaining agreement rejected coverage results in disqualifying the plan on the ground that it does not satisfy the coverage requirements for nondiscrimination.

Finally, all government plans (including the federal civil service pension plan) and plans of churches (unless they elect to be subject to the new rules) are exempted from the new participation standards as well as from the minimum vesting and minimum funding standards described below. However, both government plans and church plans must continue to meet the requirements for qualification under present law in order to make their employees eligible for the tax benefits associated with qualified plans. The committee exempted government plans from the new higher requirements because adequate information is not now available to permit a full understanding of the impact these new requirements would have on government plans. For this reason the

[9] In the case of a plan covering airline pilots under a collective bargaining agreement, the bill permits the exclusion of the employees who are not covered by the collective bargaining agreement for purposes of the coverage requirements for nondiscrimination.

[18] bill specifically provides that the Committee on Ways and Means and the Committee on Education and Labor are to study the participation, vesting, and funding practices of government plans, government plan fiduciary standards, factors affecting the mobility of government employees and those employed under Federal procurement contracts, and the need for Federal standards in each of these matters. Each committee is to submit to the House of Representatives not later than December 31, 1976, the results of the studies, together with its recommendations.

In order to minimize administrative problems, and ensure insofar as possible that plans which satisfy the requirements of the Internal Revenue Code also meet the pension standards which are to be administered by the Labor Department, and vice versa, the bill provides that the Treasury regulations with respect to the participation, vesting, and funding requirements of the bill (other than regulations to enforce the antidiscrimination requirements of sec. 401(a)(4) of the code) are to be effective for plan years beginning after December 31, 1975, only if approved by the Secretary of Labor. Where the bill's provisions apply before that date (as in the case of new plans and plans which elect earlier dates) then the regulations may be prescribed without the necessary approval of the Secretary of Labor. However, these regulations are not to apply beyond the December 31, 1975, plan year cutoff date.

To give existing plans time to adjust to the new age and service participation requirements, the effective date of these requirements is deferred to January 1, 1976, for plans in existence on January 1, 1974. For plans adopted on or after January 1, 1974, the new minimum age and service requirements will be effective in the first plan year beginning after the date of enactment. However, for existing plans which were the subject of collective bargaining agreements, the new participation standards are not to apply until the later of (1) the expiration date of the last of the present collective bargaining agreements (but not later than January 1, 1981) or (2) January 1, 1977.

Vesting.—Coverage under a pension plan does not aid an individual if he later forfeits his right to his pension benefits upon voluntary or involuntary termination of employment. This is an important consideration in view of the fact that ours is a fairly mobile economy where employees tend to change jobs frequently, especially in their younger years. Moreover, the cyclical and technological nature of certain industries results in frequent layoffs over a work career for employees in those industries, as in aerospace and defense. The committee bill deals with this problem by requiring qualified pension plans to grant covered employees reasonable minimum vested rights to their accrued benefits.

The committee bill helps to assure that covered employees will actually benefit from pension plans by requiring qualified plans, as a condition of qualification under the Internal Revenue Code to meet reasonable minimum vesting standards. Qualified plans are required to grant covered employees nonforfeitable rights with respect to their own contributions. In addition, such plans are required to provide covered employees minimum vested rights with regard to employer contributions after they have fulfilled certain specified requirements.

[19] In adopting these minimum vesting requirements, your committee was guided by two broad considerations. The first relates to the need to balance the protection offered by the minimum vesting provision against the additional cost involved in financing the plan. Employees, of course, would be accorded the maximum protection if they were granted immediate and full vested rights to plan benefits. However, it is generally recognized that a requirement for immediate and full vesting would not be feasible because it would involve such substantial additional costs that it would impede the adoption of new plans and the liberalization of existing ones.

The second broad consideration guiding the committee in regard to minimum vesting is the need to provide adequate flexibility to the hundreds of thousands of retirement plans, to enable these plans to provide adequate vesting protection to their covered employees in the light of the individual circumstances and conditions confronting them. In other words, the committee does not believe that it would be desirable to force all retirement plans into one rigid mold so far as vesting is concerned.

In view of these considerations, the committee bill provides three alternative vesting options:

Under one option, a qualified plan would be required to provide an employee with vested rights to at least 25 percent of his accrued benefits from employer contributions after 5 years of covered service, plus an additional 5 percent for each of the next 5 years and 10 percent for each of the next following 5 years. This means that under this option, at least 50 percent of the employer-provided benefits must be vested after 10 years of covered service and 100 percent vested after 15 years of covered service. This option is designed to enable plans to provide the required vesting on a gradual basis according to years of service, generally without reference to the age of the employee. This option is neutral with respect to age, since all employees who fulfill the required service requirements are entitled to the specified vesting without regard to their age.

A second option permits firms which wish to provide faster vesting for their more mature employees than for their younger ones to do so by taking into consideration the age of the employee as well as his service for purposes of computing his vested rights. Under this option, the plan is required to provide a covered employee who has at least 5 years of covered service a vested right in at least 50 percent of the accrued benefits financed by the employer's contributions when the sum of his age and years of service equals 45; the minimum required vesting percentage would thereafter be increased by 10 percentage points a year in each of the following 5 years. This would, for example, provide an employee who began work for the employer at the age of 25, a vested right in 50 percent of his accrued benefits financed by employer contributions after 10 years of covered service when he reaches the age of 35. After completing an additional 5 years of service and attaining age 40 he would then be vested in 100 percent of his accrued benefits. On the other hand, an employee who starts to work for the employer at the age of 40 under this option would at the age of 45, upon completion of 5 years of service, receive a 50 percent vested right in his accrued benefits.

[20] The third option provided under the committee bill permits qualified plans to fulfill the minimum vesting requirements by providing employees a 100 percent nonforfeitable right to accrued benefits derived from employer contributions when they have achieved at least 10 years of service. The committee provided this option because it grants covered employees complete vesting protection after the completion of a reasonably short period of service.

Because the objective is to encourage more adequate provision for retirement, plans are permitted to defer the payment of benefits to individuals with vested rights until they reach normal retirement age and are separated from the firm.[10] As a general rule, the plan will specify what is normal retirement age for this purpose. However, in order to prevent undue delay in the payment of benefits, payment must begin not later than 60 days after the close of the last plan year in which the participant (1) attains age 65, (2) reaches the 10th anniversary of the start of his participation, or (3) terminates his employment. The "10th anniversary" provision was adopted to encourage the employment of individuals who are hired at mature ages for a long enough period to enable them to earn significant benefits under the plan.

The committee further decided to apply the minimum vesting requirements to benefits accrued prior to the effective date of the provision as well as to benefits accrued after this date on the ground that employees merit equal protection with regard to plan benefits regardless of when these benefits accrued. This is achieved by generally taking into account the employee's entire service with the employer in determining both his nonforfeitable vesting percentages and the amount of accrued benefits to which these vesting percentages are applied.

To keep the operation of the minimum vesting requirement reasonable and to avoid imposing undue burdens on plans, certain periods of service are permitted to be excluded in determining the employee's nonforfeitable rights. The service which may be excluded is:

(1) service before age 25,

(2) service during a period for which the employee declined to contribute to a plan requiring employee contributions,

(3) service during any period for which the employer did not maintain the plan,

(4) seasonal service which does not include a sufficiently long period of time in each 12-month period to be counted as service for purposes of the plan,

(5) certain service broken by periods of suspension of employment, and

(6) service before January 1, 1969, unless the employee has had at least 5 years of service after December 31, 1968. (This latter exclusion was adopted to prevent the possibility that plans would otherwise be required to incur extremely large costs for benefits to previously retired employees who would otherwise

[10] However, to avoid requiring a plan to carry relatively small amounts of benefits on its books for a long period of time, the bill permits a plan to elect to pay off the employee's vested rights in the form of a lump-sum payment when the employee is separated if the amount of the distribution is less than $1,750. In addition, at the election of the employee, a plan which so provides may make lump-sum payments of any amount to employees at the time they are separated from service in lieu of retirement benefits.

[21] have the incentive to come back to a firm for relatively short periods of time, primarily in order to obtain plan benefits for their prior service).

How much protection is actually afforded to employees under the minimum vesting provision depends not only on the minimum vesting percentages set forth in the bill but also in the case of defined benefits on the accrued benefits to which these minimum vesting percentages are applied. For this reason, your committee has devoted particular attention to the development of fair and equitable procedures for the computation of accrued benefits.

Under the first option, the accrued benefit is determined by providing that the plan may not allow employees to accrue benefits in any year of service at a rate which is more than 133⅓ percent of the rate of accrual in any other year.[11] The primary purpose of this provision is to prevent attempts to defeat the objectives of the minimum vesting provisions by providing undue "backloading", i.e., by providing inordinately low rates of accrual in the employee's early years of service when he is most likely to leave the firm and by concentrating the accrual of benefits in the employee's later years of service when he is most likely to remain with the firm until retirement. Of course, a plan under which employees accrue benefits at a uniform rate would satisfy the requirements of this option. The 133⅓ percent rule also is obviously not intended to place a limit on the amount of benefit increases for future service that may be provided under plan amendments. Moreover, this rule is not to apply to the accrual rate of any plan year after the participant is eligible to retire with benefits which are not actuarially reduced on account of age or service.

Under a second option, a defined benefit plan may provide for an annual rate of accrual which is not less than 3 percent of the maximum benefit to which the participant would be entitled if he became a participant at the earliest possible entry age under the plan and served continuously until the earlier of age 65 or the retirement age specified under the plan. This treatment provides equal amounts of accrued benefits to employees who are separated prior to retirement age after having worked the same number of years, regardless of their respective ages at the time the service was performed.

Under present law, highly mobile employees such as engineers, frequently do not derive benefits from pension plans even when such plans have liberal vesting provisions because they tend to change jobs before they acquire vested rights in any particular plan. The bill approved by your committee will help such employees to secure actual benefits from pension plans. It provides that where an employer sets up different pension plans for different groups of employees the rate of vesting granted under the different plans need not be the same so long as the combined effect of all the plans is nondiscriminatory. This permits an employer to cover his highly mobile employees in a separate plan which provides faster vesting but lower benefits at normal retirement age than the other plans that he establishes for his other employees.

[11] However, it is permissible for a plan to provide an accrual rate for any year before the 11th year of service which exceeds 133⅓ percent of the accrual rate after the 10th year of service.

[22] In addition, the committee bill instructs the Secretary of Labor to conduct a full and complete study of the steps necessary to ensure that professional, scientific and technical personnel and others working in associated occupations employed under federal procurement, construction or research contracts or grants will, to the extent feasible, be protected against the forfeitures of pension or retirement rights as consequence of job transfers or loss of employment resulting from terminations or modifications of Federal contract grants or procurement policies. The Secretary of Labor is further instructed to report the results of his study to the Congress within two years after the date of enactment of the Act. Also, if he determines it to be feasible, the Secretary is to develop regulations within one year after the date on which he submits his report to the Congress, which will provide for the better protection of the vesting rights of the employees concerned. These regulations are to take effect unless either house of the Congress adopts a resolution disapproving the regulations within 90 days after they are submitted to the Congress.

Under certain circumstances, a plan's vesting rules may cause the prohibited discrimination. Questions have arisen as to whether a plan which satisfies the vesting requirements provided by your committee automatically satisfies the vesting requirements of the nondiscrimination rules. To remove any possible ambiguity on this subject, the committee bill specifically provides that a plan which satisfies the minimum vesting requirements provided by this legislation is to be treated as satisfying any requirements regarding the vesting schedule and the rate at which benefits accrue, resulting from the application of the Internal Revenue Code requirements regarding nondiscrimination, unless (a) there has been a pattern of abuse under the plan (such as a firing of employees before their accrued benefits vest), or (b) there have been, or there is reason to believe there will be an accrual of benefits or forfeitures tending to discribinate in favor of employees who are officers, shareholders, or highly compensated.

Table 3 shows that the additional costs of financing plans involved when the minimum vesting requirement adopted by your committee becomes fully effective is expected to be moderate. These cost estimates are necessarily based on assumptions as to turnover rates, age distribution, etc. However, the range of costs is believed to be broadly indicative of the expected experience of employers generally.

TABLE 3.—ESTIMATED RANGE OF INCREASE IN PENSION PLAN COSTS UNDER THE REQUIREMENTS FOR MINIMUM VESTING ADOPTED BY THE COMMITTEE

	Present vesting—			
	None	Moderate [1]	Liberal [2]	All plans
Percentage of pension plan members covered under such plans	23	56	21	100
Range of present plan cost as a percent of payroll	1.8–11.2	2.2–12.5	2.2–12.7	1.8–12.7
Range of increase in cost under committee vesting requirement:				
As a percent of payroll	.2–1.5	.1–.2	0	0–1.5
As a percent of present plan cost	5–58	1–8	0	0–58

[1] Plan provides some vesting, but less liberal than full vesting after 10 years of service.
[2] Plan provides full vesting after 10 years service or less, with no age requirement.

Source: "Estimates prepared for the Joint Commtitee on Internal Revenue Taxation," by Donald S. Grubbs, Jr.

[23] The additional costs will, of course, be zero or smallest for those plans which now have liberal vesting provisions and greatest for those plans which now provide no vesting prior to retirement. This reflects the fact that the minimum vesting provisions will generally bring the costs of the latter plans up to the level of those plans which now have liberal vesting provisions. Overall, for all plans, the cost increases resulting from the new minimum vesting requirements will range from 0 to 1.5 percent of payroll.

In the case of plans adopted after January 1, 1974—which will have been adopted with knowledge of the new requirement—the effective date is the first plan year beginning after the date of enactment. However, for plans in existence on January 1, 1974, to provide time to adjust to the new minimum vesting requirements, the effective date of the minimum vesting standards is plan years beginning after December 31, 1975. For plans, which are maintained pursuant to collective bargaining agreements, however, the minimum vesting requirements take effect for plan years beginning after the expiration of the latest agreement or December 31, 1980, whichever is earlier (but in no event before January 1, 1977).

In addition, for all plans in existence on December 31, 1973, the vesting provisions are to become effective gradually over a 5-year transition period. Under this rule, 50 percent of the vested rights generally called for under the legislation are to become effective in the first year in which the vesting requirement applies. Thereafter the required vesting is to increase 10 percentage points each year until reaching 100 percent of the vested rights generally required under the legislation after the fifth year.

Finally, the Secretary of Labor is authorized to provide variances from the generally applicable minimum vesting requirements for multi-employer plans whenever he finds that the application of these requirements would (1) increase the cost of the parties to the plan to such an extent that there would be (a) a substantial risk to the voluntary continuation of the plan, or (b) a substantial curtailment of pension levels or the levels of employees' compensation, or (2) impose unreasonable administrative burdens regarding the operation of the plan, and (3) where the application of these requirements would be adverse to the interest of plan participants generally. Under such variances, the Secretary of Labor would prescribe alternative methods by which the multi-employer plan concerned could satisfy the minimum vesting requirements for the period of time this is necessary. These variances from the vesting requirements are not, however, to be prescribed unless all plan participants and other interested persons have received adequate notice from the plan administrator of any hearing to be held to consider the variance.

Minimum funding standards.—Your committee believes that it is essential for plans to be adequately funded in accordance with a contributions schedule which will produce sufficient funds to meet the obligations of the plan when they fall due. Such an adequate contributions schedule for funding plans not only protects the rights of employees under the plan but also provides an orderly and systematic way for employers to pay their plan costs.

You committee believes that the minimum funding requirements under present law are inadequate because they do not require any pro-

[24] vision to be made to amortize unfunded past service liabilities. Instead they merely require the contributions to the plan to be sufficient to pay normal costs (the costs attributable to the current operation of the plan) and to prevent an increase in unfunded liabilities. To remedy this, your committee has provided new minimum funding standards for qualified plans. In the most typical case, the standard requires contributions to the plan to be sufficient not only to pay normal costs but also to amortize all unfunded past service liabilities in level payments over specified periods of time. A second standard requires contributions to be based on the accrued unfunded vested liabilities of the plan if this results in higher annual payments than the general funding standard. It is anticipated that this second standard will be used for only a small minority of the plans which have relatively large unfunded vested liabilities.

The new funding standards do not apply to the following types of qualified plans:

(1) Profit-sharing and stock bonus plans. (There is no need for a requirement that contributions be sufficient to fund a specified level of benefits in the case of these plans since they do not specify that participants are to receive any designated amount of benefits, but instead require the paying out of whatever benefits the funds in the plan will purchase on the date the benefits are to begin.)

(2) Plans funded exclusively through the purchase of individual insurance contracts which provide for level annual premium payments. (These plans are excluded from the funding requirements because they have behind them the funding of the insurance companies involved.)

(3) Government plans. (However, government plans are still required to meet the present funding standards which require contributions to be sufficient to pay normal pension costs plus the interest on past service liabilities. Also, as noted previously, your committee has provided for a study of government plans to determine the need for supplying funding standards.)

(4) Church plans unless these plans elect to be covered by such requirements, and

(5) Plans which after the date of enactment of the legislation do not provide for employer contributions.

In the most typical case where the first general funding standard is employed, employers maintaining single-employer plans not in existence on the effective date of the legislation must pay normal costs currently and amortize their past service liabilities in level payments over no more than 30 years. A similar amortization period of no more than 30 years is required for past service liabilities arising as a result of single-employer plan amendments after the effective date. However, in recognition of the fact that large numbers of plans assumed heavy past service liabilities prior to any requirement to amortize such liabilities, plans in existence on the effective date of the legislation are allowed a longer period—up to 40 years—to amortize past service liabilities existing at the beginning of the first plan year to which the requirement applies. In addition, multi-employer plans are allowed to amortize all past service liabilities, including those created after the effective date of the legislation, over a period of up to

[25] 40 years. This recognizes that multi-employer plans generally have an added element of financial strength in that their contributions come from a number of employers who as a group are less likely than comparable single employers to experience business difficulties.

This funding standard, which will apply to the overwhelming majority of plans, is comprehensive since it requires amortization of all accrued past service liabilities (i.e., both vested and nonvested unfunded past service liabilities).

The level payment method of funding adopted by your committee is analogous to the payment of a home mortgage in that each specified payment includes a payment for both interest and principal. It has the advantage of spreading the payments out evenly over the payment period which generally makes it easier for the employer to plan for meeting the payments. Another factor in your committee's decision is that the level payment method, while providing for adequate amortization of past service costs, initially adds only relatively moderate amounts to an employer's existing funding costs. This is because interest on unfunded accrued past service costs, which accounts for the bulk of the payments under the level payment method in the early years, is already required to be contributed to a defined benefit plan under present law.

Provision is also made for the equitable funding of experience deficiencies which arise when the actual plan costs turn out to be greater than were previously estimated on the basis of the actuarial assumptions—for example, when the value of the plan assets is less than was expected. In establishing a minimum funding standard for such experience deficiencies, the committee sought to avoid two problems. If it allowed the experience deficiencies to be funded over a very long period of time, an incentive would be provided for the use of actuarial assumptions which understate the costs since any resulting deficiencies could then be made up over a long period of time without penalty. On the other hand, if the experience deficiencies were required to be amortized over too short a period, employers would encounter hardship in meeting the annual payments. This is especially pertinent in view of the fact that most actuarial or experience deficiencies are inadvertent.

Your committee's bill seeks to avoid both these problems by allowing experience deficiencies to be funded in level amounts over a period of up to 15 years for single employer plans and up to 20 years for multiemployer plans. Symmetrical treatment is provided for experience gains which are attributable to a favorable variation between actual experience and the actuarial assumptions entering into the determination of the employer's cost and contributions.

The determination of experience gains and losses for this purpose will generally be made every three years except where the Secretary or his delegate (pursuant to regulations) finds it necessary to require the determination to be made more frequently.

Relief measures are provided to mitigate the impact of the funding requirements in cases where it would otherwise result in hardship. The bill gives the Internal Revenue Service the authority to waive the minimum funding requirement in cases where the application of this requirement would involve substantial business hardship to the employer and would be adverse to the interests of plan participants in the aggregate.

[26] However, the waived contribution must be made up in level payments over a maximum of 15 years. To avoid the indefinite postponement of the fulfillment of the funding standards, the committee bill further provides that not more than five such waivers may be made in any 15-year period.

The committee also recognizes that multi-employer plans which are negotiated as a result of collective bargaining agreements may involve different considerations in regard to funding than individual employer plans. While it is the objective of the committee's bill to require adequate funding for multi-employer plans as well as for individual employer plans, the committee is aware that a number of multi-employer plans are not as well funded as they might be at the present time and that the application of the new funding standards to such plans without an adequate transition period might cause hardship and be detrimental to the interests of the employees covered by such plans. For this reason, if 10 percent or more of the number of employers contributing to a multi-employer plan demonstrate to the satisfaction of the Secretary of Labor that they would experience substantial business hardships if they were required to amortize past service liabilities and experience deficiencies over the periods of time specified by the bill (40 years and 20 years, respectively), and if this requirement would be adverse to the interests of plan participants in the aggregate, then upon certification by the Secretary of Labor to the Secretary of the Treasury, these plans are to be allowed an additional 10 years to amortize such costs.

In addition, the Secretary of Labor is authorized to provide variances from the minimum funding requirements for multi-employer plans where he finds that the application of these requirements would increase costs to the extent that there would be a substantial risk to the voluntary continuation of the plan, impose unreasonable administrative burdens in regard to the operation of the plan and be adverse to the interests of plan participants in the aggregate.[12]

Your committee believes that the generally applicable funding standard, which requires past service liabilities to be amortized in level payments over a specified number of years, will generally provide an equitable and adequate approach to funding the vast majority of plans. However, in some cases where plans have very substantial vested liabilities and relatively small asset values, it appears desirable to require the unfunded vested liabilities to be amortized more rapidly than under the generally applicable funding standard. For this reason, your committee has provided a second funding standard, based on accrued unfunded vested liabilities. This standard is to apply in lieu of the generally applicable funding standard if it results in a higher annual contribution. Under this standard, the accrued vested liabilities of the plan and the value of its assets are determined. Where the former exceeds the latter, the contribution for that year must be sufficient to cover the first year's payment under a level annual payment schedule required to amortize the difference in 20 years. A new

[12] The conditions under which such variances from the funding requirements may be granted are identical to those applying to variances from the minimum vesting requirements described above.

[27] determination with respect to the applicability of this second funding standard is to be made in each of the succeeding years. It is contemplated that this funding standard will be required for only a small minority of qualified plans.

In general, for purposes of funding, the value of the plan's assets is to be determined on the basis of any reasonable actuarial method of valuation which takes fair market value into account under regulations prescribed by the Secretary of the Treasury or his delegate. However, to permit fixed obligations, which frequently are held until maturity, to be given stable values for funding purposes, the plan administrator is given the option of determining the value of a bond or other evidence of indebtedness (which is not in default as to principal or interest) on an amortized basis.

Your committee is aware that the actuarial assumptions made by actuaries in estimating future pension costs are crucial to the application of minimum funding standards for pension plans. This is because in estimating such pension costs, actuaries must necessarily make actuarial assumptions about a number of future events, such as the rate of return on investments (interest), employee future earnings, and employee mortality and turnover. In addition, actuaries must also choose from a number of funding methods to calculate future plan liabilities. As a result, the amount required to fund any given pension plan can vary significantly according to the mix of these actuarial assumptions and methods.

Conceivably an attempt might be made to secure uniform application of the minimum funding standards by authorizing the Secretary of the Treasury or some other authority to establish the specific actuarial assumptions and methods that could be used by pension plans. This would involve, for example, setting a specific rate of interest that could be used by certain pension plans or by specifying certain turnover rates for specified types of firms. However, the committee does not believe that this would be an appropriate procedure, since the proper actuarial assumptions may differ substantially between industries, among firms, geographically, and over time. Further, in estimating plan costs each actuarial assumption may be reasonable over a significant range and it would appear that the proper test would be whether all actuarial assumptions used together are reasonable. These considerations strongly indicate that any attempt to specify actuarial assumptions and funding methods for pension plans would in effect place these plans in a straitjacket so far as estimating costs is concerned, and would be likely to result in cost estimates that are not reasonable.

However, your committee's bill requires the actuarial assumptions of each plan to be certified by an actuary every three years (or more frequently if required by the Internal Revenue Service). These certifications will be reported to the Service. Moreover, in order to insure that such certification will be made by competent actuaries, the bill provides that the Secretary of the Treasury is to establish qualifications for actuaries and is to certify for practice before the Internal Revenue Service the persons who meet these standards. In the case of individuals applying for enrollment as actuaries before January 1, 1976, the standards and qualifications set forth by the Secretary shall include a requirement for an appropriate period of responsible actuarial experience or of responsible experience in the administration of pension plans. The Secretary of the Treasury is also to review the actuarial

[28] assumptions used by particular plans and an advisory board of actuaries is to be established to assist him in setting up general standards as to reasonableness of assumptions.

The bill also provides new and more effective penalties where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employees' rights, to the extent funded, under plans which do not meet these standards. This procedure, however, has proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs—namely, the employer.

This is achieved by imposing an excise tax where the employer fails to meet the funding standards, which starts out at a relatively modest level and increases sharply where there is continued failure to make the indicated contributions. More specifically, if an employer fails to contribute sufficient amounts to meet the new funding requirements, he will be subject to a nondeductible excise tax of 5 percent per year on the amount of the underfunding for any year. If the employer fails to make up the underfunding by 90 days after original notification by the Internal Revenue Service (but with the Service in a position to grant extensions of time), then the employer is subject to a second level excise tax amounting to 100 percent of the underfunding. This determination by the Service is appealable to the Tax Court and no assessment may be made until after the end of the litigation. Since the employer remains liable for the contributions necessary to meet the funding standards even after the payment of the excise taxes, it is anticipated that few, if any, employers will willfully violate these standards.

For plans adopted after January 1, 1974, which will have been adopted with knowledge of the new requirement, the effective date of the new funding requirements is the first plan year beginning after the date of enactment. For plans in existence on January 1, 1974, which are not maintained pursuant to collective bargaining agreements, the effective date of the minimum funding standards is deferred to plan years beginning after December 31, 1975. And for plans which are maintained pursuant to collective bargaining agreements, the minimum funding requirements take effect for plan years beginning after the expiration of the latest agreement (if this is after December 31, 1975) or after December 31, 1980, whichever is earlier.
after the later of (1) the expiration date of the last of the present collective bargaining agreements (but not later than December 31, 1980) or (2) December 31, 1976.

Other provisions to protect covered employees and their beneficiaries.—In addition to the minimum participation, vesting and funding standards provided in the bill, your committee has adopted a number of specific provisions to protect the rights of employees and beneficiaries under qualified plans.

Qualified plans that provide annuities must pay benefits in the form of a joint and survivor annuity, giving the surviving spouse an annuity equal to at least 50 percent of the annuity paid during the joint lives, unless the participant elects in writing before the annuity starting date not to take a joint and survivor annuity.

Qualified plans must provide that retirement benefits may not be assigned or alienated, except for voluntary and revocable assignments of not more than 10 percent of the benefits.

[29] Provision is made to prevent mergers or consolidation of plans from reducing the rights of participants. This is achieved by specifying that immediately after the merger each participant would be entitled to receive a benefit equal to or greater than the benefit he would have been entitled to receive immediately before the merger had the plan been terminated.

Protection is given to retired individuals and individuals who are separated from the service of the employer against reductions in private plan benefits when social security benefit levels increase. In general, under present integration procedures, social security benefits attributable to employer contributions are treated as though they were part of the private plan. As a result when the level of social security benefits increases, some integrated plans have reduced the amount of the retirement benefits that they provide for covered employees.

Present law under administrative practice provides that qualified plans may not use increases in social security benefit levels to reduce the benefits that they pay where the employees concerned are retired and are already receiving integrated plan benefits. The bill codifies this treatment for retired persons. It also extends the prohibition against reducing plan benefits where social security benefit levels are increased to cases where the individuals concerned are separated from service prior to retirement and have deferred nonforfeitable rights to plan benefits. This provision is effective for increases in social security benefits which take place after the date of enactment or on the date of the first receipt of plan benefits or the date of separation from service (whichever is applicable) if that date is later.

These changes do not affect the ability of plans to use the integration procedures to reduce the benefits that they pay to individuals who are currently covered when social security benefits are liberalized. Your committee, however, believes that such practices raise important issues. On the one hand, the objective of the Congress in increasing social security benefits might be considered to be frustrated to the extent that individuals with low and moderate incomes have their private retirement benefits reduced as a result of the integration procedures. On the other hand, your committee is very much aware that many present plans are fully or partly integrated and that elimination of the integration procedures could substantially increase the cost of financing private plans. Employees, as a whole, might be injured rather than aided if such cost increases resulted in slowing down the rate of growth of private retirement plans.

In view of the serious issues involved in the integration of private plans with the social security system, your committee believes that it is desirable to postpone action on this issue pending further study of this problem. More specifically, your committee plans to consider this overall problem again at the earliest opportunity, possibly in connection with future tax reform or social security legislation. However, your committee believes that no further integration of social security and pension benefits should be allowed under any further regulations issued by the Secretary or his delegate at least until June 30, 1975.

Portability.—In view of the fact that ours is a highly mobile economy, characterized by high employee turnover rates, various proposals have been made to establish a system for the portability of vested rights to benefits from one plan to another when an employee changes jobs.

[30] While the complete portability of vested rights to benefits from one pension fund to another is hard to achieve because of the numerous basic differences in private pension plans, your committee's bill contains a number of provisions which will achieve much of the advantage of portability. Under present law, when an employee changes jobs, it is already possible for funds representing his vested rights to benefits under his old employer's plan to be transferred to the retirement plan of his new employer without payment of tax on an optional basis—that is, if the employee and the administrators of the plans involved agree to the transfer. Your committee's bill adds another way in which individuals can transfer their retirement funds on a tax-free basis to a tax-exempt retirement account. It allows them to establish a new type of account called a "rollover account." Under the new arrangement, individuals will have the right to roll over into individual retirement accounts, without payment of current tax, complete distributions of funds financed by employers under qualified plans, H.R. 10 plans, as well as funds from individual retirement accounts, provided that the transfer into the new account is made within 60 days of the withdrawals of the funds from the old plans.

Provision also is made to supply adequate information to plan participants regarding their vested rights to retirement benefits so that they will not neglect to claim these benefits when they become eligible to receive them. In this connection, plan administrators are required to furnish each separated employee who has vested rights an individual statement showing the nature, amount and form of the deferred vested benefit to which he is entitled.

Also, in order to insure that employees will be fully alerted to their retirement benefits, the Social Security Administration will keep records regarding the vested rights of separated employees under single employer plans. Annual information pertaining to such vested rights will be forwarded by plan administrators to the Social Security Administration through the Internal Revenue Service. The Social Security Administration will then furnish this information regarding vested rights to individuals both on request and at the same time that official information is supplied to the employee or his beneficiary regarding social security benefits.

Because the furnishing of such information involves considerably more difficulties for multi-employer plans than for single-employer plans, the bill does not require multi-employer plans to supply individual statements regarding vested rights to separated employees; nor does it require multi-employer plans to file information showing the vested rights of separated employees. However, the Secretary of the Treasury after consultation with the Secretary of Health, Education and Welfare, may prescribe regulations requiring multi-employer plans to submit such information, to the extent it is found feasible.

Plan termination insurance.—Although your committee regards the development of an adequate program of plan termination insurance as essential to protect the rights of covered employees, the bill makes no provision for such plan termination insurance. This is because provision for plan termination insurance is made in H.R. 12906, to be reported by the Committee on Education and Labor.

[31] *Fiduciary requirements.*—Your committee's bill makes no change in the rules relating to fiduciaries of qualified retirement plans. As with plan termination insurance, this is not because your committee regards this matter as unimportant but rather because H.R. 12906, to be reported by the House Committee on Education and Labor, contains provisions providing for additional rules regarding fiduciary requirements.

Enforcement.—Your committee's bill relies heavily on the tax laws in order to secure compliance with the new requirements that it imposes on pension plans. Plans, for example, are required to comply with the new coverage, vesting, and funding standards in order to qualify for favored tax treatment under the Internal Revenue Code. In addition, excise taxes are imposed for failure to meet the funding standards. As a result, these substantive pension provisions would be administered by the Internal Revenue Service.

Your committee believes that primary reliance on the tax laws represents the best means for enforcing the new improved standards imposed by the bill. Historically, the substantive requirements regarding nondiscrimination, which are designed to insure that pension plans will benefit the rank and file of employees, have been enforced through the tax laws and administered by the Internal Revenue Service. As a result, the Internal Revenue Service is already required to examine the coverage of the retirement plans and their contributions and enefits as well as funding and vesting practices in order to determine that the plans operate so as to conform to these nondiscrimination requirements. Also, the Internal Revenue Service has administered the fiduciary standards embodied in the prohibited transactions provisions since 1954.

Your committee believes that the Internal Revenue Service has generally done an efficient job in administering the pension provisions of the Internal Revenue Code. The very extensive experience that the Service has acquired in its many years of dealing with these related pension matters will undoubtedly be of great assistance to it in administering the new requirements imposed by the committee bill.

However, because the bill increases the administrative job of the Service in this respect, your committee believes that it is desirable to add to its administrative capability for handling pension matters. For this reason, the committee bill provides for the establishment by the Internal Revenue Service of a separate office headed by an Assistant Commissioner of Internal Revenue to deal primarily with pension plans and other organizations exempt under section 501(a) of the Internal Revenue Code, including religious, charitable, and educational organizations. In order to fund this new office, the bill authorizes appropriations at the rate of $70 million per year for such administrative activities. It is intended that the Internal Revenue Service obtain from all appropriate pension administration sources annual statistical data to indicate the operations of the private retirement system for the purpose of evaluations and public information.

In addition to providing additional opportunities for redress in case of disagreement with the decisions of the Internal Revenue Service on pension matters, both employees and employers will be allowed to appeal determination letters issued by the Internal Revenue Service to the Tax Court after exhausting their remedies under the Internal Revenue Service administrative procedures.

[32] *Equalizing tax treatment: in general.*—Another objective of the committee bill is to provide more rational and equitable tax treatment under retirement plans.

The committee believes that there is need on equity grounds to grant individuals who are not covered by any kind of qualified pension plan some of the tax advantages associated with such plans by providing them with a limited tax deduction for their retirement savings.

In addition, there is no justification for the present widely disparate treatment which places no specific limitation on the amount of deductible retirement plan contributions for corporate employees and at the same time limits the deductible contributions to pension plans on behalf of the self-employed to a maximum of 10 percent of earned income or $2,500 a year.

This unjustifiable difference in treatment has resulted in unduly large tax advantages for certain corporate employees; it also discriminates against the self-employed and has had the undesirable result of encouraging large numbers of self-employed people to incorporate merely to secure the larger tax advantages available with respect to corporate retirement plans. This includes large numbers of professional people who are now permitted by all 50 States and the District of Columbia to incorporate.

In view of these considerations, the committee has provided the following three changes which should be regarded as one package in the sense that the adoption of all three changes are needed at the same time in order to improve the tax laws in regard to pension plans.

Equalizing tax treatment; individual retirement plans.—Your committee's bill allows individuals who are not receiving the advantages of current coverage under qualified retirement plans to take deductions for annual contributions to a new type of individual retirement plan, up to 20 percent of earned income or $1,500, whichever is less.

These retirement plans will be available to all employees who are not active participants in a qualified retirement plan, in a governmental pension plan or in an annuity plan established by a tax-exempt or public educational institution under section 403(b) of the Internal Revenue Code.[13] Self-employed individuals who are not covered by qualified retirement plans (H.R. 10 plans) are also eligible to establish individual retirement plans for themselves.

The employer of any individual who establishes a personal retirement plan will be allowed to make tax deductible contributions to that individual retirement account on behalf of the employee which will not be currently taxable to the employee so long as the sum of the employee's own deductible contribution and the employer's contribution do not exceed the allowable 20 percent of compensation—$1,500 annual limit. Unions may also establish individual retirement accounts for their members.

In order to encourage the widespread use of such individual retirement plans, your committee has provided that the contributions to such plans can be invested in a wide range of investments, including special government retirement bonds which would be issued for

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[13] Such section 403(b) annuities confer most of the tax advantages associated with qualified pension plans.

[33] this purpose, annuity contracts sold by insurance companies, mutual funds, corporate securities, banks and credit unions.

The earnings on the amounts put aside in the individual retirement accounts are to remain free of tax until they are distributed. Distributions from the individual retirement savings plans are to be taxable when received by the employee, generally upon retirement or upon death or disability. However, since the individuals' incomes will generally be relatively low when they receive such distributions, the latter will ordinarily be taxed at relatively low rates. Individuals will also enjoy tax savings from being able to defer payment of tax on the earnings of the retirement funds during the time they are retained in the tax-free plans.

Since the objective of the new provision is to encourage adequate provision for retirement needs, withdrawal of the retirement savings prior to age 59½ will result in a penalty tax equal to 10 percent of the amount of the premature distribution. However, early withdrawals are permitted without penalty where the taxpayer becomes disabled. In addition, to prevent the individual retirement savings plans from being used to postpone tax indefinitely, the retirement savings must either be distributed by the time the individual reaches age 70½ or distributed over the lives or life expectancy of the individual and his spouse beginning no later than age 70½.

Your committee anticipates that by encouraging employers to make modest contributions initially for the retirement needs of their employees, such individual retirement plans will lead eventually to the establishment of a significant number of new qualified retirement plans by employers. An employer who believes he cannot afford the entire cost of a retirement plan can start by contributing small amounts for employee individual retirement accounts, can increase his contributions over the years (providing it does not exceed the 20 percent-$1,500 annual limits per participant), and then can subsequently convert to an employer-financed qualified plan. The provisions allowing individuals to deduct contributions within the specified limits to individual retirement plans generally take effect for taxable years beginning after December 31, 1973.

Equalizing tax treatment; increasing deductions for H.R. 10 plans.—Your committee's bill grants self-employed people tax treatment with respect to retirement plans (H.R. 10 plans) which is more nearly comparable to that now accorded to corporate employees under qualified retirement plans. This is achieved by increasing the maximum deductible contributions a self-employed individual is allowed to make on his own behalf to a qualified plan from the present level of 10 percent of earned income up to $2,500 a year to 15 percent of earned income up to $7,500 a year. For H.R. 10 plans which are of the defined benefit type, provision is made for applying comparable limitations on the benefits that may be paid to self-employed individuals under regulations to be prescribed by the Secretary of the Treasury or his delegate.

In keeping with the major objective of securing more uniform tax treatment of self-employed people and corporate individuals under qualified retirement plans, contributions or benefits for self-employed people under qualified plans are also made subject to the same overall limitations that are placed on contributions or benefits for regular employees under qualified plans.

[34] Your committee has also made provision to allow self-employed individuals, whose earned income fluctuates sharply, declining to low levels in some years, to continue to set aside a specified minimum amount regularly for retirement under an H.R. 10 plan. This is achieved by permitting a self-employed individual to deduct contributions to such plans amounting to $750 or 100 percent of their earned income, whichever is less, even though these amounts are in excess of the regular deduction limits.

The new more liberal limitations on contributions or benefits for self-employed people under qualified plans are also to apply to shareholder employees of subchapter S corporations (small business corporations) who are generally subject to the same limitations as self-employed people under qualified plans. This means, for example, that contributions of up to the lesser of 15 percent of earned income or $7,500 a year may be made under qualified defined contribution plans on behalf of such shareholder employees without giving rise to current tax for them.

In addition, provision is made to insure that self-employed individuals who wish to utilize the full maximum tax allowance for their own contributions will also provide significant pension contributions for their regular employees who are covered by the pension plan. This is achieved by allowing self-employed people to count no more than $100,000 of their earned income in computing pension contributions or benefits for themselves. This prevents a self-employed individual with an extremely large income from achieving the $7,500 maximum annual deduction for his own pension contribution through the use of a low contribution rate which would be detrimental to his employees since the pension contributions on their behalf are computed using the same contribution rate. For example, a self-employed individual who counts his first $100,000 of earned income for this purpose, must contribute to the plan at least 7.5 percent of the wages of his covered employees in order to be permitted a deductible contribution of $7,500 on his own behalf.

Finally, your committee adopted provisions to improve the effectiveness of H.R. 10 plans in achieving their retirement objectives and preventing abuses in the operation of such plans. Present law disqualifies the plan if willful contributions in excess of the allowable limits are made on behalf of owner-employees since such excess contributions unduly build up their tax-free accumulations in the plan. Experience has shown that this is not an adequate remedy since disqualification of the plan for excess contributions on behalf of owner-employees penalizes the regular employees who are not in any way responsible for the excess contributions. For this reason, instead of disqualifying the plan, where excess contributions are made on behalf of the self-employed individuals, the bill adopts a new more effective penalty, namely, a tax on the employer, amounting to 6 percent a year on the amount of the excess contribution. In addition, to discourage premature withdrawal of the H.R. 10 funds by owner-employees prior to retirement age, withdrawals before such individuals attain the age of 59½ (except in case of disability) are subject to an additional tax amounting to 10 percent of such premature contributions.

The new more liberal limits in regard to contributions on behalf of self-employed people under H.R. 10 plans are effective for taxable

[35] years beginning after December 31, 1973. However, the new limits on benefits under defined H.R. 10 benefit plans (which are designed to secure comparability with the limitations applying to H.R. 10 plans of the defined contribution type) the 6-percent tax on excess contributions for self-employed individuals and the 10-percent tax on premature withdrawals by owner-employees are effective for taxable years beginning after December 31, 1975.

Overall limitations on contributions and benefits for employees under plans.—In view of the vital role that the favorable tax treatment accorded under the Internal Revenue Code plays in stimulating the growth and development of nondiscriminatory retirement plans, your committee believes that it is essential to continue this treatment. In fact, as noted above, the bill adopted by your committee extends the favorable tax treatment more generally by increasing the allowable deductible contributions of self-employed people under H.R. 10 plans and by providing for the establishment of limited retirement savings plans for individuals who are not covered by qualified retirement plans

However, after careful consideration, your committee has concluded that it is not in the public interest to make the substantial favored tax treatment associated with qualified retirement plans available without any specific limitation as to the size of the contributions or the amount of benefits that can be provided under such plans. The fact that present law does not provide such specific limitations has made it possible for extremely large contributions and benefits to be made under qualified plans for some highly paid individuals. While there is, of course, no objection to large retirement benefits in themselves, your committee believes it is not appropriate to finance extremely large benefits in part at public expense through the use of the special tax treatment. Moreover, the fact that there are no specific limits on the size of the contributions or benefits that may be made under qualified plans on behalf of highly paid employees discriminates against the self-employed whose contributions or benefits under H.R. 10 plans are limited by law. For this reason, your committee has provided specific limitations on the amount of contributions and benefits that can be provided for any one individual under a qualified plan. These limitations, which apply to both employees and self-employed people under qualified plans, have been designed to avoid abuse of the favored tax treatment to finance extremely large pensions. However, the limitations are generous enough to permit substantial retirement benefits which are adequate judged from any reasonable standard.

Under defined contribution plans (money-purchase pension plans and profit-sharing plans), the sum of the employer's contributions for the employee, a specified portion of the employee's own contributions, and any forfeitures allocated to the employee cannot exceed 25 percent of the employee's compensation or $25,000, whichever is less. These limits would also apply to contributions made to qualified plans of exempt organizations under section 403(b).

Your committee decided to take employee contributions to qualified plans into account for purposes of this contribution limit because the employee gets a tax advantage from the fact that the earnings on his contributions remain free of tax so long as they are kept in the plan, thus permitting a tax-free buildup of funds. However, unlike employer contributions under qualified plans, employee contributions are made

[36] out of taxed income. For this reason, for purposes of counting employee contributions for purposes of the 25 percent and $25,000 annual limits on contributions on behalf of any employee under a defined contribution plan, there is to be excluded the greater of (a) employee contributions amounting to 6 percent of compensation or (b) one-half of the employee's contributions.

For plans which provide defined benefits, your committee has phrased the limit in terms of the amount of annual benefits that may be paid to a participant. More specifically, the annual benefit paid under such plans cannot exceed 100 percent of the participant's average compensation for his highest 3 years of earnings (regardless of the age at which the benefits start) or $75,000 beginning at age 55 or later, whichever is less. Where the annual benefit starts before age 55, the $75,000 annual limit on benefits is adjusted downward actuarially. However, avoid any possible adverse effect on individuals with relatively modest retirement benefits, this benefit limitation is not to apply to retirement benefits which do not exceed $10,000 for the plan year or for any prior plan year. This exception from the benefit limitation is available only where the employer has not at any time maintained a defined contribution plan in which the participant was covered.

While any specific dollar limit on the amount of benefits under qualified plans is necessarily a matter of judgment, your committee believes that the annual limitation of $75,000 at age 55 or later achieves a reasonable balance in view of the considerations involved. Benefits starting at any age are allowed to amount to as much as 100 percent of average pay during the high 3 years of earnings after study disclosed that any lower percentage limit would adversely affect individuals with relatively modest earnings who are covered under generous plans. Your committee believes that it would be unwise to discourage liberal benefits for such individuals.

As noted above, the $75,000 annual limit is applied to a benefit financed by the employer which is payable in the form of a straight life annuity beginning at age 55. Correspondingly, higher benefits may be paid to the extent that they are financed by employee contributions. No actuarial adjustment is required to be made in the maximum annual limit on benefits under defined benefit plans where ancillary benefits which are not related to retirement are provided. For example, no downward actuarial adjustment in the limit is to be required for disability benefits before normal retirement age. In addition, no downward adjustment is to be made for a normal joint and survivor feature.

Moreover, to prevent abuse, the full maximum benefit may be paid only to individuals who have 10 years or more of service. Where an individual has served for less than 10 years, the maximum permissible benefit is reduced proportionately.

The contribution and benefit limits are applied in a way which prevents any individual from securing higher limits for himself merely because he is covered by several retirement plans financed by the same employer. For purposes of applying these limits, all defined contribution plans established by an employer are combined and treated as one defined contribution plan, and all defined benefit plans established by an employer are combined and treated as one defined benefit plan.

[37] Also, if an individual is covered by both a defined contribution plan and a defined benefit plan established by his employer, then an overall limit is applied to coordinate the two limits discussed above. In this case, the sum of (1) the percentage utilization of the maximum limit under the defined benefit plan and (2) the percentage utilization of the maximum limit under the defined contribution plan cannot exceed 140 percent. For example, if, under the defined benefit plan, the employee is to receive a pension of $75,000 a year (using up 100 percent of the defined benefits limit), then the maximum additions to his defined contributions plan may not exceed 40 percent of what would otherwise be his defined contributions limit. Put another way, this overall limit, if both types of plans are used equally, may be satisfied by using up 70 percent of the limits applicable to each type of plan.

Because of the vital importance of maintaining the real value of retirement benefits, the bill instructs the Secretary or his delegate, through regulations, to make annual adjustments in the allowable limits to take account of increases in the cost of living. This includes adjustments in the $75,000 annual limit to benefits paid by defined benefit plans, the $25,000 limit to contributions under defined contribution plans and, in the case of a participant who was separated from service with the firm, the amount of his average earnings in his highest compensated 3 consecutive years of service.

Your committee has provided adequate time for adjustment to the new limits on benefits and contributions under retirement plans. In general, these limits apply to contributions made or benefits accrued in years beginning after December 31, 1975. However, to ease the transition to the new rules, an active participant in a defined benefit plan on October 2, 1973, will be permitted to receive an annual benefit, based on his annual rate of compensation on that date and the plan provisions in effect on that date, which exceeds $75,000 a year, provided the benefit does not exceed 100 percent of his annual compensation on October 2, 1973. Where this "grandfather" treatment is utilized, the cost-of-living adjustments in the limits, described above, are not available.

Finally, because the objective of the limits on contributions and benefits is to keep the tax advantages associated with qualified plans within reasonable bounds and not to restrict the amount of retirement benefits that may be paid to individuals under other arrangements, the bill specifically indicates that nothing in the provisions relating to such limits (or in the provisions of the bill which relate to minimum funding standards) is to be construed to require the disqualification of any plan solely because additional benefits are provided to the employee under nonqualified portions of the plans.

Lump-sum distributions under qualified plans.—Prior to the Tax Reform Act of 1969, lump-sum distributions made by qualified pension plans were generally taxed as long-term capital gains. Such capital gains treatment, however, had the disadvantage of allowing employees to receive substantial amounts of deferred compensation in the form of lump-sum pension distributions at more favorable tax rates than other compensation received currently. The 1969 Tax Reform Act sought to ameliorate this problem by providing that any part of such lump-sum distributions which represented employer contributions accrued in plan years beginning after 1969 was to be taxed

[38] as ordinary income rather than as capital gains. In addition, the 1969 Act provided a special 7-year averaging procedure for the portion of the lump-sum distribution taxed as ordinary income.

However, while the 1969 provisions were intended to provide more equitable treatment for such lump-sum pension distributions, they have not achieved their purpose. The Treasury has had great difficulty in providing regulations to carry out this provision. Problems have arisen both in determining the amount of the ordinary income element of a distribution and in determining the precise amount of tax imposed on account of the "ordinary income" element. Moreover, in practice the new proposed regulations have proved to be very complex and it is frequently maintained that individuals receiving lump-sum distributions have been unable to compute their taxes and that accountants and tax lawyers have been refusing to attempt the computations.

Your committee believes that this situation cannot be permitted to continue. For this reason, it has provided a new method of taxing such lump-sum pension distributions which is relatively simple and yet at the same time equitable. Under the new provision, that portion of the distribution representing pre-1974 value receives capital gains treatment. The balance of the lump-sum distribution is to be taxed as ordinary income under a separate tax schedule (the tax schedule applicable to single people) generally without reductions, exclusions, or consideration of the taxpayer's other income. However, to insure that the tax paid by lower income individuals on their lump-sum distributions will generally not be more than under present law, a special minimum distribution allowance is provided under the separate tax rate schedule. In addition, averaging relief is provided for the portion of the lump-sum distribution which is taxed as ordinary income under the separate tax rate schedule by providing 10-year averaging for such income. This in effect provides a tax payable at the time of the distribution, but no greater in amount than the taxpayer could expect to pay were the income to be spread over his remaining life expectancy.

The new treatment of lump-sum distributions from qualified retirement plans is to apply to distributions made after December 31, 1973, in taxable years beginning after that date.

Salary reduction plans.—Under present law, employee contributions to qualified retirement plans are generally made out of taxed income without any tax allowance. However, in certain cases, employees have entered into arrangements with employers to accept salary reductions in return for contributions on their behalf to qualified retirement plans. If employer contributions to such plans are not taxed currently to the covered employees, this results in tax advantages for the covered employees as compared with making their own contributions to the retirement plan. Until the latter part of 1972, the Internal Revenue Service under administrative rulings recognized such salary reduction plans, providing that the amount of the reduction was not in excess of 6 percent of compensation and the plan met certain antidiscrimination requirements.

However, on December 6, 1972, the Internal Revenue Service issued proposed regulations (37 Fed. Reg. No. 235, p. 25938) providing that amounts contributed by an employer to a retirement plan in return for a reduction in the employee's basic or regular compensation or in

[39] lieu of an increase in such compensation are to be considered to have been contributed by the employee and consequently be taxable income to the employee.[14]

The proposed regulations dealing with salary reduction plans raise major issues of tax policy. The basic question is the extent to which employees should be allowed to convert what would otherwise be a nondeductible employee contribution to a retirement plan to tax-deferred employer contributions on their behalf. This, in turn, involves issues regarding the equitable treatment under the tax laws of employee contributions and employer contributions to qualified retirement plans.

In view of these basic issues, your committee has concluded that it would be desirable for the Internal Revenue Service to defer action on its regulations until the Congress has had further opportunity to consider this matter. For this reason, the bill directs the Secretary of the Treasury to withdraw the proposed salary reduction regulations issued on December 6, 1972. Moreover, no other salary reduction regulations may be issued in proposed form before January 1, 1975, or in final form before March 16, 1975. The bill further specifies that until new salary reduction regulations have been issued in final form, the law with regard to salary reduction plans is to be administered along the lines of the administration before January 1, 1972. Any salary reduction regulations which become final after March 15, 1975, for purposes of individual income tax, are not to take effect before January 1, 1975.

Labor unions providing pension benefits.—Your committee considered a provision recognizing the right of tax-exempt labor unions to provide pension benefits to its members from funds derived from members' contributions and the earnings on the contributions, without affecting their tax-exempt status. However, the committee concluded that labor unions are permitted to provide benefits in this manner under present law and as a result it decided such a provision is unnecessary. The Internal Revenue Service has recognized this result in a published ruling which provides "that payment by a labor organization of death, sick, accident or similar benefits to its individual members with funds contributed by its members, if made under a plan which has as its object the betterment of the conditions of the members does not preclude exemption of the organization under section 501(c)(5) of the code." [15]

III. REVENUE EFFECT

There are several kinds of revenue effects which can be expected to arise from H.R. 12855. These are summarized in table 4.

First, three provisions designed to equalize the tax treatment of pensions have an impact on tax deductions. These are the provisions raising the maximum deductible amount that the self-employed can set aside annually for their retirement; making provision for employee

[14] This ruling did not affect annuities provided employees of tax-exempt charitable, educational and religious organizations and employees of public educational institutions under section 403(b) of the Internal Revenue Code.

[15] Revenue Ruling 62–17, 1962–1, Cum. Bull. 87.

[40] retirement savings deductions for those not now covered under qualified retirement plans, government plans, or section 403(b) plans; and a provision which limits the maximum retirement benefit and the maximum deductible contribution on behalf of employees.

Tax revenues are also affected by the modification of the tax treatment of lump-sum distributions.

Finally, a third category of revenue effect from the bill arises not because of any change in tax deductions as such, but rather because increased amounts may be set aside by employees for vesting and funding. The bill imposes additional requirements in the areas of vesting and funding which must be met if the present favorable treatment for pensions is to continue to be available. These new requirements may result in employers making larger contributions to retirement plans, resulting in larger income tax deductions.

[41] TABLE 4.—*Estimated annual revenue effect of H.R. 12855 at 1973 levels of income and employment*

	Millions
I. Provisions designed to equalize tax treatment under pension plans:	
Increase in maximum annual deductible contribution by the self-employed under H.R. 10 plans to the greater of $750 (but not in excess of earned income) or 15 percent of earned income up to $7,500 [1]	−$175
Allowing an individual not covered by a qualified retirement plan, government plan, or section 403(b) plan to deduct annually up to the lesser of $1,500 or 20 percent of compensation for contributions by him or on his behalf to a tax exempt retirement account, annuity, or bond plan established by him or to certain trusts established by employers or associations of employees (long-run effect) [2]	−355
Limiting the maximum annual benefit under defined benefit plans to the lesser of $75,000 (where benefits begin at age 55 or later) or 100 percent of average compensation for the three consecutive calendar years aggregating the highest compensation and limiting annual contributions under defined contribution plans to the lesser of $25,000 or 25 percent of compensation, with a cost-of-living adjustment to the dollar ceilings in the case of active participants and to the resultant amount under the 100 percent rule in the case of participants separated from service [3]	+10
Total, provisions designed to equalize tax treatment under pension plans	−520
II. Revised tax treatment of lump-sum distributions from retirement plans (long-run effect) [4]	+60
III. Revenue effect of minimum vesting provision.[5]	
Case 1: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute a substitute for cash wages	−130
Case 2: Assuming that the additional employer contributions to pension plans resulting from the minimum vesting requirement constitute an addition to cash wages	−265
Case 3: Assuming that benefit levels of pension plans are adjusted downward to absorb the additional employer contributions to pension plans resulting from the minimum vesting requirement	0

NOTE.—There will be some revenue loss from funding but data are not available to determine the extent of this loss.

[1] Maximum deductible amounts effective for taxable years beginning after Dec. 31, 1973; other provisions effective for taxable years beginning after Dec. 31, 1975.

[2] Maximum deductible amounts effective for taxable years beginning after Dec. 31, 1973; other provisions effective on Jan. 1, 1974.

[3] Apart from the exception for certain active participants in corporate defined benefit plans on Oct. 2, 1973, effective for contributions made or benefits accrued in years beginning after Dec. 31, 1975.

[4] Effective for distributions or payments made in taxable years beginning after Dec. 31, 1973.

[5] Effective for plan years beginning after the date of enactment for plans adopted after Jan. 1, 1974. Effective for plan years beginning after Dec. 31, 1975, for plans in existence on Jan. 1, 1974, except: (1) for plans under collective bargaining agreements, effective for plan years beginning after the agreement termination date (but not before Dec. 31, 1975) of the last agreement relating to the plan or Dec. 31, 1980, whichever is earlier; (2) for labor organization plans, effective for plan years beginning after the date of the second convention of the organization (but not earlier than Dec. 31, 1975) held after the date of enactment or Dec. 31, 1980, whichever is earlier; and (3) where the plan administrator elects, effective for plan years beginning after the date of enactment but before the latest date available to each of the above categories of existing plans, respectively.

Provisions designed to equalize tax treatment of retirement plans.—It is estimated that the provision increasing the maximum annual deductible pension contribution by self-employed persons on their own behalf to the greater of $750 (but not in excess of earned income) or 15 percent of earned income (up to $7,500) will result in an annual revenue loss of $175 million.

[42] The provision allowing an individual not covered by a qualified retirement plan, government plan, or section 403(b) plan to deduct annually the lesser of $1,500 or 20 percent of compensation for contributions by him or on his behalf to a tax exempt retirement account, annuity, or bond plan established by him (or to certain trusts established by employers or associations of employers) is estimated to involve a revenue loss amounting to $225 million for 1974 and rising to $355 million for 1977 (at 1973 income levels).

On the other hand, a revenue increase of $10 million a year at 1973 income levels is estimated to result from limiting the maximum annual benefit under defined benefit plans to the lesser of $75,000 (where benefits begin at age 55 or later) or 100 percent of average compensation for the three consecutive calendar years aggregating the highest compensation and limiting annual contributions under defined contribution plans to the lesser of $25,000 or 25 percent of compensation, with a cost-of-living adjustment to the dollar ceilings in the case of active participants and to the resultant amount under the 100 percent rule in the case of participants separated from service.

Altogether, when fully effective, these three provisions involve an estimated annual net revenue loss of $520 million.

Tax treatment of lump-sum distributions.—The revised tax treatment of lump-sum distributions from retirement plans (which provides for taxing that part of lump-sum distributions which is attributable to 1974 and later years as ordinary income subject to 10-year averaging) is expected to result in the long run in annual revenue gains amounting to $60 million a year based on 1973 levels of income.

Revenue effect of minimum vesting and funding provisions.—The new minimum vesting standards, which generally become effective for plan years beginning after 1975, will also involve an indirect loss of revenue, ranging from zero to an estimated $265 million a year (at 1973 income levels).

The minimum vesting requirement involves little or no revenue loss to the extent that the benefit levels of plans are adjusted to absorb the increased employer costs resulting from the requirement. This is because, in that event, the requirement would have no effect on the deductions taken for contributions to plans or on the taxable income of covered employees. If the additional amounts required to be contributed to pension plans as a result of the vesting standards are a substitute for cash wages, rather than a net addition to cash wages, the annual revenue loss is estimated at $130 million. This could occur, for example, if the additional employer payments into the pension plan are taken into consideration in setting future wage increases. In this event, the revenue loss results from the fact that the covered employees are permitted to postpone payment of tax on the employer contributions involved, instead of being required to pay tax currently, as would be the case had they received an equivalent amount of wages. Some part of this postponed $130 million of taxes presumably will be recovered in the future in tax payments on the benefits paid out by the plan.

The upper range of the estimate, $265 million, represents the revenue loss if it is assumed that the additional employer payments into the pension plans required by the new vesting standards constitute an

[43] addition to the cash wages that will be paid in any event. In this case employers will have larger total wage bills (for the sum of cash wages and wage supplements) and hence will take larger tax deductions, giving rise to a $265 million revenue loss.

It appears that realistically there is likely to be a combination of the three effects suggested above.

No revenue estimate is given for the increased funding requirements under the bill. Data are not available which would make a reliable estimate of this type possible. However, it is believed that the minimum funding requirements will have a relatively modest revenue effect.

IV. GENERAL EXPLANATION

A. Participation and Coverage

(Secs. 1011, 1015, 1017, 1021, and 1023 of the bill and Secs. 401, 410, and 414 of the Code).

PLAN PARTICIPATION—AGE AND SERVICE REQUIREMENTS

Present law

The Internal Revenue Code does not generally require a qualified employer pension, profit-sharing, stock bonus, annuity, or bond purchase plan to adopt any specific age or service conditions for participation in the plan.[1]

Existing administrative practice allows plans to exclude employees who (1) have not yet attained a designated age or (2) have not yet been employed for a designated number of years, so long as the effect is not discriminatory in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. Also, under administrative practice, a plan may exclude employees who are within a certain number of years of normal retirement age (for example, 5 years or less) when they would otherwise become eligible, if the effect is not discriminatory.

On the other hand, in the case of a plan benefiting owner-employees,[2] the plan must provide that no employee with 3 or more years of service may be excluded (sec. 401(d)(3)).

However, all plans may exclude part-time employees whose customary employment does not exceed 20 hours a week, and seasonal employees whose customary employment does not exceed five months in any calendar year.

General reasons for change

The committee believes that, in general, it is desirable to have as many employees as possible covered by private pension plans and to begin such coverage as early as possible, since an employee's ultimate pension benefits usually depend to a considerable extent on the num-

[1] As described below (2. Plans Where a Collective Bargaining Unit is Involved: Other Anti-discrimination Provisions), a qualified plan must meet certain coverage standards. Several of the alternative standards require certain percentages of employees, or of eligible employees, to be covered by the plan, but in such cases the employer is permitted to exclude employees who fail to meet the plan's service requirements, not exceeding five years of service.

[2] An owner-employee is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[44] ber of his years of participation in the plan. This is particularly important for employees who, because of the nature of their employment, shift from employer to employer over their working careers. In addition, early participation tends to spread the cost of providing employees with adequate pensions more evenly over the various firms for which the employee has worked over his entire working career, instead of concentrating the cost on his last few employers.

Of course, the general desirability of early participation must be balanced against the cost involved for the employer. Also from an administrative standpoint, it is not desirable to require coverage of transient employees, since benefits earned by short-term employees, in any case, are quite small. On the other hand, the committee believes that overly restrictive age and service eligibility requirements can arbitrarily frustrate the effective functioning of the private pension system. In view of these considerations, the committee has concluded that it is appropriate to specifically limit age and service eligibility requirements which an employer may incorporate in a qualified pension plan.

Explanation of provisions

In general.—In view of the considerations outlined above, the committee bill provides that a plan which is qualified under the Code is not to require, as a condition of participation, more than one year of service, or an age greater than 25 (whichever occurs later).[3] The committee believes that this rule will significantly increase coverage under private pension plans, without imposing an undue cost on employers. From an administrative point of view, however, the rule will allow the exclusion of employees who, because of youth or inexperience with the job in question, have not made a career decision in favor of a particular employer or a particular industry. Also, to encourage plans which provide 100 percent immediate vesting, the committee bill provides that such plans may require 3 years of service (and on age of 25) as a condition of participation. The committee believes that these rules take full account of the reasonable administrative and cost needs of plans to exclude employees in high turnover or high cost of benefit categories, and there is no authority in the tax law, apart from the specific provisions of the bill (including the maximum age provision discussed below), to allow qualified plans to exclude employees on account of age or service.

Year of service defined.—For purposes of the vesting and participation rules, the committee bill provides flexibility by indicating that the Secretary is to define a "year of service" by regulations in a manner which provides for its determination on a reasonable and consistent basis. For example, the regulations could specify that a plan could provide that each employee who had met the age and service requirements was to begin his participation on the anniversary date of his own employment, or that all eligible employees would be admitted on the anniversary date of the plan, or that each employee would be covered under the plan on the first quarterly anniversary date of the plan following the anniversary date of his employment.

[3] This rule applies whether or not the plan is a trusteed plan. That is, a plan funded through purchase of annuities from an insurance company is subject to these rules, as is a plan with investments managed by a trustee.

[45] However, to ensure that no abuse situation arises, the bill provides certain guidelines as to what constitutes a "reasonable" definition of a year of service. For example, under the bill, the plan's definition of a year of service would have to be such that no employee with more than 17 months of continuous [4] service could be excluded from the plan on account of service; moreover, the average employee (assuming hypothetically that employees were hired at the same rate each day throughout the year) could not have a wait of more than 12 months for participation. Of course this definition does not apply for purposes of benefit accrual, and a plan may use any reasonable definition of "year of service" for this purpose that is consistently applied, so long as the plan meets the antidiscrimination requirements of the law.

There are some industries whose normal work schedules are substantially different than those of more typical businesses. To deal with this problem, the committee bill provides that the regulations defining "year of service" are to take this factor into account. For example, the regulations might provide that in appropriate cases 100 hours of employment constitute a month, or 1,000 hours of employment constitute a year.

Participation of temporary and seasonal employees.—In the case of the seasonal employee, whose customary employment is at least 5 months, his normal season will be treated as a year. For example, if there is a 5-month fishing season in a certain area, and a fisherman is employed throughout the season by a company having a qualified pension plan, then, on the anniversary date of his employment, the fisherman is to be treated under the plan as though he had at least twelve months of continuous service for purposes of determining his right to participate in the plan.

Break in service.—The bill also provides a series of rules as to the effect of an employee terminating his service with an employer but then subsequently returning. These determinations are used in deciding whether the vesting schedule is to start over after the participant's break in service or to continue as of its status when the break in service first occurred. The rules governing the treatment of breaks in service set forth below in general are designed to place the employee, when he returns to service, at the same point in the vesting schedule that he was before the break in service, insofar as this is practicable without creating serious administrative problems. The bill provides for four interrelating rules.

First, where a break in service has occurred, a plan can provide that where an employee subsequently returns to service, the earlier service is not added to the more recent service until the employee has been back at least a year. This rule makes it unnecessary to search out the extent of prior service in the case of employees who return but stay for only a short period of time.

A second rule provides that where an employee has been in service at any time in the past for a sufficiently long period of time to obtain a vested right to 50 percent or more of the accrued benefits from employer contributions, upon return to employment his prior service,

[4] The term "continuous" is also to be defined in regulations to take account of the problem of seasonal employees, as well as factors such as sick leave, holidays and vacation periods, etc.

[46] before the break in service, is to be taken into account in applying the participation and vesting rules to his current situation. (The prior service would satisfy the plan's service requirements for participation.) The first rule set forth above, however, provides an exception to this rule.

Third, in the case of an employee who has completed 4 consecutive years of service before the break in service occurs, except as provided in the first rule above and the fourth rule below, service before the break is to be taken into account upon the employee's return to employment.

Fourth, in the case of an employee who has a break in service for a period of six years or more, service performed by the employee before the break in service need not be taken into account under the plan except in the case of employees coming under the second rule set forth above—that is, only where an employee has a vested right to 50 percent or more of employer contributions. Thus, where longer breaks in service occur, it will not be necessary to take into account prior service except in those cases where the employee had previously built up vested rights to the level of 50 percent or more.

Other rules.—The committee intends that Treasury regulations specify the extent to which service with a predecessor of the employer is to be counted for purposes of the eligibility requirements. In the case of a multiemployer plan, service with any employer who was a member of the plan is to be counted towards an individual's participation requirement (sec. 1015 of the bill).

For purposes of these rules (and elsewhere in the bill), a "multiemployer plan" is a plan maintained pursuant to a collective bargaining agreement, to which more than one employer is required to contribute, and to which no one employer makes as much as 50 percent of the contributions. (After a plan has once qualified as a multiemployer plan, however, up to 75 percent of the contributions may be made by a single employer without affecting the multiemployer status of the plan.) In addition, the Secretary of his delegate is authorized to prescribe regulations establishing certain other requirements in the case of a multiemployer plan, dealing, for example, with the extent to which the plan should be liable to make benefit payments to participants, regardless of whether the participant's employer continues to make contributions under the plan.

Maximum age requirement.—In order not to discourage the hiring of older employees, the bill would permit a defined benefit pension plan to exclude employees who are within 5 years of normal retirement age at the time they would otherwise become eligible to participate if the exclusion does not result in a situation which is inconsistent with the coverage requirements of the tax law. Also, the plan may provide that the employee is not eligible to begin drawing retirement benefits until 10 years after he began to participate in the plan of participation (sec. 1021 of the bill). If a maximum age provision were to be prohibited, in the case of a defined benefit plan the cost considerations of providing a defined benefit to an older employee might discourage the hiring of the elderly. In the case of a defined contribution plan (such as profit-sharing plan or a money purchase pension plan), however, these cost considerations do not generally apply, and the committee therefore did not see why a maximum age limitation of this type should be permitted.

[47] *H.R. 10 plans.*—The provisions of present law with respect to coverage under an owner-employee (H.R. 10) plan are not changed by the committee's bill. Present law already requires relatively early participation (after 3 years of service) and 100-percent immediate vesting in the case of owner-employee plans. The committee concluded that the retention of these provisions of present law was needed to protect the rights of employees in such cases. H.R. 10 plans will use the same rules as to a year of service, seasonal or part-time service, and breaks in service as will apply under the committee bill to corporate plans.

Government and church plans.—These provisions (as well as the corresponding provisions of the bill relating to vesting and funding) do not apply in the case of government plans, including the Federal civil service plan, and plans sponsored by State and local governments (including the District of Columbia), and any plan to which the Railroad Retirement Act applies. These plans may continue to remain qualified by continuing to meet the current law requirements (as in effect on the day before enactment). Also, new government plans may be qualified if they meet the requirements of present law. However, the Committee on Ways and Means and the Committee on Education and Labor are to study the extent to which it would be desirable to bring government plans under Federal participation, vesting, funding, and fiduciary standards, as well as matters affecting mobility of government employees and those employed under Federal procurement, construction, or research contracts or grants. The committees are to report to the House of Representatives no later than December 31, 1976.

Likewise, church plans (and plans of associations or convention of churches) will be exempt from the requirements of the bill unless the church files an election, in a form and manner to be prescribed in regulations, electing to come under the participation, vesting, and funding provisions of the bill (and the other rules which relate to these provisions), rather than to comply with the requirements of present law. Once an election is filed, however, it will be irrevocable. Generally, a "church plan" includes any plan maintained by a church or association or convention of churches, other than a plan primarily for benefit of employees in an unrelated trade or business of the church, or a multiemployer plan which includes employers which are not churches. However, for purposes of this definition of "church plan", if the plan was in existence on January 1, 1974, and at that time covered employees of another organization exempt from tax (under sec. 501) which was an agency of the church, then employees of the agency are to be considered as employees of the church.

Coordination of regulations.—In order to minimize administrative problems, and ensure insofar as possible that plans which satisfy the requirements of the Internal Revenue Code also meet the pension standards which are to be administered by the Labor Department, and vice versa, the bill provides that the Treasury regulations with respect to the participation, vesting, and funding requirements of the bill (other than regulations to enforce the antidiscrimination requirements of sec. 401(a)(4) of the code) are to be effective for plan years beginning after December 31, 1975, only if approved by the Secretary of Labor. Where the bill's provisions apply before that date (as in the case of new plans and plans which elect earlier dates) then the regulations

[48] may be prescribed without the necessary approval of the Secretary of Labor. However, these regulations are not to apply beyond the December 31, 1975, plan year cutoff date.

PLANS WHERE A COLLECTIVE BARGAINING UNIT IS INVOLVED; OTHER ANTIDISCRIMINATION PROVISIONS

Present law

Under present law (sec. 401(a)(3)), a qualified retirement plan must cover either (1) a specified percentage of all employees (generally, 70 percent of all employees, or 80 percent of those eligible to benefit under the plan if at least 70 percent of all employees are eligible) [5] or (2) such employees as qualify under a classification which is found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. (A plan is not *per se* discriminatory for purposes of these rules merely because it is limited to salaried or clerical employees.)

Also, under present law, either the contributions or the benefits provided under a qualified plan must not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees.

General reasons for change

Where employees covered under a collective bargaining unit prefer current compensation or some other form of benefits to coverage under a pension plan, employers sometimes are unable to establish a plan for other employees because the percentage requirement cannot be satisfied if the bargaining unit employees are not covered. It is then necessary for the plan to qualify as one which has coverage requirements that do not discriminate. The Service's approach (see Rev. Rul. 70–200, 1970–1 CB 101), which has generally been upheld by the courts, has been to look at the compensation of the group which is covered under the plan, and to allow the plan to qualify if the compensation of most of the participants is substantially the same as that of the excluded employees, the plan covers employees in all compensation ranges, and employees in the middle and lower ranges are covered in more than nominal numbers. Where most of the lower-paid nonsupervisory personnel are members of a collective bargaining unit which elects not to be covered by a pension plan, the remainder of the employees may include relatively large percentages of supervisors or highly compensated employees. As a result, under present law it may be impossible—because of the antidiscrimination requirements—to establish a qualified plan for the remaining employees.

Your committee believes that this situation can result in a hardship, where nonunion employees of an employer are forced to forego the benefits of a pension plan merely because those employees who are covered under a collective bargaining agreement choose nonpension benefits, or nonpension benefits plus pension benefits at a lower level than those provided nonunion employees. At the same time, the committee is

[5] In applying these numerical tests under present law, there are excluded employees who have been employed not more than a minimum period prescribed by the plan (up to 5 years), part-time employees (customary employment for not more than 20 hours in any one week), and seasonal employees (those whose customary employment is for not more than 5 months in any calendar year).

[49] concerned that any change in the law should not result in a situation where an employer might be able to exclude these employees from the pension plan without compensation for this in the form of other types of benefits. To deal with this situation, the committee bill provides that collective bargaining employees may be excluded for purposes of applying the coverage test, where the agreement does not provide that the union employees are to be included in the plan and there is evidence that retirement benefits have been the subject of good faith bargaining between the union employees and the employer.

Explanation of provisions

Collective bargaining unit.—The committee bill eases the application of the provisions of existing law by providing that employees covered under a collective bargaining agreement can be excluded for purposes of the coverage requirement if the employees are excluded from the plan and there is evidence that the retirement benefits have been the subject of good faith bargaining between the union employees and the employer.

If pension plan coverage had been discussed with the representatives of the union employees and no pension coverage was provided, either because the union employees were covered under a union plan (which might or might not offer comparable benefits to those provided under the employer plan), or because the employee representatives opted for higher salaries, or other benefits, in lieu of pension plan coverage, or for some other valid reason, then it would be permissible to exclude those union employees from the calculations. In effect, the collective bargaining agreement employees could then be excluded from the plan. Since this provision is intended to relax the coverage requirements of present law, in circumstances where the union employees elect not to participate in the plan, it follows, of course, that any plan which meets the coverage rules of present law, even though it excludes certain union employees, would not be adversely affected as to its tax-qualified status by this provision.

The committee anticipates that in any case where collective bargaining unit employees were excluded from a plan under this provision, the Internal Revenue Service will receive information as to the justification for the exclusion before ruling that the plan is qualified. There is no requirement that the collective bargaining agreement specifically state that the employees have elected to be out of the plan or to take a lower level of benefits. However, there must be evidence that the retirement benefits have been the subject of good faith bargaining between the union employees and the employer.[6]

The committee bill also provides that a plan is not to be considered discriminatory because it covers air pilots represented in accordance with the Railway Labor Act while not covering other employees working for the same employer if it covers a sufficient number or a nondiscriminatory cross-section of such pilots.

Nonresident alien employees.—The bill provides for the exclusion, for purposes of applying the coverage requirements and the antidiscrimination requirements, of those employees who are nonresident

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[6] Once this issue had been negotiated, the union and the employer would not be required under this provision to renegotiate the issue at each bargaining session. However, the committee has been informed that it would constitute an unfair labor practice, within the meaning of the Federal labor laws, for an employer to refuse to negotiate in good faith with a labor union concerning retirement benefits. An example of good faith bargaining would include agreements or memoranda of understanding between railway companies and their employee representatives designed to effect changes in the Railroad Retirement Act of 1937 or Chapter 22 of the Internal Revenue Code, or both.

[50] aliens with no United States income from the employment in question. It was believed that the United States tax laws should not impede appropriate pension plan benefits for United States citizens or persons with United States earned income, merely because comparable benefits were not afforded to nonresident aliens with no United States income from the employment in question. Also, the mere processing of such cases would take an inordinate amount of time because of the complexity of applying rules to integrate the appropriate foreign equivalent of Social Security with the benefits or contributions provided by the employers under such plans.

Affiliated employers.—The committee bill also provides that in applying the coverage test, as well as the antidiscrimination rules, the vesting requirements, and the limitations on and benefits, employees of all corporations who are members of a "controlled group of corporations" (within the meaning of sec. 1563(a)) are to be treated as if they were employees of the same corporation. Thus, if two or more corporations were members of a parent-subsidiary, brother-sister, or combined controlled group, all of the employees of all of these corporations would have to be taken into account in applying these tests. A comparable rule is provided in the case of partnerships and proprietorships which are under common control (as determined under regulations), and all employees of such organizations are to be treated for purposes of these rules as though they were employed by a single person. The committee, by this provision, intends to make it clear that the coverage and antidiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation. For example, if managerial functions were performed through one corporation employing highly compensated personnel, which has a generous pension plan, and assembly-line functions were performed through one or more other corporations employing lower-paid employees, which have less generous plans or no plans at all, this would generally constitute an impermissible discrimination. By this provision the committee is clarifying this matter for the future. It intends that prior law on this point be determined as if this provision had not been enacted.

At the same time, however, the committee provision is not intended to mean that all pension plans of a controlled group of corporations or partnerships must be exactly alike, or that a controlled group could not have pension plans for some corporations but not others. Thus, where the corporation in question contains a fair cross-section of high- and low-paid employees (compared to the employees of the controlled group as a whole), and where the plan coverage is nondiscriminatory with respect to the employees of the corporation in question, it is anticipated that the Internal Revenue Service would find that the plan met the antidiscrimination tests, even though other corporations in the controlled group had a less favorable retirement plan, or no plan at all. On the other hand, if, looking at the controlled group as a whole, it were found that a disproportionate number of highly compensated employees were covered under the plan of the corporation in question, or that the average compensation of covered employees was substantially higher in that plan than the average compensation of noncovered employees, it would be anticipated that the plan would not be

[51] found to be qualified, because the corporation does not contain a fair cross section of the controlled group employees.

Supervisory employees.—Under the committee bill, the category of "supervisors" is to be dropped from the list of personnel which a plan may not discriminatorily favor. The committee has been informed by the Treasury Department that all persons who are supervisors within the intent of present law also are officers, shareholders, or highly compensated employees, and that as a result this deletion will result in no substantive change in the antidiscrimination provisions of present law.

Coverage of temporary and seasonal employees.—In applying the coverage rules, the bill makes several changes from present law. In applying the 70 percent and 80 percent coverage tests, employees who fail to meet the minimum age and service requirements prescribed by the plan may be excluded (assuming these employees are actually excluded from the plan). These requirements may not be more than the top limit of one-year-service and 25-year-age requirements (or 3-year-service, immediate-full-vesting, and 25-year-age alternative) described above with respect to participation. Of course, the plan may provide lesser age and service requirements.

Present law permits exclusion, in applying the coverage calculations, of employees whose customary employment is for not more than 5 months in any calendar year; the bill retains the 5-month period but permits computations to be made on the basis of any 12-month period (not merely the calendar year) depending upon the period specified in the plan itself. Part time employees (as defined in regulations) may also be excluded from the plan.

Work product contributions.—In some industries, contributions may be made under a plan based on the work product of an individual who is not a participant (for example, contributions based on tonnage of minerals mined or processed). Obviously, such an individual may be excluded under the plan, notwithstanding the fact that contributions are made based on his work, if the individual fails to meet the minimum age or service requirements, or other lawful conditions that the plan imposes for participation. On the other hand, a person could be a participant in a plan even though neither he nor his employer make contributions on his behalf.

Effective dates

These provisions apply generally to plan years beginning after the date of enactment of the bill. However, to allow time for amendment for plans in existence on January 1, 1974, the provisions are to take effect in these cases for plan years beginning after December 31, 1975, unless the plan administrator makes an irrevocable election to have the provisions apply sooner (under regulations prescribed by the Secretary or his delegate), in which case the provisions will take effect at the beginning of the first plan year which occurs after the election.

Where the plan is subject to the provisions of a collective bargaining agreement in effect on January 1, 1974, the effective date is further postponed until plan years beginning after December 31, 1976, or, if later, plan years beginning after the expiration of the collective bargaining agreement (or the expiration of the last relevant agreement in the case of a multiemployer plan or a single plan subject to more than one collective bargaining agreement), but without regard to any ex-

[52] tension made after the date of enactment. For this purpose, a collective bargaining agreement will not be considered as terminated if it can be (or is) reopened with respect to relatively narrow issues only. For example, a collective bargaining agreement would not be considered as being terminated for this purpose if it can be reopened with respect to the benefit payable to a surviving spouse, if it can be reopened because of a change in payments with respect to voluntary coverage under Part B of the Medicare benefits under the Social Security Act, or if it can be reopened to increase benefits with respect to a quite limited group of employees.

A question has arisen as to how the effective date rules are to be applied to a plan which includes employees subject to one or more collective bargaining agreements and also employees not under any such agreement. The intent is that the presence of an insignificant number of union members as participants in a plan is not to be sufficient to delay the effective dates for an additional 5 years. On the other hand, the presence of a small number of nonunion participants should not force the untimely renegotiation of labor-management contracts. As a result, your committee intends that a plan is to be regarded as maintained pursuant to a collective bargaining agreement if (1) either the contribution levels or the benefit levels under the plan are to be determined under the agreement and (2) at least 25 percent of the participants are members of the unit of employees covered by the agreement. In addition, where an employer has one plan for collective bargaining unit employees and another plan for other employees, but those plans are essentially the same with regard to benefits and contributions, then the two will be considered as one for purposes of applying the rule described above as to when a plan with both union and nonunion participants is to be entitled to delayed effective date provisions. Finally, where an employer has a plan for collective bargaining unit employees and another plan for other employees, and the second plan consists of two parts, one part of which is essentially the same as that for the collective bargaining employees, the part which is essentially the same will be considered as a part of the collective bargaining plan for purposes of this effective date provision.

In the case of a plan maintained by a tax-exempt (under sec. 501 (c)(5)) labor organization for its own employees, the effective date is postponed to plan years beginning after December 31, 1976, or, if later, the first plan year following the date on which the second convention of the organization is held after the date of enactment. But, in any event, all plans (including those subject to existing collective bargaining agreements) are to be subject to these provisions in plan years beginning after December 31, 1980.

An existing plan which would be entitled to a delayed effective date for the new participation, vesting, funding, etc. provisions is to be permitted to elect to have all those provisions apply sooner. Any such election must be made under Treasury regulations, must not be piecemeal (i.e., it is not permitted to be made for, say, vesting, without also applying to participation, funding, etc.), and is irrevocable.

Revenue effect

The revenue effect of these provisions is expected to be minimal.

B. Vesting

[53] (Secs. 1012, 1014, 1015, 1017, 1021, 1023, and 1024 of the bill and secs. 401, 411, 414, and 6690 of the Code.)

Present law

Plans which qualify under the Internal Revenue Code are now required to provide vested (i.e., nonforfeitable) rights to participating employees when they attain the normal or stated retirement age. Employees must also be granted vested rights if the plan terminates or the employer discontinues his contributions.

However, qualified corporate plans are generally not required to provide vested rights to participating employees before normal retirement age unless this is considered to be necessary—in view of the likely pattern of employee turnover—to prevent discrimination against the rank and file employees in favor of officers, shareholders, supervisors, or highly paid employees. In other words, preretirement vesting is required only where its absence would cause discrimination in favor of officers, etc., who could be expected to remain with the firm long enough to retire and qualify for benefits, while the rank and file employees would continually be separated from the firm and lose their benefits.

Under an owner-employee plan,[1] the rights of all employees must vest in full as soon as they become participants (sec. 401(d)(2)(A)).

General reasons for change

Unless an employee's rights to his accrued pension benefits are nonforfeitable, he has no assurance that he will ultimately receive a pension. Thus, pension rights which have slowly been stockpiled over many years may suddenly be lost if the employee leaves or loses his job prior to retirement. Quite apart from the resulting hardship, your committee believes that such losses of pension rights are inequitable, since the pension contributions previously made on behalf of the employee may have been made in lieu of additional compensation or some other benefits which he would have received.

Today, slightly over two-thirds of the private pension plans provide some vested rights to pension benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have been employed for a fairly long period with a firm or are relatively mature. Since there is no general applicable legal requirement for preretirement vesting, some plans do not offer this type of vesting at all, and among those plans which do, there is no uniformity in the vesting rules as provided. At present, only one out of every three employees participating in employer-financed plans has a 50-percent or greater vested right to his accrued pension benefits. Even for older employees, a substantial portion do not have vested rights. For example, 58 percent of covered employees between the ages of 50 and 60, and 54 percent of covered employees 60 years of age and over, still do not have vested rights to even 50 percent of their accrued pension benefits.[2] As a result, even employees with substantial periods of service may lose pension benefits on separation from employment. Extreme cases have been noted in which employees have

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[1] An owner-employee is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[2] U.S. Treasury Department—Fact Sheet, Pension Reform Program, as reprinted in Material Relating to Administration Proposal Entitled the "Retirement Benefit Tax Act," Committee on Ways and Means, 93d Cong., 1st sess., p. 37, Table B.

[54] lost pension rights at advanced ages as a result of being discharged shortly before they would be eligible to retire. In addition, your committee believes that more rapid vesting is desirable because it will improve the mobility of labor, and in this manner promote a more healthy economy.

For reasons indicated above, your committee concluded that it is necessary and desirable to provide a minimum standard of vesting for all qualified pension plans. Clearly, however, it would be counterproductive to increase employer costs by more rapid vesting to such an extent as to significantly curtail the creation of new retirement plans (or to significantly curtail the increase of benefits in existing plans). The committee bill deals with this problem by requiring that all qualified plans must meet one of three minimum standards for vesting.

Explanation of provisions

General rule.—The committee bill provides that a qualified plan would have to meet one of three vesting standards with regard to benefits derived from employer contributions:

1. a graded vesting standard, under which the employee must be at least 25 percent vested in his accrued benefit after 5 years of covered service, with a gradual increase in this percentage in subsequent years, so that the employee must be 100 percent vested after 15 years of service;
2. full vesting after 10 years of covered service; or
3. a "rule of 45", under which an employee with 5 or more years of covered service must be at least 50 percent vested in his accrued benefit when the sum of his age and years of covered service total 45, with 10 percent additional vesting for each year thereafter.

Whichever of these alternatives is adopted, each employee would have to be fully and immediately vested in his accrued benefit derived from his own contributions.[3]

It should be made clear that the standards provided in the committee bill are only minimum standards. The bill's provisions are not intended to prohibit plans with more rapid vesting than that required under the standards in the bill.

Your committee believes that the new vesting rules should provide flexibility, so as to allow plans to choose from several reasonable standards a vesting schedule best suited to the needs of the particular business, and so as not to disrupt existing plans which already have provided reasonable vesting under one of several formulas. In addition, a transition rule and delayed effective dates are provided, so that plans may be amended in an orderly manner to come into compliance with the new minimum standards. Compliance with any of these standards, together with continued vitality of the antidiscrimination standards of the Internal Revenue Code, should afford substantial protection to employees against possible loss of their pension rights.

Graded vesting.—One of the alternatives under the committee bill provides that a qualified plan (whether trusteed or insured) would be required to give each participant vested rights to at least 25 percent of his accrued benefit from employer contributions after 5 years of

[3] Thus, in general, the rules described hereafter relate only to benefits derived from employer contributions.

[55] service, plus 5 percentage points a year for each of the next 5 years and 10 percentage points a year thereafter. This would mean that there must be 100 percent vesting after 15 years of covered service.

This approach has the advantage of providing some vesting at a relatively early point in the employee's career. Thus, if the employee changes jobs after 5 years of service, he would be protected in his rights to at least some part of his accrued benefit. This rule (and, to a lesser extent, the 10-year 100-percent vesting rule and the rule of 45 vesting rule) proceeds on the assumption that some part of the obligation to provide reasonable retirement benefits should be shifted from the employee's last employer and should be shared by those who employed him earlier in his working career.

Also, because vesting occurs gradually, this alternative tends to bring down the cost of the vesting requirement to manageable levels by minimizing the cost of establishing a new plan or improving benefits under an existing plan. By avoiding the "notch" effect of an employee becoming entitled to too much of his vested rights in any one year, it avoids giving the employer an incentive to dismiss an employee rather than to absorb the sharp increase in pension plan costs that would result from a sudden increase in the vesting percentage after a number of years of service.

Ten-year 100-percent vesting.—Another alternative under the committee bill provides that a qualified plan could meet the vesting requirements by giving each participant vested rights to 100 percent of his accrued benefit derived from employer contributions after 10 years of service.

This approach avoids the recordkeeping and other administrative costs involved in accounting for partially vested rights. In the case of the employee who serves for 10 years, this alternative provides greater vesting protection than the graded vesting rule (discussed above) or, in general, the rule of 45 (discussed below).

The "rule of 45".—The third alternative under the bill, known as the rule of 45, would require that a plan provide each employee with vested rights to at least 50 percent of his accrued benefit when the sum of his age and years of covered service equals 45 (subject to a minimum service requirement of 5 years), with at least 10 percent additional vesting for each year of service thereafter.

The age-weighted approach has the advantage that it provides more protection to the older worker, who is closer to retirement, and who may not get another chance to earn a pension if he leaves his employment prior to retirement.[4] For this reason, your committee believes that the rule of 45 should be available as an alternative for those plans which would prefer to take an age-weighted approach.

Transition rule.—Your committee has concluded it is important that all qualified plans ultimately meet one of the three minimum standards in the bill. However, to impose the full force of these standards on existing plans without some transition period would, in some cases, subject these plans to substantial additional costs to pay for the required vesting, possibly causing a reduction of benefits in some plans, or even plan termination. To ease the cost factor in the case of plans already in existence which have not previously been subject to vesting requirements such as those set forth in the committee bill, the bill

[4] Under the present tax law, all rights must be fully vested when the employee attains the normal or stated retirement age, but an older employee who terminates his service prior to reaching retirement age generally does not have to be vested under present law (except to prevent discrimination).

[56] provides a transitional rule under which plans actually in effect on December 31, 1973,[5] would have a reduced vesting requirement for the first 5 years to which the new rules apply.

During the first year to which the bill's vesting standards apply, the plan would have to provide at least 50 percent of the regular requirement under the applicable vesting schedule—this 50-percent level would have to then be increased by 10 percentage points a year, so that the new rules would fully apply in the sixth year after the effective date. For example, under the graded vesting approach, during the first year in which the rules were applicable, an employee with 5 years of covered service would be at least 12.5 percent vested in his total accrued benefit (50 percent of the 25-percent requirement which is generally to apply after 5 years of service); this would increase to 18 percent the next year as the next step in the transition period was reached and also as the employee moved along the graded vesting schedule (60 percent of 30 percent), 24.5 percent the next year (70 percent of 35 percent), 32 percent the next year (80 percent of 40 percent), 40.5 percent the next year (90 percent of 45 percent), 50 percent the next year (100 percent of 50 percent), and by an additional 10 percentage points each year thereafter under the fully effective graded vesting schedule alternative of the bill. By use of this gradual approach, your committee believes that it will be possible to implement the new rules with a minimum of disruption to existing plans.

Preparticipation service.—Once an employee becomes eligible to participate in a pension plan, generally all his years of service with an employer, including preparticipation service, are to be taken into account for purposes of determining his place on the vesting schedule.

However, the plan may ignore service during a period for which the employee decided not to make contributions to a plan requiring employee contributions. Also, service need not be taken into account for periods for which the plan employer did not maintain the plan (e.g., periods before the plan was established or after the employer discontinued contributions but the plan was kept in existence for the purpose of paying already-earned benefits when due).

The committee bill also provides that for purposes of the vesting schedule, service before age 25 may be ignored whether or not the employee was a participant in the plan. This will have the effect of not discouraging plans from providing immediate participation and accrual of benefits for all employees. For example, in a plan providing for immediate participation, at age 30 an employee who had started on the job at 18 would have to be at least 25-percent vested in 12 years of accrued benefits under these rules (instead of only 5 years of accrued benefits, which would be the case if the plan did not permit participation until the employee was 25).

Service for an employer is to be taken into account for purposes of placement on the vesting schedule, even though the service was in a different division of the corporation, or with a different corporation member of the affiliated group. However, the bill does not require that such service be taken into account for purposes of accruing bene-

[5] A plan which went into effect after this date would not be eligible to use the transitional rule, even if the plan agreement included a retroactive clause which provided that the plan was in effect "as of" December 31, 1973.

[57] fits while the employee works for a division which does not have a plan. This may be illustrated by the following example.

Assume that an employee begins work at age 25 for division A of a corporation, which does not have a pension plan, and, at age 40 he transfers to division B, which does have a plan. Under all of the vesting standards, the employee would immediately become fully vested in the benefits which accrue under the plan, because of his 15 years of prior service with the employer.[6]

Benefits accrued in the past.—Generally, the vesting requirements of the bill are to apply to all accrued benefits, including those which accrued before the effective date of the provision. Years of service prior to the effective date also are to be counted for purposes of determining the extent to which the employee is entitled to vesting. For example, in the case of a plan electing the graded vesting alternative, if an employee joined a company at age 30 (at which time a plan was in effect), became a participant in the plan at age 35, and was age 40 on the effective date of the vesting provisions, he would have to become at least 50-percent vested at that time based on 10 years of service (although this percentage would be reduced under the transition rule for plans in effect on December 1, 1973). However, he might not have more than 5 years of accrued benefits since the minimum benefit accrual is based on participation.[7]

This would occur because of his 5 years of participation under the plan plus his 5 years of preparticipation service. Without this pre-effective date rule, it was apparent to your committee that employees who are now older employees would receive the advantages of required vesting only for the accrued benefits they would be able to build up gradually in the future and would receive no protection for benefits accrued prior to the effective date of these provisions, which would usually be the bulk of the benefits earned during their lifetimes.

Your committee considered various methods of providing that pre-effective date service be taken into account in the case of older employees only, but concluded that most such methods provided some type of undesirable "notch" effect and in most cases would result in little cost saving to the employer relative to the rule adopted in the bill.

However, it does not appear to be desirable to provide for retroactive vesting for employees who have already terminated their service with the employer. since this would create a substantial unexpected cost for the plan (thereby possibly jeopardizing the size of benefits for employees still covered under the plan) and might involve serious recordkeeping problems. Thus, the committee bill specifically provides that the plan is not required to take into account service performed prior to January 1, 1969, until the employee has served at least 5 years with his employer after December 31, 1968.

[6] Conversely, an employee who worked for 5 years in division B, and then shifted to division A, would continue to increase his percentage of vesting in the benefits which he had accrued under the division B plan, even though division A did not have a plan. Of course he would accrue no benefits in the division B plan on account of his division A service (unless the plan provides otherwise).

[7] The employee need have only 5 years of accrued benefits, because the vesting provisions are to apply to pre-effective date service only to the extent of the employee's accrued benefits. The new participation standards are not to apply before the effective date of those standards: if these facts were to occur in the future, the employee would be at least 50-percent vested in at least 9 years of accrued benefits.

[58] *Multiemployer plans.*—In the case of a multiemployer plan governed by a collective bargaining agreement, the vesting requirements of the committee bill generally are to be applied as if all employers who are parties to the plan constituted a single employer. For example, years of service with employers A and B under the plan will be counted together in determining vesting, even though the employee now works for employer C (sec. 1014 of the bill).

Service that is seasonal, intermittent, etc.—For purposes of the minimum vesting rules, the question of whether an employee has performed a "year of service" will be determined in accordance with the same regulations which define this term in connection with the participation requirements, described above. Of course, a seasonal or part time employee who performs a year of service for purposes of determining his place on the vesting schedule, may nonetheless accrue benefits at a slower rate than his full-time, year-round counterpart. However, the relationship between the rate of accrual for a full-time employee, and a part-time or seasonal employee would have to be reasonable and applied on a consistent basis under the plan in order to meet the antidiscrimination requirements. Service with a predecessor of the employer would also be counted, for purposes of the vesting rules, to the extent provided in regulations. Your committee anticipates that the regulations in this area will prevent a situation where an employee might lose his rights to vesting as a result of a business reorganization.

The basic rules have been set forth in terms of "years of service". However, the committee recognizes that there are a substantial number of industries in which the common concepts of years, months, weeks, or hours of service do not apply. For example, it may be appropriate in some industries to provide that a participant must work at least 1,000 hours in order to have completed a "year of service" for purposes of the participation rules and for purposes of determining where he is to be placed on the vesting schedule. Under the bill, the regulations are to take into account such variations of customary working periods.

It must be noted that it is not necessary that the "year of service" concept used for participation or vesting purposes be the same as the "year of service" concept used for purposes of accrual of benefits. For example (as indicated above), in a particular industry it may be appropriate to advance a person one year on the vesting schedule if he has completed 1,000 hours of work during the plan year. However, that same plan may provide that a full year's worth of benefits will accrue only if the employee completes 1,600 hours of service during the plan year. In such a case, completion of 1,200 hours would provide an accrual of .75 of a year's benefits, 1,000 hours would provide accrual of .625 of a year's benefits, 800 hours would provide accrual of .5 of a year's benefits.

Permitted forfeitures of vested rights.—A qualified retirement plan under the committee bill may provide that an employee's vested rights in accrued benefits derived from employer contributions (but not from his own contributions) may be forfeited in the event of the employee's death (although this exception is not to apply if the employee had retired or could have retired and a "joint and survivor" annuity was to be provided).

[59] Also, a plan is permitted to suspend payment of benefits while the participant is working for the employer (for example, where an early retiree returns to work to increase his subsequent pension benefits). In the case of a multiemployer plan, the benefits may be suspended if the employee has resumed employment in the same industry even though not with the same employer. These rules are not to prevent suspension of part of an early retirement supplement (such as a so-called social security supplement) on account of reemployment, even with another employer or in another industry.

In addition, the bill provides for circumstances under which a retroactive plan amendment, if approved for this purpose by the Secretary of Labor, may be permitted to divest accrued benefits that had already become nonforfeitable. In order to be approved by the Secretary of Labor, such a retroactive amendment which divests what were otherwise nonforfeitable benefits, must have been initiated by the Secretary of Labor or proposed by the plan administrator and the Secretary of Labor must be satisfied that the administrator has given adequate notice to all plan participants and other interested persons. The Secretary of Labor must then give those interested persons an opportunity to be heard and must notify the Secretary of the Treasury of any such hearing. Further, the Secretary of Labor may approve such a divesting retroactive amendment only if he finds that (1) the amendment affects the plan only to such an extent as is necessary or appropriate to carry out the purposes of this pension bill and to provide adequate protection to the participants and beneficiaries, (2) but for the amendment, there would be a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or the levels of employee compensation, and (3) failure to make the amendment would be adverse to the interests of plan participants in the aggregate. Your committee concluded that, when such conditions occurred and those procedural safeguards were followed, it was appropriate to permit these divestitures.

It is permissible for the employee's vested accrued benefits to be "cashed out" under specified circumstances. On termination of a plan, if the value of the nonforfeitable benefit is less than $1,750, then the benefit may be cashed out by a lump-sum distribution whether or not the employee agrees to receive the distribution (but only if the plan permits such a distribution without regard to the employee's preferences). If the employee agrees to the cashing out of his nonforfeitable benefit then, whether or not the amount is less than $1,750, the benefit may be cashed out if the distribution was made on termination of the employee's participation in the plan or under such other circumstances as may be provided by Treasury regulations. Such a nontermination cashing out of accrued benefit might be permitted, for example, on the occasion of a revision of the formula for computation of accrued benefits under the plan. It must be noted that the rule described above permits the cashing out of vested accrued benefits, but the service to which those benefits relate nevertheless must continue to be taken into account, in accordance with the rules described above (service that is seasonal, intermittent, etc.) for purposes of determining whether the employee has met the service requirement for participation and for purposes of determining the employee's place on the vesting schedule

[60] with regard to benefits that accrue in the future. Also in cases where the employee's accrued benefit is not cashed out when the employee leaves the employer's service, if the employee is later reemployed, his percentage of vesting in the benefit which accrued before the service break may be increased on account of service which occurs after the break.

With the limited exceptions noted above, no rights, once they are required to be vested, may be lost by the employee under any circumstances (although, as under present law, the plan may pay the employee the actuarial value of his vested rights upon separation from service). For example, a vested benefit is not to be forfeited because the employee later went to work for a competitor, or in some other way was considered "disloyal" to the employer.[8] Also, rights to benefits are not to be forfeited merely because the employer (or plan administrator) cannot find the employee.

Accrued benefits.—Under the committee bill, the vested employee is protected in his rights to all, or a certain percentage, of his "accrued benefit." It is necessary to provide a statutory definition of an "accrued benefit" because, unless this is a defined amount, vesting of an "accrued benefit" in whatever form is specified by the plan has little, if any, meaning. In the case of any retirement plan other than a defined benefit pension plan, under the bill the employee's "accrued benefit" is the balance in his plan account.[9] This would include, for example, a money purchase pension plan, a profit-sharing plan and a stock-bonus plan.

In the case of a defined benefit plan the bill provides that the accrued benefit is to be determined under the plan, subject to certain requirements. The term "accrued benefit" refers to pension or retirement benefits and is not intended to apply to certain ancillary benefits, such as medical insurance or life insurance, which are sometimes provided for employees in conjunction with a pension plan, and are sometimes provided separately. To require the vesting of these ancillary benefits would seriously complicate the administration and increase the cost of plans whose primary function is to provide retirement income. Also, where the employee moves from one employer to another, the ancillary benefits (which are usually on a contingency basis) would often be provided by the new employer, whereas the new employer normally would not provide pension benefits based on service with the old employer. Also, the accrued benefit to which the vesting rules apply is not to include such items as the value of the right to receive benefits commencing at an age before normal retirement age, or so-called social security supplements which are commonly paid in the case of early retirement but then cease when the retiree attains the age at which he becomes entitled to receive current social security benefits, or any value in a plan's joint and survivor annuity provisions to the extent that exceeds the value of what the participant would be entitled to receive under a single life annuity.

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[8] Some plans also provide that an employer may have lien rights against employee interest in a pension plan. These clauses would also be prohibited under the committee bill, except where the plan requires that the employee be given prior notice of any impending lien and there is a judicial hearing on the probable validity of the employer's claim.

[9] Separate accounting for each employee is required under the committee bill in the case of contributions to a defined contribution plan and for voluntary employee contributions to a defined benefit plan.

[61] Generally, an individual's "accrued benefit" under a defined benefit plan is to be expressed in the form of an annual benefit commencing at normal retirement age. Normal retirement age is the age specified in the plan, which may not be later than age 65 (or, if later, the 10th anniversary of the time the participant commenced participation in the plan).

To encourage older employees to remain on the job, many plans provide for a faster rate of benefit accrual in the employee's later years; thus, an employee might accrue a benefit equal to 1.5 percent of compensation for each year of service until age 55, and 2 percent per year thereafter. This technique is known as "back loading".

The committee believes that it is desirable to allow plans to continue to offer a reasonable amount of back loading as an incentive to its older employees. At the same time, it is obviously necessary to put some limits on this device; otherwise a plan which wishes to evade the vesting requirements could provide for de minimis accruals until an employee's last years of employment, at which point very large accruals would be provided. The committee bill takes account of both these factors by providing, in general, that the plan may not provide back loaded accruals which are more than one and one-third times the rate of accruals for prior years. For purposes of this test, the "rate" of accrual may be either a dollar or percentage rate.

This 133⅓ percent standard may be used only by plans which continue to accrue benefits during participation at least until the participant is eligible to retire (at early retirement age or normal retirement age) with actuarially unreduce benefits. "Front loading" must be kept within the same 133⅓ percent limits, except that a plan is permitted to provide a greater degree of front loading during the employee's first 10 years of service. For years of service after the participant is eligible to retire with unreduced benefits, however, the plan may discontinue benefit accrual, or may provide for front loaded or back loaded benefit accruals with respect to those years. Of course, benefits payable at a particular age will not be considered to be actuarially unreduced on account of age or service if the value of the benefits payable at that age is less than the actuarial value of benefits payable at any subsequent age.

A plan will not fail to meet the back loading requirements merely because a plan amendment (or scheduled benefit increase) increases the rate of benefit accrual for the current year or for future years under the plan, without providing past service credits. For example, if a plan provides a 1 percent rate of accrual for all participants for 1976, and a 2 percent rate of accrual for all participants for years after 1976, this would satisfy the test (subject only to the antidiscrimination requirements of the tax law) even though 2 percent is more than one and one-third times 1 percent.

For purposes of making the loading calculation, it will be assumed that social security benefits, cost of living adjustments, investment performance (where relevant), and all other relevant factors used to compute plan benefits will remain constant.

In order not to impose an undue cost burden on plans which provide for early retirement (for example "30 and out" plans) the committee bill makes clear that the fact that benefits under the plan may be payable to certain employees before normal retirement age may be disregarded.

[62] The 133⅓ percent rule is difficult to apply in the case of certain plans, such as flat benefit plans, which provide for the payment of a flat benefit after completion of a specified period of service. Thus, the committee bill provides an alternative accrued benefit standard that may be met in lieu of the 133⅓ percent rule discussed above. Under this standard, each participant must accrue, for each year of participation (as indicated above, the year of participation used in accruing benefits need not be computed in the same manner as is used for determining "year of service" for purposes of participation and for determining one's status on the vesting schedule), not less than 3 percent of the benefit to which he would be entitled if he participated in the plan for 33 and one-third years and served until age 65 (or any earlier normal retirement age under the plan). Of course, where a plan provides for a more rapid rate of accrual, this would satisfy the test. For example, a plan providing a flat benefit of $200 a month after 20 years of service (accruing benefits for each participant at a rate of 5 percent a year) would satisfy the test even though no additional benefits were accrued after 20 years of service.

Under the 3 percent approach, as under the 133⅓ percent test, early retirement benefits or social security supplements may generally be disregarded in determining if the 3-percent test has been met. Also, a plan amendment which increases the maximum benefit payable under the plan will not disqualify the plan if appropriate adjustments are made to the accrual schedule for years after the benefit increase becomes effective.

As in the case of the 133⅓ percent standard, under the 3-percent test the level of social security benefits and other relevant factors are to be treated as remaining constant. Where compensation is relevant in determining the maximum benefit, the maximum benefit is to be computed as though the employee continued to earn compensation at the same rate that is relevant under the plan. In other words, if the plan provides benefits based on high 3-year average compensation, then that average compensation based on the facts as they exist at the time the accrual is to be made, is to be assumed to continue until age 65 (or earlier normal retirement age). However, in no event is compensation to be taken into account for a period of more than 10 consecutive years.

In order to make clear that rate of accrual rules are not to be manipulated in order to achieve discrimination in favor of employees who are officers, shareholders, or highly compensated, the bill specifies (in the rules for coordination of the vesting standards with the antidiscrimination standards, below) that the Internal Revenue Service is to take account of rates of accruals as well as vesting schedules in determining whether there is prohibited discrimination.

Changes in vesting schedule.—Under the bill, if a plan is amended in a manner which changes its vesting schedule, each person who is a participant in the plan on the date the amendment is adopted (or is a participant in the plan on the amendment's effective date) is to continue to vest his accrued benefits at no less than the rate at which those benefits had been scheduled to be vested under the preamendment vesting schedule. This is to apply both to accrued benefits from preamendment service and to subsequent accrued benefits, and is to apply whether or not the participant had any vested benefits at the time of the amendment. The application of this rule may be illustrated by the

[63] following example: Suppose that A is a participant in a plan which follows the minimum requirements of the graded vesting schedule and that A has completed 4 years of service on the amendment date. The amendment provides that the plan is to vest under the minimum requirements of the 10-year 100-percent vesting schedule. Under this rule, at the end of A's next (fifth) year of service, he is to be 25 percent vested in his accrued benefits, as he would have been had the amended vesting schedule not been adopted. This vesting percentage is to be increased by 5 percentage points for each of the next 5 years, as under the minimum requirements of the graded vesting schedule. However, at the end of the tenth year of service, A's vesting percentage becomes 100 percent, because that is the higher rate provided under the new vesting schedule. The same vesting percentages would apply in each of the years if the amendment had been to change the vesting schedule in the opposite manner (i.e., from 10-year 100-percent vesting to graded vesting).

Allocations between employer and employee contributions.—In plans where there are both employer and employee contributions, it will be necessary to allocate the accrued benefit between the portion derived from the employer contributions, and the portion derived from the employee contributions. This allocation may have to be made because the employee is always fully vested with respect to amounts attributable to his own contributions but not necessarily with respect to those of the employer. Also, information of this type would be needed if an employee, upon leaving employment, desires to withdraw his own contributions.

In the case of any plan other than a defined benefit pension plan, the accrued benefit derived from the employee's contributions under the bill is the amount in his own separate account. If employee and em ployer contributions were not accounted for separately, the employee-contributed portion of the total accrued benefit would be treated as the fraction of the total which is the ratio of employee contributions to total contributions (after taking account of withdrawals).

In the case of a defined benefit pension plan which provides an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), the accrued benefit derived from mandatory employee contributions (which could never be in excess of his total accrued benefit under the plan) would be treated as the total amount of the employee's "accumulated contributions" multiplied by a conversion factor.[10] In general, the conversion factor, which initially is to be fixed at 10 percent for a normal retirement age of 65, is to be used to convert the amount of the accumulated contributions to a single life annuity commencing at normal retirement age. For other normal retirement ages, the conversion factor is to be determined by regulations.

In determining the employee's accumulated contributions, under the bill, interest on the employee's mandatory contributions is to be compounded annually, initially at a rate of 5 percent (beginning with the first plan year subject to the vesting requirements imposed under the committee bill) to the date when the employee would reach normal

[10] Voluntary employee contributions are to be treated the same as a separate account.

[64] retirement age. In addition, any interest accumulated on the employee's contributions (either compounded or simple) in accordance with the terms of the plan, prior to the date when the vesting provisions of the bill first apply to that plan, are to be treated as part of the employee's accumulated contributions. For purposes of this rule, an employee's mandatory contributions include any contributions made to the plan by the employee as a condition of employment, or of participation in the plan, or of obtaining benefits under the plan which are attributable to employer contributions.

The bill authorizes the Secretary or his delegate to adjust the conversion factor, and the assumed rate of interest on employee contributions, on a prospective basis, from time to time, as may be appropriate, but requires him to give at least one year's notice of any such action. The adjustment in the interest rate would be made by comparing the long-term money rates and investment yields for a 10-year period ending at least 12 months prior to the year in which the adjustment would first apply, with the corresponding rates and yield for the 10-year period from 1964 through 1973.[11]

The committee anticipates that the Treasury, in determining money rates and investment yields, will use a composite of a number of indicators. For example, one possible approach might be to give equal values to the dividend yields of the Dow-Jones Industrial Average and the Standard and Poor's 500-Stock Average, and to the interest rates of Barron's or Moody's highest-rated bonds and United States Treasury long-term obligations. This composite, for the 1964–1973 base period, would be set at 5, and the interest rate in the future would be determined by the Treasury Department's comparison of this composite for the base period, with the same composite for the then most recent 10-year period. It is contemplated that this interest rate will be adjusted less often than annually, and that due regard will be given by the Treasury Department to the impact of any such adjustment on existing plans.

Discrimination.—Under present law, rapid vesting requirements are sometimes imposed on a plan in order to prevent discrimination. Your committee anticipates that the higher vesting standards provided in the bill will reduce the need to require faster vesting in order to achieve this purpose. On the other hand, there undoubtedly still will be cases where it will be necessary to require that the plan provide vesting over and above that required under the bill to prevent discrimination under a plan in favor of officers, shareholders, and highly compensated employees. Under the committee bill, the Internal Revenue Service is to require more rapid vesting (such as by requiring a greater portion of the accrued benefit to become vested or by requiring the benefit to accrue faster in order to minimize the possible discriminatory effects of "back loading") if it appears that there had been, or is likely to be, forfeitures under the plan which have the effect of discriminating in

[11] To forestall the need for plan amendments, the committee anticipates that a plan could satisfy the requirements of these provisions if it provided that interest on mandatory employee contributions would be computed at a rate of 5-percent, or at such other rate as may be required from time to time under the Internal Revenue Code of 1954, and the regulations issued thereunder.

[65] favor of the officers, etc. For example, in a profit-sharing plan, such forfeitures could directly benefit the proscribed class of individuals. But in a defined benefit plan there could also be discrimination by reducing the cost to the employer of providing a disproportionate amount of benefits for executives. In other words, if most highly paid employees remain (or are likely to remain) on the job, while other employees tend to leave, the Internal Revenue Service could find a pattern of discrimination (whether or not it was the result of a deliberate policy of dismissing employees in order to prevent vesting) and could require more rapid vesting (for example, by adjusting the vesting schedule, the accrual rate, or both).

Also, present law is designed to ensure that in the event of early plan termination, the benefits under the plan are not paid to employees who are officers, shareholders, or highly compensated employees in a discriminatory manner. The committee bill contains a provision to make it clear that the vesting requirements under the bill are not intended to operate to overturn these rules. Thus, for example, in the event of an early plan termination, a highly compensated employee might receive less than his otherwise vested benefit under the bill, if this were necessary to prevent discrimination.

Plan termination.—Under present law, all accrued benefits in a qualified pension plan must become fully vested (to the extent then funded) in the event of a termination, or the complete discontinuance of contributions under a pension plan. This rule will no longer be necessary with respect to discontinued contributions, because the committee bill (sec. 1013) now provides for an excise tax on underfunding. Employers whose plans are subject to the funding requirements of the committee bill cannot terminate their plans merely by discontinuing contributions, since the employers continue to remain liable for the required contribution.[12] However, the committee bill makes clear that this rule of full immediate vesting is still to apply in the case of a termination, or a partial termination. (Examples of a partial termination might include, under certain circumstances, a large reduction in the work force, or a sizable reduction in benefits under the plan.) Moreover, even after the plan has terminated, the employer is still under an obligation to pay the required funding of the plan through the date of termination and these make-up amounts (if any) are to be taken into account in determining the accrued liabilities which may become vested upon termination.[13]

Class year plans.—A class year plan is a profit-sharing or stock bonus plan which provides for the separate vesting of employee rights to contributions (or rights derived from contributions) to a plan on a year-by-year basis and the withdrawal of these amounts on a class-by-class basis as they mature. The minimum vesting requirements of the bill applicable to a class year plan are satisfied under the bill if the plan provides for 100-percent vesting of the benefits derived from employer contributions within 5 years after the end of the plan year

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[12] Plans which are not subject to the funding requirements (e.g., profit-sharing plans, church plans, and government plans) can be required to provide vesting of employee benefits (to the extent funded) if contributions are completely discontinued.

[13] In the case of a multiemployer plan the Secretary or his delegate may provide by regulations for the situation where all the employers of the terminated plan did not contribute at the same rate or on the same basis.

[66] for which the contributions were made. A separate rule is needed for class year plans since they are structured differently than most other types of plans. The 5-year full vesting rule provided in this case by the committee bill assures an employee who terminates his employment under a class year plan that he will not forfeit his rights to more than 4 years of employer contributions.

Recordkeeping requirements.—To carry out the intent of the vesting provisions (primarily those involving intermittent employment), the employer would be required to keep records of the years of service of his employees and the percentage of vesting which the employees had earned, together with any additional information required by the Secretary or his delegate in order to determine the employee's benefits. In the case of a multiemployer plan, the employer would furnish the required information to the plan administrator (who would be required to maintain the records), in accordance with regulations.

Failure to maintain or furnish the required records would result in a civil penalty of $10 for each employee with respect to whom the failure occurs, unless it is shown that the failure is due to reasonable cause. The committee expects that the necessary records will be retained by employers for at least 10 years following a break in service. After that, the employee could still establish his right to vesting based on prior service, but the burden of producing the evidence would shift to the employee.

In addition, the Social Security Administration is to be informed, in a time and manner to be prescribed under regulations, when an employee terminates his service prior to retirement with vested benefits.[14] This information, in turn, will be supplied to plan participants and beneficiaries upon request, and when the individual applies for social security benefits. This provision should minimize the danger that vested rights may be lost because a participant is unaware that he is entitled to receive a pension. (Regulations will provide for the situations where adequate records are not available for periods before the effective date of bill.)

Under the bill, the "plan administrator" would generally be the person so designated under the plan or, if there were no designation, the employer or organization who maintained the plan.

Variations.—In the case of a multiemployer plan, the bill (in sec. 1015) permits the Secretary of Labor to prescribe an alternate method (often referred to as a "variance") of satisfying the vesting schedules and accrued benefit requirements with respect to benefits attributable to employer contributions, if it is established to his satisfaction that rigid application of the requirements of the bill would increase the costs of the plan to such an extent that there was a substantial risk that the plan would be terminated, or there would be a substantial reduction in the benefits under the plan, or in the compensation of the employees. Such a variance could also be granted to prevent an undue administrative burden in connection with the plan.

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[14] In the case of a multiemployer plan, the information would generally be furnished only when the employee left the plan; there would be no need to notify the Social Security Administration merely because the participant changed employers. Also, because of the large "turnover" rate in multiemployer plans, your committee contemplates that the regulations will provide that in the case of a multiemployer plan, no reporting is required for a reasonable period of, say, 2 years after the employee has last performed service under the plan.

[67] The rules for such variances (which may be considered by the Secretary of Labor either on his own motion or on petition by the plan administrator, and only with appropriate notice and hearing safeguards) are described in detail below (in the funding portion of this general explanation).

Joint and survivor annuities.—Under present law, there is no requirement that a qualified employee plan must provide for survivor annuities. This can result in a hardship where an individual primarily dependent on his pension as a source of retirement income is unable to make adequate provision for his spouse's retirement years should he predecease her. To correct this situation, the committee's bill requires that if a plan provides for a lifetime annuity then, where the participant has been married for the 5-year period ending on the annuity starting date, the plan must provide for a joint and survivor annuity (or an arrangement, such as supplementary benefits for the participant's spouse, which has essentially the same effect) where the survivor annuity is at least half of the annuity payable to the participant during the joint lives of the participant and his spouse.

The plan is not required to provide this benefit unless the employee has been married throughout the 5-year period ending on the annuity starting date. This has been done so that plans can provide reasonable protection against adverse selection such as might occur, for example, where a single person "marries" immediately before retirement, retires, and then chooses to take heavily subsidized joint and survivor benefits in the form of a lump-sum distribution. Although your committee's bill does not require joint and survivor benefits to be subsidized (i.e, to be in excess of the actuarial value of a single-life annuity), neither does your committee wish to provide a disincentive to such subsidized benefits.

In addition, concern was expressed that if an employee could provide such protection for his spouse only if he had already retired, then this would provide an unwarranted artificial incentive to exercise early retirement rights where available. Your committee concluded that it was preferable not to provide an artificial stimulus to exercise of these rights (or an added cost to the providing of these rights) of the sort that would result from requiring a survivor annuity to be paid only when the basic annuity was already in pay status. As a result, the bill requires the survivor annuity to be payable if the participant after reaching the earliest age at which retirement is permitted (whether or not retired), where the participant and his spouse have been married throughout the 5-year period ending on the date of the participant's death. This is to be applied on a person-by-person basis. Thus, if a plan permits retirement as early as age 50 with 30 years of service, but otherwise retirement benefits are to be payable only upon attaining age 65, the earliest retirement age for an employee who began work at 25 would be age 55.

The plan may provide that the participant has a reasonable period (as prescribed in regulations) before the annuity starting date during which he may elect in writing—after having received a written explanation of the terms and conditions of the joint and survivor annuity and the effect of such an election—not to take the joint and survivor

[68] annuity. The bill permits a plan to protect against adverse selection by providing that any election to take a single-life annuity (instead of a joint and survivor annuity) or any revocation of such an election would not become effective if the participant dies within some period of time (not in excess of 2 years) of such election or revocation. The plan would be permitted in such a case to disregard the election or revocation. This formulation of the bill's requirements provides flexibility in that it does not require the plan to provide any such rule as to delayed effect if those in control of the plan choose not to do so. The bill does not require the plan to "subsidize" the joint and survivor annuity. Consequently, such a joint and survivor annuity could be less (in terms of dollars per annuity payment) than the single life annuity. Also, the bill does not forbid plans from making reasonable actuarial adjustments to take appropriate account of the possibility that otherwise total costs would be increased because of adverse selection.

The joint and survivor annuity requirements are to apply only to plans to which the new vesting requirements of this bill are applicable. In other words, the joint and survivor rules would not apply to government plans, they would not apply to church plans unless an election had been made to come under the new rules, and the effective date in the case of existing plans would be delayed to the same extent that the effective date is delayed generally with regard to the new vesting provisions. Of course, the plans not subject to these provisions (or to which the new provisions would not apply for some years into the future) may offer joint and survivor options if they wish to do so. The mandatory provisions of the bill will not apply unless that participant's annuity starting date is on or after the effective date with regard to that plan and would not apply unless that participant was an active participant in the plan on or after that effective date.

Plan mergers.—The committee bill contains a provision (sec. 1021) to ensure that the rights of participants are fully protected in the event of plan mergers. Under this provision, which applies to any plan merger occurring after October 22, 1973, each participant must be entitled to receive a benefit immediately after the merger (determined as if the plan then terminated) which has not less than the value of the benefit he would have been entitled to receive immediately before the merger (determined as if the plan then terminated. Moreover, the funding of his accrued benefit must be at least as adequate after the merger as it was before the merger. Without such a provision, the committee was concerned that the rights of plan participants might be diluted in some instances, as the result of plan mergers. As a further safeguard, the bill requires that in the case of any plan merger which occurs after enactment, the plan administrator must give 30 days notice to the Internal Revenue Service, including an actuarial statement indicating that the requirements of the bill have been met.

Alienation.—To further ensure that the employee's accured benefits are actually available for retirement purposes, the committee bill also contains a provision requiring the plan to provide that benefits may not be assigned or alienated. (Of course, this provision is not intended to prevent the transfer of benefit rights from one qualified plan to another.)

[69] Nevertheless, a plan will be permitted to provide for voluntary and revocable assignments (not to exceed 10 percent of any benefit payment).

This provision is not intended to interfere with the current practice in many plans of using vested benefits as collateral for reasonable loans from the plans, where the "prohibited transactions" provisions of present law (sec. 503 of the Code) and other fiduciary requirements are not violated.

Benefits of terminated participants.—Protection is given to retired individuals and individuals who are separated from the service of the employer against reductions in private plan benefits when social security benefit levels increase. In general, under present integration procedures, social security benefits attributable to employer contributions are treated as though they were part of the private plan. As a result when the level of social security benefits increases, some integrated plans have reduced the amount of the retirement benefits that they provide for covered employees.

Present law under administrative practice provides that qualified plans may not use increases in social security benefit levels to reduce the benefits that they pay where the employees concerned are retired and already receiving integrated plan benefits. The bill codifies this treatment for retired persons. It also extends the prohibition against reducing plan benefits where social security benefit levels are increased to cases where the individuals concerned are separated from service prior to retirement and have deferred nonforfeitable rights to plan benefits. This provision is effective for increases in social security benefits which take place after the date of enactment or on the date of the first receipt of plan benefits or the date of separation from service (whichever is applicable) if that date is later.

These changes do not affect the ability of plans to use the integration procedures to reduce the benefits that they pay to individuals who are currently covered when social security benefits are liberalized. Your committee, however, believes that such practices raise important issues. On the one hand, the objective of the Congress in increasing social security benefits might be considered to be frustrated to the extent that individuals with low and moderate incomes have their private retirement benefits reduced as a result of the integration procedures. On the other hand, your committee is very much aware that many present plans are fully or partly integrated and that elimination of the integration procedures could substantially increase the cost of financing private plans. Employees, as a whole, might be injured rather than aided if such cost increases resulted in slowing down the growth or perhaps even eliminated private retirement plans.

In view of the serious issues involved in the integration of private plans with the social security system, your committee believes that it is desirable to postpone action on this issue pending further study of this problem. More specifically, your committee plans to consider this overall problem again at the earliest opportunity, possibly in connection with future tax reform or social security legislation. However, your committee believes that no further integration of social security and pension benefits should be allowed under any further regulations issued by the Secretary or his delegate at least until June 30, 1975.

[70] *Payment of benefits.*—To ensure that a participant can reasonably expect to receive his benefits during his retirement years, the committee bill requires a qualified plan (to which the basic vesting provisions apply) to commence payment of benefits to the participant (unless he elects otherwise in writing and this election is permitted by the incidental death benefits rule) not later than the 60th day after the close of the plan year in which the latest of these events occurs: (1) the participant attains age 65; (2) the 10th anniversary of the time the participant commenced participation in the plan; or (3) the participant terminates his service with the employer. This requirement is set in terms of the end of a plan year, rather than the date on which the event occurs, in order not to disrupt unduly the administrative practice of plans that begin retirement benefits for all new retirees on the same date. The second of the above alternatives (the 10th anniversary of commencement of service) is designed to permit a defined benefit plan to have an adequate period of time in which to fund the benefit for a person who first enters the plan at a relatively late age. The third of the above alternatives (termination of service) has been added in recognition of the fact that these benefits are designed primarily to provide for the participant's retirement.

Effect of withdrawal of employee contributions.—At the present time, many employee plans require employees to make contributions in order to receive employer contributions (or benefits to be funded by the employer). Some such plans permit employees to withdraw their contributions (or the benefits derived from their contributions) but impose as a "penalty" for such withdrawal the forfeiture of some or all of the benefits derived from employer contributions. Where this occurs, the effect is to reduce the retirement protection afforded to the employee. Your committee is not at this point expressing a view as to whether employee contributions or the right to withdraw those contributions are desirable features of retirement plans. However, it does not appear appropriate to provide for forfeitures derived from employer contributions merely because of a withdrawal by the employee. Accordingly, the committee bill specifically requires all qualified plans to forbid forfeitures of nonforfeitable benefits derived from employer contributions solely because of withdrawals by employees of any parts of the benefits derived from the employees' contributions.

This limitation is to apply only to plans to which the new vesting provisions of the bill apply.

Comparability of plans having different vesting provisions under the antidiscrimination rules.—There are certain classes of employees, such as engineers, whose rate of job mobility is so high, that many of them would not receive protection even under the vesting provisions provided under the bill. To be effectively covered under a pension plan, these employees would have to receive a very substantial amount of vesting during their first 5 years of employment. At the same time, if all employees were to be provided with vesting on this rapid a basis under the plan, the cost might be so high that the employer would terminate the plan, or drastically reduce the benefits under the plan. To meet this situation, the committee bill contains a provision which would allow the engineers and other employees with a similar problem, in effect, to trade off some of their benefits in exchange for earlier vesting.

[71] Under present law a single plan may satisfy the antidiscrimination requirements (sec. 401(a)(4)), if either the contributions or the benefits do not discriminate in favor of certain enumerated employees. Generally, profit-sharing plans, stock bonus plans, and money purchase plans can satisfy this requirement if the contributions are nondiscriminatory even though the benefits may discriminate. Defined benefit plans can satisfy this requirement if benefits are nondiscriminatory even though the contributions are discriminatory. A target benefit plan, a type of money purchase plan, may satisfy the requirement if the anticipated benefits do not discriminate even though the contributions do. (For this purpose actual investment experience is not considered.) Also under existing law, two plans can be considered as one for purposes of satisfying the antidiscrimination requirements, either as to contributions or benefits.

Under the committee bill an employer might set up two retirement plans, one with very rapid vesting, the other with slower vesting, but with higher benefits. The bill provides that for the purposes of applying the antidiscrimination rules, the two plans could be considered as a unit (as under present law) and the plan with more rapid vesting would not be considered discriminatory merely because of this feature (even if highly compensated employees were covered under the plan), if contributions were comparable or (in the case of defined benefit plans) if benefits under this plan were scaled down appropriately in relation to benefits provided under the plan with less rapid vesting. (Of course, each plan would have to at least meet the minimum vesting schedule provided in the committee bill and would also have to be nondiscriminatory as to the employees covered by it.)

Thus, in the case of a defined contribution plan, the tax deductible contributions to both plans would be required to be the same in proportion to covered compensation. This would mean, in effect, that employees in the plan with less rapid vesting would receive increased benefits as the result of forfeitures,[15] whereas there would be relatively few forfeitures under the plan with earlier vesting.

In the case of a defined benefit plan, the same principle of comparability would apply, but here the level of benefits under the plan with earlier vesting would have to be lower, in relation to the benefits provided under the other plan. Generally, these comparisons would be made on an actuarial basis, in accordance with regulations.

By this provision the committee is clarifying this matter for the future. It intends that prior law on this point be determined as if this provision had not been enacted.

Protection of pension rights under government contracts.—Many employees, such as engineers, who are employed in industries engaged to a substantial extent in the performance of Federal contracts, have an unusually high rate of mobility which results to a considerable extent from terminations or modifications of Federal contracts, grants, or procurement policies. As a result of this unusual mobility, these employees are particularly susceptible to the loss of their pension rights due to changes in their employment status before they can become vested.

[15] If the employer reduced his tax deductible contributions under the plan because of forfeitures, the tax deductible contributions to the plan with early vesting would also have to be reduced; comparatively, the employees in the plan with less rapid vesting would always have to accumulate larger benefits in proportion to compensation.

[72] To meet this situation, the bill directs the Secretary of Labor to undertake a study, in consultation with professional societies, business and labor organizations, and other Federal agencies, of steps to be taken to ensure that professional, scientific, technical, and other personnel employed under Federal contracts are protected against loss of their pensions resulting from job transfers or loss of employment. The Secretary of Labor is to report to Congress on this subject within 2 years after the date of enactment and shall, if feasible, develop recommendations for Federal procurement regulations to safeguard pension rights in this situation within one year after filing his report. These regulations are to become effective unless either House of Congress adopts a resolution of disapproval within 90 days after the proposed regulations are submitted to the Congress by the Secretary of Labor. Of course, individual government agencies would be free to take action to protect the rights of workers employed under agency contracts, even if no comprehensive regulations, applicable on a government-wide basis, could be developed.

Church and government plans, and union-sponsored plans.—Church and government plans (described above under participation and coverage) are exempt from the vesting provisions of the bill but must comply with the requirements of present law in this area (as in effect on the day before enactment) in order to be qualified. Church plans may elect to come under the provisions of the bill and, once made, such an election will be irrevocable.

The committee bill also exempts from the vesting requirements plans which do not, at any time after enactment, provide for employer contributions—in other words, union-sponsored plans. Since these plans are, in effect, controlled by the employees for whose benefit they are established, there is no need to impose the vesting requirements of the bill. However, if the plan provides for employer contributions, the mere fact that no such contributions are made (either because the plan is fully funded, or because the employer fails to comply with the funding requirements of the bill, or for some other reason), will not result in an exemption for the plan from the vesting requirement.

Effective dates

These provisions apply generally to plan years beginning after the date of enactment of the bill. Later effective dates (which may vary from 1976 to 1981, depending on the circumstances of the plan) are provided in the case of plans in existence on January 1, 1974, in order to afford such plans adequate opportunity to adopt any amendments needed in order to conform to the new requirements resulting from this bill. The effective date provisions are described more fully above, in the discussion of participation and coverage requirements.

Revenue effect

Estimates of the revenue effect of the minimum vesting provisions vary with the assumption made about the relationship between additional employer contributions to pension plans and cash wages. If it is assumed that the additional employer contributions will be a substitute for cash wages, the estimated revenue loss is $130 million. On the other hand, if it is assumed that the additional employer contributions will be an addition to cash wages, the estimated revenue loss

[73] $265 million. The estimates under both cases assume that benefits under pension plans are not decreased and that no benefit increases are foregone as a result of the bill. The estimates are based on 1973 levels of income and employment.

C. Funding

(Secs. 1013, 1033 of the bill and secs. 404, 412, 4971, 6059, 6692, 7517 of the Code)

Present law

Under present tax law, contributions to a qualified pension plan generally must be sufficient to pay the liabilities created currently (*i.e.*, the normal pension costs) plus the interest due on unfunded accrued pension liabilities (past service costs) (regs. § 1.401–6(c)(2)(ii)).[1] This tends to keep the amount of unfunded pension liabilities from growing larger, but does not require any contributions to be made to amortize the principal amount of the unfunded liabilities.

Pension plan liabilities[2] generally are estimates and are based on actuarial calculations. Consequently, all actuarial methods, factors, and assumptions used must, taken together, be reasonable and appropriate in the individual employer's situation (Regs. § 1.404(a)–3(b)). When applying for a determination letter from the Internal Revenue Service that a plan is qualified, the actuarial methods, factors, and assumptions used generally must be reported to the Service, along with other information to permit verification of the reasonableness of the actuarial methods used. Changes in actuarial assumptions and methods must be reported annually to the Service.

Actual experience may turn out to be different from anticipated experience, changing the estimated pension liabilities (and needed contributions) and resulting in experience loss or experience gain. Depending on the circumstances, the contributions needed to make up experience losses may be deducted currently or may be added to past service costs and deducted only on an amortized basis.[3] Similarly, depending on the circumstances, experience gains may reduce the plan cost currently or reduce costs under one of the spreading methods used to determine the amounts deductible.[4]

The value of plan assets also affects the amount of contributions. Under administrative rulings, assets may be valued by using any valuation basis if it is consistently followed and results in costs that are reasonable.

If an employer does not make the minimum required contributions to a qualified plan, under administrative practice the deficiency may be added to unfunded past service costs. However, the plan also may be considered terminated, and immediate vesting of the employees' rights, to the extent funded, may be required.

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[1] This requirement applies only to pension and not to profit-sharing or stock bonus plans.

[2] In determining liabilities, an employer must take into account factors such as the basis on which benefits are computed, expected mortality, interest, employee turnover, and changes in compensation levels.

[3] Under the "10-percent" deduction limit (sec. 404(a)(1)(C) of the Code), if the experience loss occurs using the same assumptions as previously, the additional contributions, subject to certain restrictions, may be deducted currently. If the deficit results from a loss in asset values or revaluation of liabilities using more conservative assumptions the deficit may be added to past service cost. Rev. Rul. 57–550, 1957–2 C.B. 266.

[74] *General reasons for change*

Significant tax benefits are allowed under the Internal Revenue Code for plans that provide for employee retirement. Implicit in these tax benefits is the requirement that tax qualified plans will in fact provide the retirement benefits promised. However, the available evidence has demonstrated that a significant portion of existing tax qualified pension plans have not been adequately funded and are not accumulating sufficient assets to pay benefits in the future to cover employees. As a result, many employees now covered by tax qualified pension plans may not actually receive the pensions they have been promised, because the needed funds will not be available. Your committee believes that the present minimum funding requirement for plans qualified under the Internal Revenue Code is not adequate to prevent this underfunding, since it does not require any payment to reduce the amount of the outstanding unfunded liabilities, which may be substantial. As a result, your committee's bill provides new minimum funding standards.

Under the bill, normal costs of covered plans are to be currently funded. Additionally, newly-established unfunded past service liabilities of covered plans generally are to be amortized over no more than 30 years, although existing past service liabilities generally are to be amortized over no more than 40 years. In addition, experience deficiencies generally are to be amortized over no more than 15 years. (Generally, longer periods are to be allowed for multiemployer plans.) Alternatively, if funding requirements are higher under a second general standard which is based on accrued vested liabilities, this standard is to apply in lieu of the rules set forth above. Under this standard, accrued vested liabilities are determined, as also are the value of the plan's assets. To the extent the vested liabilities exceed the value of assets, the first year's payment under a 20 year amortization schedule (principal and interest) of unfunded vested liabilities is to be paid in the current year. A new determination with respect to the applicability of this second general standard is to be made in each of the succeeding years, starting with a new 20 year period. Of course, pension liabilities may be amortized at a faster rate than under the minimum required standard, if desired.

Your committee recognizes that the amount required to fund a pension plan is in large part determined by actuaries' estimates of future plan costs, which in turn are based on the actuarial methods and assumptions used for each plan. Consequently, the determination of the amount of contributions that must be made to a plan to adequately fund the plan benefits is significantly affected by the professional decisions of the plan's actuary. Since there is no existing government regulation or licensing requirement for actuaries as there is for, *e.g.*, lawyers and accountants, your committee believes that minimum standards of competence should be established for persons who make actuarial computations for qualified plans. Consequently, the bill requires the Secretary of the Treasury (in regulations that are also to be approved by the Secretary of Labor) to set standards of competence for persons who make actuarial reports to the Internal Revenue Service. The bill

[4] See Rev. Rul. 59-153, 1959-1 C.B. 89, discussing a pension plan using the "entry age normal method," where adjustment for gains is generally made by deducting the amount of gains arising in any year from the next year's deductible limit under sec. 404(a)(1)(C). See also Rev. Rul. 65-310, 1965-2, C.B. 145, discussing a plan using the "frozen initial liability method," where adjustments for gains are spread automatically as a part of current and future normal costs.

[75] also provides that actuaries enrolled to practice before the Service are to certify plan costs and report the actuarial methods and assumptions used for each pension plan. Your committee also contemplates that the Secretary will establish an actuarial advisory board to provide assistance in setting standards for enrolling actuaries, setting guidelines for actuarial assumptions and in other pertinent matters.

Additionally, your committee believes that the current sanctions on an employer for failure to adequately fund his qualified plan are inappropriate, since they may not affect an employer's decision to underfund his plan. For example, an employer may not feel any reason to make the minimum required contributions to his plan if the only consequence of underfunding is to give his employees vested rights in the amounts that are already funded. To resolve this problem, the bill provides an excise tax on the failure to meet the minimum funding requirements.

Your committee also recognizes that, within limits, employers who are financially unable to meet the funding requirements should be allowed to postpone paying contributions to their plans. Therefore, the bill allows the Internal Revenue Service to grant variances from certain minimum funding requirements if the employer demonstrates that substantial business hardship would otherwise result and that applying the minimum standard would be adverse to the interests of plan participants in the aggregate. The amount for which the variance is granted is to be amortized over no more than 15 years. The bill also provides that the Secretary of Labor may allow variances that would provide longer amortization periods for funding multiemployer plans if substantial business hardship would otherwise result. Additionally, in certain cases, the Secretary of Labor is to be able to prescribe alternative funding methods for multiemployer plans.

Explanation of provisions

Minimum funding rules, in general.—Your committee's bill establishes new minimum funding requirements for qualified plans so these plans will accumulate sufficient assets within a reasonable time to pay benefits to covered employees when they retire. Of course, contributions generally may be greater than these minimum requirements if the employer so desires (however, see discussion below under *Maximum deductions for plan contributions*). The new funding rules generally are to apply to any plan that, after the effective date of the funding provisions for the plan in question, has qualified (or has been determined by the Internal Revenue Service to qualify) under section 401(a), 404(a)(2) (employees' annuities plans), or 405(a) (bond purchase plans) of the Code. However, the new requirements generally are not to apply to profit-sharing or stock bonus plans, governmental plans, certain church plans, plans with no employer contributions, and certain insured plans. Once a plan or trust has been tax qualified, the minimum funding requirements will apply, and they are to continue to apply to the plan or trust, even if it later loses its qualified status. If a plan loses its qualified status, the deduction rules for nonqualified plans are to apply even though the minimum funding standard continues to apply to the plan.

Generally, under the new funding requirements the minimum amount that an employer is to contribute annually to a defined benefit pension plan includes the normal costs of the plan (as under current law), plus amortization of past service liabilities, experience losses,

[76] etc. The minimum amortization payments required by the bill are calculated on a level payment basis—including interest and principal—over stated periods of time. Generally, initial past service liabilities and past service liabilities arising under plan amendments are to be amortized over no more than 30 years (40 years for the unfunded past service liabilities on the effective date of these new funding rules, in the case of existing plans), and experience losses are to be amortized over no more than 15 years. However, generally experience gains and losses need not be calculated more often than every three years. With respect to multiemployer plans, past service liabilities generally may be amortized over no more than 40 years, and experience losses over no more than 20 years. However, an alternative funding standard, based on contributing a portion of the unfunded nonforfeitable liabilities under the plan, is to be used if it brings a higher level of funding in any year than would the basic minimum funding standard. This alternative standard is to apply both to multiemployer and other plans.

If an employer would otherwise incur substantial business hardship, and if application of the minimum funding requirements would be adverse to plan participants in the aggregate, the Internal Revenue Service may waive the requirement of current payment of part or all of a year's contributions of normal costs, and amounts needed to amortize past service liabilities and experience losses; the amount waived (plus interest) is to be amortized not less rapidly than ratably (including interest) over 15 years, and no more than 5 waivers may be granted for any 15 consecutive years. (As described subsequently other variances may be allowed by the Secretary of Labor for multiemployer plans.)

For money purchase pension plans, the minimum amount that an employer is to annually contribute to the plan is the amount that must be contributed for the year under the plan formula. For purposes of this rule, a plan (for example, a so-called Taft-Hartley plan) which provides an agreed level of benefits and a specified level of contributions during the contract period is not to be considered a money purchase plan if the employer or his representative participated in the determination of the benefits. On the other hand, a "target benefit plan" is to be treated as a money purchase plan for purposes of the minimum funding rules.

Under the new funding rules, generally each covered plan is to maintain a new account called a "funding standard account." This account is to aid both the taxpayer and Internal Revenue Service in administering the minimum funding rules. The account also is used to assure that a taxpayer who has funded more than the minimum amount required is properly credited for that excess and for the interest earned on the excess. Similarly, where a taxpayer has paid too little, the account is to assist in enforcing the minimum funding standard, and to assure that the taxpayer is charged with interest on the amount of underfunding.

Each year the funding standard account is to be charged with the liabilities which must be paid to meet the minimum funding standard. Also, each year the funding standard account is to be credited with contributions under the plan and with any other decrease in liabilities (such as amortized experience gains). If the plan meets the minimum funding requirements at the end of each year, the funding standard

[77] account will show a zero balance (or a positive balance, if the employer has contributed more than the minimum required). If the minimum contributions have not been made, the funding standard account will show a deficiency (called an "accumulated funding deficiency").

The funding rules established by the bill are in addition to the rules which provide the maximum deduction limits for contributions to a plan. However, generally a contribution that is required by the minimum funding rules is to be deductible currently. In addition, the rules governing the maximum deduction limitations are to be changed to make them more compatible with the minimum funding requirements.

Normal costs and initial past service liabilities.—Your committee's bill specifically continues the requirement of present law that the normal costs (arising from current liabilities) of a defined benefit pension plan must be currently funded. In addition, in order to give assurance that a plan will have sufficient assets to pay benefits, the bill establishes new minimum requirements for funding accrued past service liabilities. In general, the bill requires that an employer's contribution to a defined benefit pension plan for initial past service liabilities is to be sufficient to amortize these liabilities, on an accrued basis, over no more than 30 years from the date that the plan is established (40 years for multiemployer plans).

For a plan in existence on the date of enactment, unfunded past service liabilities existing as of the effective date of the new funding provisions applicable to the plan are to be treated as initial past service costs to come under the minimum funding rules and are to be amortized over no more than 40 years. This longer period will allow existing plans sufficient time to make the transition into the new funding rules. Since existing plans may have to be amended to meet the new vesting and participation requirements of the bill (and these amendments would affect plan costs), the 40-year amortization period is to be allowed for past service liabilities existing as of the plan year for which the bill becomes effective, including those liabilities arising from amendments made to meet the new vesting and participation requirements, even if those amendments are made retroactively after the effective date respecting the plan. However, the 40-year amortization is allowed only with respect to liabilities arising from retroactive amendments that are made by the time the employer must file his tax return for his taxable year in or with which the first plan year to which the new minimum funding requirements apply ends. In the cast of multiemployer plans, such retroactive amendments may be made within two years after the close of the first plan year to which the new minimum funding requirements apply.

The minimum funding requirement for past service liabilities in effect is analogous to payment over 30 years of a loan secured by a home mortgage. It requires contributions to the plan to be made not less rapidly than if made on a level payment basis over 30 years, with each payment including both interest and principal. For example, if the past service liability is $1,000,000 at the time a plan is established, the minimum level payment that is to be made each year, for 30 years, to meet the funding requirement (calculated at an interest rate of 6 percent per annum over the 30-year period) is $68,537 per year (assuming contributions are made at the beginning of each year). In addition, the employer would be required to contribute annually to the plan an amount equal to the normal cost of the plan.

[78] The interest rate to be used in calculating the minimum payments for amortization of initial past service liabilities is the same rate as that used in determining plan cost, at the time the plan is establised, or at the time the new funding requirements apply to the plan, in the case of plans in existence on the date of enactment. (Similarly, the interest rate used to amortize past service liabilities arising from amendments, to amortize experience losses, and to amortize contribution waivers also is the rate used to determine plan costs at the time the liability in question first arose.) If the interest rate used to determine plan costs is changed as of a later date in order to conform with experience, the initial amortization schedule of level payments is not to be changed, but the consequent increase (or decrease) in plan costs is to be amortized as an experience loss or gain (treated in the manner described below).

Under your committee's bill, the basic minimum funding rules—both those which apply to all past service liabilities and those which apply to normal costs—require funding on the basis of accrued, (that is, both vested and nonvested) liabilities, not merely on the basis of vested liabilities. The use of accrued liabilities for this purpose appears appropriate because it generally provides the most orderly and comprehensive method for funding the plan's entire liabilities. In this way, gradual payments will be made to fund all of a plan's present liabilities, including the presently nonvested accrued liabilities which are expected to vest in the future. Moreover, funding on the basis of accrued liabilities tends to produce somewhat more rapid funding, and as a result generally provides more protection to plan participants.

Generally, the 30-year amortization requirements initially add only moderately to an employer's funding cost under present law. This is true because under present law interest on unfunded accrued past service liabilities (which accounts for the bulk of the level amortization payments required under the bill in the early years) must be contributed to a qualified pension plan. Therefore, your committee believes that 30-year amortization will not hamper an employer in starting a new plan, or in adding plan amendments, that includes past service liabilities. Similarly, the 40-year amortization will not unduly increase present costs of an employer with an existing plan.

Plan amendments.—The bill provides that past service liabilities created by plan amendments are to be treated generally in the same way as initial past service liabilities of new plans for purposes of the minimum funding rules. Under the minimum funding rules these liabilities are to be amortized separately over a 30-year period (40 years for multiemployer plans) from the date the amendment is adopted even if this precedes the date on which benefits increase. For example, if the unfunded accrued past service liability added by an amendment is $100,000, the employer generally is to amortize this increase in past service liability in 30 annual payments of $6,854 (assuming an interest rate of 6 percent and that contributions are made at the beginning of each plan year).

Plan amendments which decrease past service liabilities (by decreasing plan benefits) are treated consistently with plan amendments increasing benefits; that is, decreases in past service liabilities from plan amendments are to be amortized over 30 years (40 years for multiemployer plans). Consequently, the minimum amortized annual payments to fund past service liabilities that must be contributed by an

[79] employer who decreases plan benefits generally will not be less, in any one year, than amortized payments required for an employer who started out with a plan providing the same (lower) benefits. (Of course, a decrease in benefits will often also decrease the normal cost which must be funded annually.)

Under the bill plan amendments may be made on a retroactive basis, to a limited extent, without the approval of the Secretary of Labor. In this case, plan amendments may be made after the close of a plan year and yet apply to that year if they are made within the time for filing the employer's return (including extensions) for the employer's taxable year with or within which that plan year ends. (Since a single employer's plan year is not a workable standard for multiemployer plans, with respect to multiemployer plans, an amendment may be made within two years after the close of the plan year.) It is expected that this provision may be used to decrease plan liabilities where an error has been made in calculating the amount of benefits that can be provided and funded under the minimum standard. However, amendments made under this provision are not to decrease accrued benefits of any participant determined as of the beginning of the first plan year to which the amendment applies.

This provision also may be used with respect to increases in plan liabilities. As discussed above, to the extent that past service liabilities are added by plan amendments that are effective as of the effective date of the new funding requirements for existing plans, and are made within the time allowed for retroactive amendment, these past service liabilities may be amortized over a 40-year period.

Your committee also recognizes that in certain cases where plan participants would otherwise suffer substantial adverse consequences, it may be appropriate for plan benefits to be retroactively reduced beyond the limit described above. Therefore, the bill provides that, on application of the plan administrator (or on motion of the Secretary of Labor) and after proper notice to all interested parties and a public hearing where interested parties are provided adequate opportunity to be heard, the Secretary of Labor may approve a retroactive decrease in plan benefits (whether or not nonforfeitable). However, before such approval is granted, the Secretary of Labor must make findings of fact that if the amendment is not approved, there would be a substantial risk that the plan would not be continued, a substantial risk of a curtailment of benefits (more than the curtailment that would occur with approval of the amendment), or a substantial risk that current levels of employee compensation would be substantially curtailed. Furthermore, the Secretary of Labor must find that failure to approve the amendment would be adverse to the interests of plan participants in the aggregate. Any amendment approved by the Secretary of Labor is to be retroactive only for such limited time period, and is to decrease benefits only to such extent, as is necessary or appropriate to carry out the purposes of the bill and as is necessary or appropriate to provide adequate protection to plan participants and beneficiaries

Your committee's bill provides that a retroactive decrease in benefits approved by the Secretary of Labor is not to eliminate a funding deficiency for purposes of the nondeductible 5 percent excise tax (discussed below). However, a reduction in benefits may be used to correct a funding deficiency for purposes of the 100 percent excise tax on underfunding (discussed below).

[80] *Experience losses and gains.*—During the course of a pension plan, actual plan experience may turn out to be poorer than anticipated. For example, the value of plan assets may turn out to be less than expected. Where this occurs, there generally will be an "experience loss" which must be funded if the plan is to be able to pay the benefits owed.[5] Since experience losses relate to previously established plan liability, they may indicate that the plan has become underfunded in relation to the required minimum for funding normal costs and past service liabilities. Consequently, your committee believes it is reasonable to require faster funding for these amounts than for newly established past service liabilities. The bill provides that under the minimum funding rules these losses are to be amortized (with level annual payments, including principal and interest) over not more than 15 years (20 years for multiemployer plans) from the date the loss is determined. Your committee believes that a 15-year amortization period generally will provide adequate funding of experience losses, while at the same time protecting employers from potentially severe financial burdens arising from experience losses created by uncontrollable events.

Your committee understands that the 15-year period, while protecting the financial security of plans, generally will not discourage pension plans such as "final average pay plans" which increase accrued benefits as pay increases, and thus are generally desirable from the employee's view. Additionally, it is believed that under the 15-year requirement employers will not be subject to unnecessary financial burdens where they have experience losses beyond their control.

A pension plan also may have experience gains during the course of its operation. These gains would occur because experience is more favorable than anticipated. For example, the value of plan assets may be greater than expected. The bill treats experience gains symmetrically with experience losses, so that gains are spread over 15 years (20 years for multiemployer plans) from the date they are determined.

The bill provides that changes in plan cost that result from changes in the Social Security Act (or other retirement benefits created by State or Federal law), from changes in the definition of wages under section 3121 of the Code, or from changes in the amount of such wages taken into account for purposes of section 401(a) (5) (relating to integration with Social Security, etc.) are treated as experience losses (or gains). It is expected that the actuarial assumptions for plans affected by social security, etc. now generally will allow for such changes since to a substantial extent these changes may be anticipated. In this circumstance, if changes in plan cost from changes in social security were not treated as experience gains to be amortized, employers with plans that did not properly allow for social security changes might be able to, upon increases in social security payments, substantially decrease current contributions and thereupon plan participants would receive correspondingly less protection.

[5] However, the bill provides that experience gains and losses are to be determined under the funding method used to determine costs under the plan. It is understood that some funding methods, such as the "aggregate method", do not provide experience gains or losses, but differences between anticipated and actual experience are subsumed in the basic funding requirements of the method. If a plan were to use such a funding method, it is anticipated that the plan would not need to separately amortize experience gains or losses.

[81] Your committee recognizes that plan experience rarely conforms to anticipations on a year-by-year basis, but that experience often is close to expectations over a longer period. Therefore, to smooth fluctuations in funding required by amortization of experience gains and losses, the bill provides that experience gains and losses are to be determined at least every three years and generally need not be determined any more frequently. However, under the bill the Secretary of the Treasury may provide by regulations that experience gains and losses are to be determined more frequently than every three years, in particular cases. Your committee expects that this generally will be required only for plans that show an unusual need for frequent calculations, such as for plans with relatively high claims for payments with respect to assets available.

Additional funding standard.—Your committee recognizes that certain plans with a high proportion of nonforfeitable benefits in relation to assets available may not be adequately funded under the basic minimum funding standard. Therefore, an additional minimum funding standard is provided in the bill which is to be used in any year in which it would require a greater amount of plan contributions than would the basic minimum funding standard.

Under the additional funding standard, the plan is to determine unfunded nonforfeitable liabilities (total nonforfeitable liabilities less plan assets). Then the amount required to amortize these unfunded nonforfeitable liabilities over a period of 20 years (including principal and interest) is to be calculated. The amount to be contributed is the first year's payment under that amortization schedule. This calculation is to be repeated each year (on the basis of a new 20 year period) in which the additional funding standard would require a higher contribution than the basic standard. Since the amount of unfunded nonforfeitable liabilities generally will decrease with contributions, in succeeding years the payment under the additional funding standard generally will be less than the prior year's payment. Therefore, this is a declining balance method of funding.

Your committee anticipates that the amount of unfunded nonforfeitable liabilities generally will be reported on an annual basis to the Department of Labor, and, thus, the basic figures required for this calculation will be readily available to most plans. Additionally, your committee understands that this additional standard will apply infrequently but that it will bring about necessary additional funding in the few cases where it will apply.

Variance from funding requirements.—At times an employer's financial circumstances may prevent him from meeting the minimum funding requirements. Your committee does not believe that in such a situation an employer should be forced to abandon his plan. To deal with cases of this type the bill provides that upon a demonstration by the employer of substantial business hardship and a showing that application of the minimum funding requirements would be adverse to the interests of the plan participants in the aggregate, the Internal Revenue Service may waive all or part of the minimum funding requirements for a year, including normal costs, amortization of past service costs and amortization of experience losses. However, to limit the underfunding which may occur in cases of this type, the bill provides that the Service may not waive all or part of the funding requirements for more than five years (whether or not consecutive) in any

[82] fifteen-year period. Also, the Service may not waive amortization of previously waived contributions.

The bill provides that in determining whether substantial business hardship exists for single employer plans, the Service is to take into account factors such as whether the employer is operating at an economic loss (which may not be the same as operating at a tax loss), whether there is substantial unemployment or underemployment in the employer's trade or business, and whether it is reasonable to expect that the plan will be continued only if the waiver is granted. The determination of substantial business hardship is not to be limited to an examination of these factors, however, nor must all these factors be met for there to be a finding of substantial business hardship.

In determining whether a waiver should be granted, your committee contemplates that substantial business hardship generally will only occur in situations where the employer did not foresee, and could not reasonably have been expected to foresee (at the time the plan or plan amendment which gave rise to the liability in question was established), the event which causes the business hardship. Your committee contemplates that the Service will grant a waiver of funding normal cost only in unusual situations and will make a separate determination for each instance of waiving normal costs. Additionally, your committee expects that each successive application for waiver will be viewed in light of previous waivers' effects on the financial security of the plan, and that only rarely will the Service waive normal cost for more than one or two plan years based on the same business hardship.

The bill provides that if a waiver of funding requirements is in effect, the plan may not be amended in a way that would increase plan liabilities (through increasing benefits, changing the accrual of benefits, or changing the rate at which benefits become nonforfeitable) as long as there are any unfunded waived contributions outstanding under the plan. It is contemplated that generally other plans of the employer may not be established or amended to establish or increase benefits during a period of waiver. However, your committee contemplates that regulations will provide that an employer may reduce waived liabilities at a rate faster than that provided by the minimum funding requirements. It is also expected that in considering whether a waiver should be granted. the Service will weigh as a factor against the waiver any recent plan amendment (e.g., within three years before the request for waiver) that increases plan liabilities.

It is also contemplated that the Service may apply reasonable conditions to a waiver, and, for example, as a condition of waiver the Service may require plan amendments that eliminate previous recent increases in liabilities. It is recognized that the approval of the Secretary of Labor may be required in some cases, however, to retroactively reduce plan benefits. If a plan were to be amended to increase plan liabilities (or if a condition of waiver otherwise were violated) the amount waived and not yet amortized would immediately become part of the current minimum funding requirement in the year the condition is breached (and consequently this amount would immediately be charged to the funding standard account).

The amount waived by the Service must be amortized in no more than 15 equal annual payments (including interest and principal),

[83] beginning the year after the year the waived contributions were due. If a shorter period were required, after several years of waiver an employer's total contributions could be so high that it would be quite difficult to meet this obligation, particularly if the employer were just returning to financial stability. The bill provides that the amortization of the amount waived may not itself be waived in subsequent years.

Your committee's bill also provides a special relief provision for multiemployer plans, allowing longer periods to amortize past service costs or experience losses. This extension of time may be allowed if 10 percent or more of the employers contributing to the plan demonstrate to the Secretary of Labor that they would experience substantial business hardship if required to meet the otherwise applicable amortization requirements. In this case also, however, a variance is not to be allowed unless application of the minimum funding standards would be adverse to the interests of plan participants in the aggregate. In this case the Internal Revenue Service is to extend the amortization period for the time recommended by the Secretary of Labor, up to a maximum extension of 10 years (and therefore a maximum amortization period of 50 years for past service costs and 30 years for experience losses). In determining whether substantial business hardship exists in the case of multiemployer plans, the Secretary of Labor is to take into account factors such as (but not limited to) whether there is substantial unemployment or underemployment within the industry, whether the sales and profits of the industry are depressed or declining, and whether it is reasonable to expect that the plan will continue only if the waiver is granted.

Your committee believes that a strong showing of hardship must be made for longer extensions to be made available and it is intended that only rarely are extensions of more than 5 years to be allowed. Furthermore, as is the case generally with waivers, if the plan is amended to increase liabilities (through an increase in benefits, a change in the accrual of benefits, or a change in the rate of vesting) during the period that the waived liabilities are unfunded, the waiver is immediately to terminate and the waived liabilities are to become a part of the current year's minimum funding requirements. In addition, reasonable conditions may be applied to extensions of amortization periods. For example, if an extension is allowed for amortizing liabilities a corresponding extension might be appropriate for amortizing corresponding experience gains, or amendments that decrease plan liabilities.

Your committee also recognizes that in some situations it would be inappropriate to require multiemployer plans to meet the basic funding requirements. To meet this problem, the bill provides that the Secretary of Labor may prescribe an alternate funding method for a multiemployer plan, determining the annual contributions and credits to the funding standard account. The Secretary of Labor may also prescribe, under the variance procedure, alternative methods for satisfying the requirements of the bill with respect to changing the multiemployer plan's funding method or plan year.

A variance may be prescribed by the Secretary of Labor only after the Secretary holds a public hearing on the plan in question and allows interested persons, including participants and beneficiaries of the plan, an opportunity to present their views. In this regard, a variance cannot be granted unless the Secretary of Labor is satisfied (and makes a finding) that all plan participants and other interested persons have received adequate notice from the plan administrator

[84] prior to any public hearing on the variance. If a variance is to be granted, the Secretary of Labor, after a public hearing, is to make a finding that the basic funding requirements would increase plan costs to such an extent that there would be a substantial risk that the plan would be terminated, that benefits under the plan would be substantially decreased without the variance, that (if the plan were continued at its current level) employee compensation would be substantially decreased, or that unreasonable administrative burdens would be imposed on the plan under the basic funding requirements. Additionally, the Secretary of Labor is to make a finding that the basic funding requirements (or discontinuance of the plan) would be adverse to the interests of plan participants in the aggregate. A variance is to be allowed by the Secretary of Labor only for such a limited period as is necessary or appropriate to carry out the purposes of the bill, and to provide adequate protection to plan participants and beneficiaries. In addition, the alternative method prescribed by the variance must also conform to these standards so that the method is necessary or appropriate to carry out the purpose of the bill and the method would provide adequate protection to participants and beneficiaries under the plan.

It is intended that generally applications for variances are to be made before the last day for timely contribution of the amount in question, and are to be acted upon expeditiously by the Internal Revenue Service and the Secretary of Labor.

The funding standard account.—As previously indicated, the bill requires that each covered plan must maintain a funding standard account. The purpose of this account is to facilitate the determination of whether a plan has met the minimum funding standard. A plan will meet the minimum funding requirements only if, at the end of each plan year, the account does not, on a cumulative basis, have an excess of charges for all plan years over credits for all plan years. The account is to be charged each year with the normal costs for that year and with the minimum amortization requirements for past service costs, experience losses, and waived contributions for each year. On the other hand the account is to be credited with the contributions made for the year, with amortized portions of cost decreases, resulting from plan amendments and experience gains, and with any waived contributions.

To determine if the plan meets the minimum funding standard, the funding standard account is to be reviewed as of the end of each plan year. However, the bill provides that an employer may contribute to a plan after the end of his taxable year and up to the date of filing his tax return, and these contributions may relate back to his previous taxable year. Thus, for example, where the plan and taxable years are the same this will allow payments made within this time to relate back to the previous plan year for purposes of the minimum funding requirements and the funding standard account. This should provide an employer with sufficient time to reconcile the funding standard account and make the contributions needed to avoid underfunding.

If the account has a positive balance at the end of the plan year, the employer will have contributed more than the minimum funding standard requires. Since income will be earned on amounts in the plan, the bill provides that this positive balance is to be credited with interest,[6] which will reduce the need for future contributions to meet the

[6] The interest rate or rates to be used to charge or credit the account are to be consistent with the rate or rates used under the plan to determine costs and are to be charged or credited in accordance with regulations.

[85] minimum funding standard. On the other hand, if the funding standard account has a deficit balance, the employer will have contributed less than required under the minimum funding rules, and the deficiency is to be charged with interest. Interest is charged in this case because the deficiency will become larger over time by the amount of income the plan would have earned had the minimum requirements been complied with and therefore the employer will have to pay more to the plan than just the amount he failed to contribute in the plan year. (A plan in existence on the date of enactment will start with a zero balance in its funding standard account on the effective date for the new funding rules applicable to the plan. Similarly, a newly-established plan will start with a zero balance in its funding standard account.)

An example of the operation of the funding standard account for a single employer defined benefit pension plan is described below.

It is assumed that in 1978 the plan is established with a past service liability of $1 million and a normal cost of $70,000. The interest rate used to determine liabilities under the plan for 1978 and for all years in this example is 6 percent per year. It is also assumed that this plan chooses to determine experience gains and losses on an annual basis, rather than every three years, as is generally allowed under the bill. In the first plan year, the employer contributes $138,537. The plan's funding standard account for 1978 will be as follows:

Credits:	
Employer contributions	$138, 537
Charges:	
Normal cost	70, 000
Amortization—initial past service cost (30 years)	68, 537
Total	138, 537
Net balance	0

In the year 1979 the plan is amended (effective for 1979), increasing past service liabilities by $100,000. The plan's normal cost for benefits as amended is $75,500. There is a net experience gain of $5,000 over the prior year. In this year, the employer's contribution is $165,975. The plan's funding standard account for 1979 will be as follows:

Credits:	
Employer contributions	$165, 975
Amortization—experience gain (15 years)	486
Total	166, 461
Charges:	
Normal cost	75, 500
Amortization—initial past service liability	68, 537
Amortization—past service liability from amendment (30 years)	6, 854
Total	150, 891
Balance	15, 570
Interest on balance	[1] 934
Net balance	16, 504

[1] This assumes that all amounts other than interest are charged and credited at the beginning of the year.

[86] In 1980 the normal cost of the plan is $76,200. There is an experience loss for the preceding year of $10,000. The employer contributes $135,572. The plan's funding standard account for 1980 will be as follows:

Credits:	
Employer contributions	$135,572
Amortization—experience gain	486
Total	136,058
Charges:	
Normal cost	76,200
Amortization—initial past service liability	68,537
Amortization—past service liability from amendment	6,854
Amortization—experience loss (15 years)	971
Total	152,562
Net	−16,504
Balance from previous year	16,504
Balance	0
Interest on balance	0
Net balance	0

In case the additional funding standard applies, the funding standard account is to be charged with the excess of the amount to be contributed under the additional funding standard over the amount to be charged as normal cost, amortization of past service costs and experience losses, less the amortized credits for plan amendments that decrease liabilities and for experience gains. (However, to ensure the account is properly maintained, these amounts also are to be charged and credited to the account in this case.)

The funding standard account—special rules—combining and offsetting amounts to be amortized.—Your committee recognizes that the amortization rules may require a plan to keep accounts for amortizing a number of different items. While the amortization charges and credits to be entered in the funding standard account for any one year will net out to a single figure, some may prefer not to maintain a number of different amortization accounts. Therefore, the bill provides that amounts required to be amortized may, at the taxpayer's discretion, be combined into a single amount to be amortized.

The bill provides, pursuant to regulations to be issued by the Secretary of Treasury, that amounts which are amortizable credits and charges may be offset against each other with the balance to be amortized over a period determined on the basis of the remaining amortization periods for all items entering into the credits or charges, whichever is greater. Also, pursuant to regulations, amortizable credits (or amortizable charges) may be combined into one credit or one charge to be amortized over a period determined on the basis of the remaining amortization periods for all items entering into the combined amount. It is expected that if a taxpayer elects to offset or combine amounts to be amortized, this election will apply to all amounts (both charges and credits) required to be amortized for the year of election.

An example of the netting and combining of amortizable amounts by a single employer plan is described below.

[87] It is assumed that the plan has no past service cost. It is also assumed that the plan chooses to determine experience gains and losses on an annual basis rather than every three years as is generally allowed under the bill. In year 1, the plan has an experience loss of $40,000. In year 2, the plan has an experience gain of $15,000. In year 3, the plan has an experience loss of $10,000. In all these years the plan uses a 5-percent per annum interest rate in computing its plan costs.

The $40,000 experience loss that occurs in year 1 must be amortized over 15 years, requiring annual payments of $3,670. The first payment to amortize this amount is made in year 2.

At the end of year 2 (after one payment of $3,670) the remaining unamortized balance of the $40,000 experience loss is $38,145.[7]

The $15,000 experience gain that occurs in year 2 also is to be amortized over 15 years. Alternatively, it may be combined with the remaining experience loss of $38,145, reducing the unamortized loss by ($38,145 minus $15,000) to $23,145. It is expected that under regulations to be issued by the Secretary of the Treasury, the balance of $23,145 may be amortized over 14 years (the remaining amortization period of the greater amount), in equal annual payments of $2,227. At the end of year 3 (after one payment of $2,227) the remaining unamortized balance of the netted experience loss and gain is $21,964 (requiring annual payments of $2,227 over 13 years).

The $10,000 experience loss that occurs in year 3 would be amortized over 15 years in equal payments of $918 per year if it were to be separately computed and amortized. On combining this loss with the previous net experience loss, the base for amortization is ($21,964 plus $10,000) or $31,964. It is anticipated that under regulations to be issued by the Secretary of the Treasury this amount may be amortized by 13 annual payments of $3,145 ($2,227 plus $918) and thereafter one payment of $1,780.

Special rules—the full funding limitation.—In some cases, the difference between the total liabilities of the plan (all accrued liabilities including normal cost) and the total value of the plan assets may be smaller than the minimum funding requirement for the year. For example, this could occur where the plan assets had increased substantially and unexpectedly in value. Where the excess of total plan liabilities over assets is less than the minimum funding requirement otherwise determined, your committee believes that an employer should not have to contribute more than the amount of this excess liability, for upon contribution of this amount the plan will become fully funded. As a result, in this case the bill provides that the amount to be charged to the funding standard account (and to be contributed), is to be limited to the difference between the total liabilities of the plan and the fair market value of the plan assets. Since the full funding limitation reduces the amount otherwise required to be contributed to a plan, it appears appropriate to use the lower of fair market value or the value of plan assets as normally determined. (As discussed below, the value of plan assets as normally determined may be greater than fair market value in certain cases and in such situations use of the normal valuation method could inappropriately limit contributions to a plan.)

[7] This is based on the assumption of a 5 percent interest charge on the unpaid balance during the year.

[88] When the full funding limit applies, the amortization schedule for charges and credits to the funding standard account are to be considered as fully amortized, and these schedules generally are to be eliminated from the calculations under the funding standard account. However, if the plan is amended in later years to increase plan liabilities, a new amortization schedule would be established with respect to this increase in liabilities. For years after the full funding level is reached, the funding standard account will continue to be charged with the normal cost of the plan. Consequently, unless asset values increase correspondingly with the increase in plan liabilities, eventually the full funding limitation will not be applicable and the employer will have to make contributions to the plan to meet the minimum funding requirements.

If the employer fails to make the required contributions in a year in which the full funding limitation is applicable, the excise tax (described below) on underfunding in that year is to be based only on the amount that should have been contributed, given the full funding limitation.

For the purpose of calculating the full funding limitation, the bill provides that plan liabilities (including normal cost) are to be determined under the funding method used by the plan to determine costs for the year, if the liabilities can be directly calculated under this funding method. However, if this cannot be done under the plan's funding method, in order to allow the full funding limitation to apply, the bill provides that the accrued liabilities are to be calculated under the entry age normal method, solely for the purpose of determining the application of the full funding limitation.

Whether the full funding limitation applies generally is to be determined at the end of the plan year, after all plan liabilities for that year have accrued. For purposes of the full funding limitation, the value of plan assets generally is to be determined as of the usual valuation date for the plan. Since, as discussed above, contributions generally can be made to a plan after the end of a plan year and yet relate back to the previous plan year, there should be no timing problem with respect to such year-end calculations.

Special rules—money purchase pension plans.—Generally, the funding standard account for money purchase pension plans is to be charged annually with the amount that must be contributed for the year under the plan formula, and is to be credited with the amount that is paid. As a result, employers who have these plans must annually make the payments required under the plan. If the employer does not make sufficient contributions to meet the minimum funding requirements, he is to be subject to the excise tax described below. However, the Internal Revenue Service may waive the contributions required, in the same manner as it may waive these contributions for defined benefit pension plans.

For purposes of the funding rules, a "target benefit plan" generally is to be treated as a money purchase pension plan. However, a plan (for example, a so-called Taft-Hartley plan) that provides an agreed level of benefits and a specified level of contributions is not to be considered a money purchase pension plan if the employer or his representative participated in the determination of the benefits.

[89] *Special rules—collectively bargained plans and plans of controlled groups.*—Plans maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers often provide for a predetermined level of contributions over a period longer than 12 months. Your committee believes that for the funding requirements to be workable in these cases, employers generally must be allowed to base their contributions on the bargained and agreed upon basis. Consequently, for purposes of maintaining the funding standard account, a plan year of a plan maintained pursuant to a collective bargaining agreement generally is to be considered as extending for the term of the collective bargaining agreement. This provision is intended to adapt the minimum funding standard to those plans where contributions are fixed by contract in accordance with a fixed standard, such as a specific dollar amount per hour of covered employment or a specific dollar amount per ton of coal mined.

Under such a plan if the actuarial assumptions were reasonable and the actuarial calculations were correct as of the beginning of the term of the agreement, and the agreed contributions were made, there would be no deficiency in the funding standard account for the term of the collective bargaining agreement. Any experience loss could be made up by adjustment of the contribution rate or the level of benefits for the term of the next agreement. The special definition of plan year would not affect the required periods of amortization or the computation of the excise tax; also, with respect to collectively bargained plans it is intended that experience gains and losses generally are to be determined at the end of each contract period, or at the end of every 3 calendar years if more appropriate for the particular plan.

The bill also provides that, to meet the needs of other collectively bargained plans, the Secretary of the Treasury may issue regulations that provide other periods that may be treated as plan years. For example, it is understood that some multiemployer, collectively bargained plans are based on a number of contracts, each expiring at different times. It is expected that in this case the regulations would provide that the plan could use a 12-month period (or perhaps longer period if needed) for the plan year. In this case, when experience losses are determined, the plan trustees could arrange for an increase in contributions for the next year, or could arrange for a decrease in future benefits to allow negotiations to occur later to increase contributions. Additionally, as discussed above, limited retroactive plan amendments would be allowed without the approval of the Secretary of Labor for up to 2 years after the end of the plan year, so benefits could be reduced to a limited extent if needed to avoid a funding deficiency.

The bill also provides that in the case of collectively bargained plans, the minimum funding standard is to be determined as if all participants in the plan were employed by a single employer. The bill provides the same treatment for deduction purposes. This merely restates existing law.

In the case of a plan adopted by more than one corporation which is a member of a controlled group of corporations (within the meaning of section 1563(a) of the Code without regard to section 1563 (a)(3)(C)) the bill provides that the minimum funding standard

[90] and the excise tax on underfunding and the new rules with respect to maximum deduction limits (described below) are to be determined as if all members of the controlled group which adopted the plan were a single employer. Allocations of the minimum funding requirements, excise tax liability and deduction limits between members of the controlled group are to be determined under regulations prescribed by the Secretary of the Treasury.

Exclusions from coverage—insured plans.—If a pension plan is funded exclusively with certain individual insurance contracts, the bill provides that the plan is not subject to the minimum funding requirements. Your committee believes that if qualified insurance contracts are used to fund a plan and payments are timely made, the plan will be properly funded.

The contracts that are to qualify for this treatment are level annual premium individual insurance contracts where the premium is paid from the first date of an individual's participation in the plan (and from the time an increase in benefits becomes effective) and is not paid beyond the individual's retirement age. Also, the benefits under the plan must be the same as the benefits provided by the individual contracts at normal retirement age. In addition, the benefits must be guaranteed by the insurance company to the extent that premiums are paid. For the contracts to qualify, the insurance company must be licensed to do business in the State where the plan is located. Furthermore, premiums for all plan years must have been timely paid or the policy reinstated. In addition, rights under the contracts must not have been subject to a security interest during the plan year, and no loans must have been made on the policy during the plan year.

If any of these requirements are not satisfied, then the normal rules with respect to the funding standard must be followed. If a plan is initially funded with qualified insurance contracts, but, *e.g.*, a contract payment is not made, then the plan will become subject to the minimum funding rules and an excise tax may be owed (as described below) if the plan funding falls below the minimum standard. (Generally, if the payments had been timely made until this time, the funding standard account for the year of nonpayment would start with a zero balance, the accrued plan liabilities and properly amortized amounts would be charged to the account for the year in question, and any excise tax owed would be based on the net charges to the funding standard account for that year.)

Exclusions from coverage—profit-sharing plans, etc.—Under present law profit-sharing and stock bonus plans do not require a definite predetermined formula for determining the portion of profits to be shared annually with the employees. Since the contributions to these plans may be varied substantially year-by-year under the plan, your committee believes that it is inappropriate for profit-sharing and stock bonus plans to be governed by the minimum funding standard.

On the other hand, employer contributions under money purchase pension plans must be definitely determinable and fixed without being geared to profits. It is appropriate for these plans to be governed by the minimum funding standard since the application of this standard (as under present law) will require the employer to make definitely determined contributions to the plan.

[91] Your committee intends that plans generally are to be considered money purchase pension plans which meet the "definitely determinable" standard where the employer's contributions are fixed by the plan, even if the employer's obligation to contribute for any individual employee may vary based on the amount contributed to the plan in any year by the employee. For example, it is expected that a matching plan which provides that an employer will annually contribute up to 6 percent of an employee's salary, but that this contribution will be no more than the employee's own (nondeductible) contribution, will meet the "definitely determinable" criteria. In this case, the employer's contributions are set by the plan, will not vary with profits, and cannot be varied by the employer's action (other than by a plan amendment). (Of course, the plan must meet the nondiscrimination and other requirements of the Code to be qualified.)

Your committee understands that some plans are based solely on contributions from participating employees, without contributions of employers. In this case, your committee believes it would be inappropriate to make the employer responsible for the contributions of his employees. Consequently, where the plan has not provided for any employer contributions at any time after the date of enactment of the bill, the plan is to be exempt from the minimum funding standards and the excise tax on underfunding. Similarly, it would be inappropriate for the employer to be responsible for voluntary employee contributions, and consequently, voluntary contributions (and benefits attributed thereto) are to be disregarded for purposes of the minimum funding standard and the excise tax on underfunding.

Exclusions from coverage—government plans and church plans.— It has been argued that government plans should be exempt from the funding standards since the taxing power can be viewed as a practical substitute for these standards. On the other hand, your committee is concerned with reports that in the case of a number of governmental units, such generous pension promises have been made and so little funds have been set aside currently, that the practical likelihood of imposing sufficient taxes to pay those benefits may be open to question. In view of this conflict, your committee does not believe present law should be changed at this time regarding government plans which are qualified under the Federal tax laws.

The bill, therefore, provides that any tax-qualified government plan that meets the requirements of existing law with respect to funding will be exempt from the new minimum funding requirements. (This generally means that these plans must currently contribute normal cost plus interest on unfunded past service cost.) This exemption will apply both to existing and newly-established government plans.

In view of the information received with respect to possible underfunding problems of the plans, the bill provides that your committee and the Committee on Education and Labor are to study whether plans maintained by Federal, State, or local governments are adequately funded (taking into account the new minimum funding standards of the bill). Your committee and the Committee on Education and Labor are to submit to the House of Representatives the results of this study together with recommendations on funding standards for government plans by December 31, 1976.

[92] Under the bill, government plans are plans established and maintained for their employees by the United States Government, or by the government of any State or political subdivision of a State, or by any agency or instrumentality of such governments. Also, except for the study described above, a plan to which the Railroad Retirement Act of 1935 or 1937 applies is to be treated as a government plan.

The bill also generally exempts church plans from the new funding requirements if these plans meet the funding requirements of present law. However, a church plan may elect to have all the provisions of the Internal Revenue Code regarding participation, vesting, funding, and form of benefit apply. If such an election is made, then the minimum funding provisions will apply to the plan. (Under the bill, once it is made, the election is irrevocable.)

A church plan is defined under the bill as a plan established and maintained by a church (or convention or association of churches) that is tax-exempt under section 501 of the Code. However, a church plan does not include a plan established and maintained primarily for the benefit of persons employed in connection with an unrelated trade or business. Nor does a church plan include a multiemployer plan if one or more employers are not tax-exempt under section 501 of the Code as a church (or convention or association of churches). With respect to plans in existence on January 1, 1974, if the plan applied on that date to employees of any tax-exempt agency of a church (or convention or association of churches) which established and maintained the plan, then the employees of the agency are to be treated as employees of the church (or convention or association of churches).

Coordination of regulations.—In order to minimize administrative problems, and ensure insofar as possible that plans which satisfy the requirements of the Internal Revenue Code also meet the pension standards which are to be administered by the Labor Department, and vice versa, the bill provides that the Treasury regulations with respect to the participation, vesting, and funding requirements of the bill (other than regulations to enforce the antidiscrimination requirements of sec. 401(a)(4) of the code) are to be effective for plan years beginning after December 31, 1975, only if approved by the Secretary of Labor. Where the bill's provisions apply before that date (as in the case of new plans and plans which elect earlier dates) then the regulations may be prescribed without the necessary approval of the Secretary of Labor. However, these regulations are not to apply beyond the December 31, 1975, plan year cutoff date.

Actuarial considerations—enrollment of actuaries to practice before the Internal Revenue Service.—Defined benefit pension plan costs generally are actuarial estimates of future costs of the plan. In estimating pension costs, actuaries must make assumptions ("actuarial assumptions") about a number of future events, such as the rate of return on investments ("interest"), employees' future earnings, and employee mortality and turnover. Actuaries also must choose from a number of methods to calculate future plan liabilities. The amounts required to fund any given pension plan can vary significantly according to the mix of these actuarial assumptions and methods. As a result, the assumptions and methods used by actuaries are basic to the application of minimum funding standards for defined benefit pension plans.

[93] Your committee believes that actuaries who perform services for qualified pension plans and report to the Internal Revenue Service regarding these plans should meet a reasonable standard of competence and be held to a standard of reasonableness in choosing their methods and assumptions. The bill requires that the actuarial assumptions which are used are to be reasonable in the aggregate; this restates present law. However, there is no existing government regulation of the actuarial profession as there is, for example, for lawyers and accountants. Te resolve this problem, the bill provides that standards and qualifications are to be established for enrolling actuaries to practice before the Internal Revenue Service (with regard to actuarial matters only).

Under the bill, the standards and qualifications to be satisfied for any person applying after 1975 for enrollment as an actuary are to include education and training in actuarial mathematics and methodology, and an appropriate period of actuarial experience. The education and training requirement is to be evidenced by a degree in actuarial mathematics or its equivalent from an accredited college or university, successful completion of an examination in actuarial mathematics and methodology to be given by the Secretary of the Treasury, or successful completion of other actuarial examinations deemed adequate by the Secretary. Your committee anticipates that actuaries also will be enrolled to practice before the Department of Labor with respect to pension plans. In order to make the enrollment requirements uniform for practice before the Internal Revenue Service and the Department of Labor, regulations issued by the Secretary of the Treasury with respect to standards and qualifications for actuaries are to be effective after December 31, 1975, only if approved by the Secretary of Labor. (Similarly, your committee anticipates that regulations issued by the Secretary of Labor with respect to qualification of actuaries are to be effective after that date only if approved by the Secretary of the Treasury.)

The bill provides a special rule with respect to individuals applying for enrollment before 1976. For such individuals, the standards and qualifications for enrollment are to include a requirement for an appropriate period of responsible actuarial experience or of responsible experience in the administration of pension plans.

Your committee contemplates that the procedure for enrollment of actuaries will appropriately recognize the need for independent, competent professional work, and consequently practice without enrollment will be allowed only in unusual cases.

Your committee intends that the Secretary also establish duties relating to practice before the Internal Revenue Service by actuaries who are enrolled to practice. These duties may be similar to those required for attorneys, certified public accountants, and others who practice before the Internal Revenue Service, appropriately modified to take account of the special requirements of actuarial practice. For example, it is contemplated that the regulations will require an enrolled actuary to notify the Secretary if he discovers that an actuarial statement he prepared was not filed with the Secretary.

[94] In formulating enrollment regulations (including regulations relating to application for enrollment after 1975), it is your committee's intent that the Secretary recognize to the extent feasible the varying degrees of actuarial skill required in the examination of different types of plans. For example, it is understood that many smaller and simpler plans are administered on the basis of standard actuarial tables which are widely published and on the basis of standard earnings assumptions. In these cases your committee has been informed that contributions have been adjusted from time to time to reflect deviations between actual plan experience and the standard actuarial and interest assumptions used. To the extent feasible, it is anticipated that the Secretary will make it possible to use such standard tables, etc., in the examination of these smaller and simpler plans, and make it possible for this work to be done by persons with the needed education and experience in pension plan administration whether or not their training includes the highest level of actuarial skills. The limited number of persons with a high level of actuarial skills makes it desirable that the standards acceptable for those examining smaller and simpler plans not be as restrictive as in the case of those examining the larger plans.

It is contemplated that the Secretary of the Treasury would reserve the power to suspend from practice before the Service any person enrolled to practice as an actuary after due notice and opportunity for hearing. Discipline might be imposed upon an enrolled actuary shown to be incompetent, or who does not comply with the rules and regulations established by the Secretary. Your committee intends that proceedings brought against enrolled actuaries will be instituted in the same general manner as proceedings against others practicing before the Service and will follow the same general procedure as other disciplinary proceedings. Generally, disciplinary proceedings would involve a complaint served on the actuary, an opportunity for answer, and an evidentiary hearing before a hearing examiner who would render a decision (appealable to the Secretary of the Treasury). An actuary involved in such a proceeding would have a right to be represented by counsel. It is contemplated that the discipline imposed could include suspension from practice before the Service, and that under appropriate circumstances a petition for reinstatement could be granted.

Actuarial considerations—reports of actuaries.—The Internal Revenue Service must receive detailed information on the actuarial assumptions and methods used to be able to evaluate whether costs of a qualified defined benefit pension plan have been properly determined. To resolve this problem, the bill requires periodic actuarial reports to be filed with the Internal Revenue Service by plan administrators of defined benefit plans subject to the new minimum funding standard. Consequently, actuarial reports will not be required for plans funded through qualified insurance contracts, and profit-sharing and money purchase plans, among others. However, actuarial reports will be required of any defined benefit plan subject to the new minimum funding standard, whether or not it remains tax-qualified.

Actuarial reports are to be made for the first plan year (or the first plan year to which this section applies) and every third year there-

[95] after. Under the bill the Secretary may require more frequent reporting if necessary. The Secretary might require more frequent reporting in particular cases (for example, where a plan is to determine experience gains or losses more frequently than every three years) or in all cases if necessary. If the plan administrator fails to timely file the required actuarial reports, he will be subject to a penalty of $1,000 for each such failure unless it was due to reasonable cause.

Under the bill, the plan administrator generally is the person designated as such by the plan instrument. If no administrator is so designated, the administrator will be the employer for a single employer plan, and will be the joint board of trustees, etc., for a plan maintained by several employers or several employers and an employee organization. In other cases, the plan administrator will be the person prescribed by regulations issued by the Secretary of the Treasury.

The periodic actuarial reports must be prepared and signed by actuaries enrolled to practice before the Internal Revenue Service. The reports must include a description of the plan, a description of the funding method and actuarial assumptions used to determine costs under the plan, a certification as to whether the plan is adequately maintaining a funding standard account, and any other information regarding the plan as the Secretary may require. For example, it is contemplated that the periodic reports will include detailed information on the basis for any change in actuarial assumptions.

The actuary who prepares the reports must certify that, to the best of his knowledge, the report is complete and accurate. He must also certify whether, in his opinion, the funding method is reasonable and the actuarial assumptions used to determine the plan costs are reasonable in the aggregate. It is contemplated that the actuary will be subject to discipline and may be suspended from practice before the Internal Revenue Service if he falsely certifies a report.

Actuarial considerations—actuarial assumptions, methods, valuation of assets.—Since actuarial calculations determine plan costs, the bill includes several basic rules regarding these calculations. Under the bill, plan liabilities must be determined on the basis of actuarial assumptions that, in the aggregate, are reasonable. Your committee recognizes that frequently there is a range of actuarial assumptions which may be appropriate for determining the costs of a defined benefit pension plan, and the choice of the appropriate assumptions is very much a matter of judgment. In this circumstance, an employer may attempt to substitute his judgment for that of his actuary, which may lead to situations where plan costs are not being independently determined by an actuary. Your committee believes that it is inappropriate for an employer to substitute his judgment in these matters for that of a qualified actuary, and it is contemplated that if such a circumstance were to arise an actuary would have to refuse giving his favorable opinion with regard to the plan.

Since the actuarial assumptions used must be reasonable in the aggregate, it is anticipated that, on audit, the Internal Revenue Service will (as presently) require a change of assumptions where they do not meet this standard. However, unless the assumptions used are substantially unreasonable, it is contemplated that generally the Service will not require a change of assumptions to be made effective for years prior to the year in which the audit is made.

[96] Under the bill, plan liabilities are to be determined under the funding method used generally to determine costs under the plan. In addition, since a change in the actuarial method used can have a substantial effect on a plan's cost, the bill also provides that the Internal Revenue Service must approve, pursuant to regulations, a change in the plan's funding method before the new method may be used to calculate plan costs. Similarly, approval must be obtained for a change of the plan year before the new year may be used by a plan. It is expected that the regulations under this provision will establish rules similar (but appropriately modified) to the regulations governing approval of changes in accounting methods. Therefore, it is expected that generally before a change in actuarial method or plan year will be approved a taxpayer must establish a substantial business purpose for the change and that consideration will be given to all the facts and circumstances with respect to the change. It is contemplated that a change in funding method is to be allowed only if it does not significantly adversely affect the funding of the plan. Also, your committee contemplates that upon approving a change in actuarial method or plan year, conditions are to be established to prevent distortion of income or distortion of funding of the plan.

Your committee recognizes that there are a substantial number of accepted methods of valuing assets of pension plans and many of these methods are designed to take into account market value and also to level out short-run market swings. Your committee believes that such valuation methods are appropriate since sharp, short-run variations in asset values could significantly affect the required funding if fair market value were the only accepted method of valuing assets for funding purposes. This would be inappropriate since pension plans are funded to meet the needs of the long-run, frequently over an employee's whole working life. On the other hand, your committee also recognizes that pension plans must value assets in a way that takes into account market value. Otherwise, there may be no relation between a plan's funding program and the assets actually available to pay benefits.

Under the bill, generally plan assets are to be valued on the basis of any reasonable actuarial method of valuation that takes into account fair market value, pursuant to regulations to be issued by the Secretary of the Treasury.

Your committee anticipates that fair market value generally would be an acceptable valuation method. On the other hand, it is contemplated that using cost or book value without taking account of changes in fair market value would not be an acceptable valuation method.[8] However, it is intended that acceptable valuation methods may include (but not be limited to) the use of a moving average (over, *e.g.*, five years), or increasing asset values each year by a stated percentage of the previous year's asset value under the assumption that an even long-range appreciation will occur (in some cases, this increase may be reduced by realized appreciation or other income received from the asset). Another alternative method may be to capitalize the current amount of income from each asset as a perpetuity, using the plan

[8] However, in a case where fair market value tended to fluctuate around cost, a reasonable actuarial method may determine that cost is the appropriate value.

[97] valuation rate of interest. For a valuation method to be reasonable, it is expected that the asset values obtained under the method of valuation used are to bear a reasonable relationship to fair market value, and that if fair market value and the value under the method used differ significantly over a period of several years that the value under the plan would be adjusted accordingly. However, where an unacceptable method is being used by an existing plan, it is contemplated that the Service will allow a transition so that the plan will have time to write up its asset values. Furthermore, it is expected that the method chosen must be used consistently by the plan.

It is also expected that the regulations will provide reasonable methods for valuing life insurance or annuity contracts, which will recognize the special nature of such contracts for valuation of pension plans.

Your committee also recognizes that often a pension plan will acquire bonds or other debt instruments as a long-term investment to be held until maturity. In that event, it would seem inappropriate to require the plan to change its valuation of the bond in accordance with market fluctuations. Therefore, the bill provides that a plan may elect to value its bonds or evidence of indebtedness on an amortized basis. At the election of the plan, the amortization may run from initial cost at purchase to par value at earliest call date or to par value at maturity. This election is to be made at the time and in the manner prescribed by regulations. The election is to be revocable only with the consent of the Internal Revenue Service and is to apply to all bonds and evidences of indebtedness owned by the plan. Although the bill explicitly recognizes this as one reasonable method of valuation that a plan may use to value bonds or evidences of indebtedness, other valuation methods may be used for these assets. (Also, it may be reasonable to use the method explicitly recognized for bonds or indebtedness for valuing other assets.)

Actuarial considerations—actuarial advisory board.—Your committee believes that the Secretary of the Treasury could be significantly aided in resolving a number of problems regarding actuaries and actuarial assumptions, etc., if he had the advice of experienced actuaries drawn from different areas of practice. Accordingly, your committee intends that the Secretary establish an advisory board chosen from among experienced actuaries in government, teaching, business and insurance, and independent consulting practice.

Your committee intends that the board advise the Secretary in such matters as the enrollment system for actuaries, reasonable standards and criteria for determining actuarial assumptions to be used for plans, and determining what constitutes generally accepted principles of actuarial practice.

Enforcement.—The sanctions under present law on the failure to meet the minimum funding requirements appear to have little effect on an employer's decision to fund a plan at the required minimum levels. To resolve this problem, the bill imposes an excise tax on the employer if he fails to fund the plan at the minimum required amounts (only if a waiver has not been obtained).

The tax initially is to be 5 percent of the accumulated funding deficiency—the excess of charges over credits in the funding standard account—at the end of the plan year. If a plan year ends with an ag-

[98] gregate funding deficiency, the employer will owe a 5 percent excise tax on the deficiency and that tax may be due for the taxable year of the employer with or within which the plan year ends. Furthermore, a deficiency in a prior year will continue in later years (and will be increased with interest), until paid. The 5 percent tax will apply to each year (of the employer) in which there is a funding deficiency at the end of the plan year. For example, if there is a funding deficiency in 1978 that is not corrected until 1980, there will be a 5 percent tax on the 1978 deficiency and a 5 percent tax on the 1979 deficiency (which will be the same as the 1978 deficiency plus interest).[9] If the deficiency is corrected within the time allowed for contributions for the year 1980, there would be no 5 percent tax for 1980.

In any case in which the 5 percent tax is imposed and the accumulated funding deficiency is not corrected within the correction period allowed after notice by the Internal Revenue Service, a 100 percent tax equal to the accumulated funding deficiency (to the extent not corrected) is to be imposed on the employer. In accord with present law respecting the excise taxes with regard to private foundations, neither the 5 percent nor the 100 percent taxes are to be deductible.

As discussed above, the bill provides that an employer's contributions to a plan that are made by the time for filing its tax return can relate back to the year of that return. Consequently, generally an employer will have a period of time after the close of the plan year to contribute to the plan and avoid the excise tax on underfunding. In addition, the bill provides that for purposes of the minimum funding requirements, a plan can be amended to a limited extent without the approval of the Secretary of Labor after the close of the plan year, but by the time for filing the employer's return for the taxable year with or within which the plan year ends (in the case of multiemployer plans, the amendment may be within two years of the close of the plan year). This allows limited retroactive decreases in plan benefits so liabilities for the excise tax can be reduced or eliminated when there has been a mistake in estimating the amount of benefits that an employer could properly fund.

As discussed above, under certain conditions a plan also may be retroactively amended with the approval of the Secretary of Labor for earlier years. Such a retroctive amendment is not, however, to eliminate a funding deficiency for purposes of the initial 5 percent tax, although it may constitute correction for purposes of the 100 percent tax.

The minimum period allowed for correcting any funding deficiency after notice from the Service is 90 days from the date of mailing a notice of deficiency with respect to the 5 percent tax. However, this period may be extended for the time that the Internal Revenue Service determines is reasonable and necessary to eliminate the accumulated funding deficiency (and is automatically extended for any period in which a deficiency cannot be assessed under section 6213(a) relating to petitions to the Tax Court). It is intended that the Secretary require significant reasons before granting an extension under this provision.

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[9] Of course, if an employer fails to contribute a plan's normal cost in any year, that amount will not thereafter become a past service cost (or experience loss to be charged in amortized amounts. The funding standard accounts will show as a deficiency subject to tax each year until corrected the unpaid normal cost plus interest (as well as any unpaid past service cost, plus interest).

[99] It is intended that reasonable conditions may be applied to any extension of time, such as (but not limited to) a requirement that regular payments be made toward funding the deficiency and such as not allowing a plan amendment that increases plan costs until the deficiency is paid off. Correction generally will be made by paying off the principal amount of the funding deficiency plus interest to the date of payment, at the rate used to determine plan costs for the years the deficiency remained unpaid.[10]

In the usual case, the excise taxes will be owed when a deficiency is showing in the plan's funding standard account. However, as under present law, where the actuarial assumptions used in determining the minimum funding requirements are unreasonable in the aggregate, the Service may on audit retroactively (for open years) require a change in these assumptions. Such a change may result in a change in the plan's funding standard account. If a funding deficiency occurs as a result of such change, an excise tax may be levied. It is expected that retroactive changes of actuarial assumptions would occur only where the initial assumptions used were substantially unreasonable.

The bill provides special rules for applying the excise tax to collectively bargained plans. Generally, the "plan year" for a collectively bargained plan will be considered to be the contract period. If, at the beginning of that contract period, the actuarial assumptions used in setting the plan contributions are reasonable in the aggregate, and the actuarial calculations are correct, then generally no excise tax will be owned by employers who timely pay their appropriate share of the plan contributions during the contract period. However, to the extent that plan contributions are not timely paid, the funding standard account may show a deficiency and an excise tax would be owed. (The excise tax would be owed on the basis of the employer's taxable year and not on the basis of the plan year which runs for the period of the contract.) When a plan has such an accumulated funding deficiency, generally the tax will be imposed only on the employers who do not timely contribute, since the underfunding is the result of their failure to contribute.

At the end of a contract period, even assuming that all contributions were timely made, a collectively bargained plan can have experience losses. In that event, the next contract must provide for the experience loss. This generally will be by higher contributions, though it could also be by amending the plan to decrease benefits. If appropriate adjustments in contributions or benefits do not occur, then the plan will have a funding deficiency and an excise tax will be owed. Liability for this tax is to be determined first on the basis of failure to meet the required employer contributions under the plan, and then on the basis of respective liabilities for contributions under the plan.

The bill also provides special rules for applying the excise tax to a controlled group of corporations. Under the bill, if corporations that are members of a controlled group (defined by section 1563(a) of the Code without regard to section 1563(e)(e)(C)) adopt a plan, the excise tax on underfunding is to be determined as if all the corporations were a single employer, and the tax is to be allocated to each corportion in accord with regulations prescribed by the Secretary of

[10] It is contemplated that if a plan becomes subject to the full funding limitation after it has an accumulated funding deficiency that no correction will be required, but the nondeductible 5 percent first level excise tax will be owed for each year in which there is an accumulated funding deficiency.

[100] the Treasury. It is expected that generally the minimum funding requirements will be allocated proportionately to the relative amount of plan liabilities attributed to the employees of such corporation and any funding tax will be allocated in proportion to failures to make these required minimum contributions.

Maximum deductions for plan contributions.—If an employer wishes to deduct contributions to an employee benefit plan which are greater than the minimum contributions required, the amount deductible will be subject to the maximum deduction limits.

Contributions to a pension plan presently are deductible under three alternative provisions, the "5 percent" method which allows deductions to be taken for contributions not in excess of 5 percent of the annual compensation of the covered employees (sec. 404(a)(1)(A) of the code), the "level cost" method (sec. 404(a)(1)(B) of the code), and the "normal cost" method (sec. 404(a)(1)(C) of the code).

Unlike the "level cost" method and the "normal cost" method, the 5-percent limitation on contributions is often unrelated to the funding needs of the pension plan, for it frequently is not determined by the level of benefits provided by the plan. Consequently, the 5-percent method has allowed employers to contribute and deduct more than is reasonably needed to fund a pension plan.

The bill repeals the 5-percent deduction limitation (present sec. 404(a)(1)(A) of the code). Thus, deductible contributions under a qualified pension plan generally are to be limited under either the "level cost" or the "normal cost" methods. However, in place of the 5 percent limitation, the bill adds a new sec. 404(a)(1)(A) (discussed below) relating to contributions needed to meet the minimum funding standard.

The "normal cost" method (sec. 404(a)(1)(C) of the Code) presently allows a maximum deduction of normal cost plus 10 percent of unfunded past service costs. The 10 percent figure includes interest as well as principal, and therefore this method is not the same as 10-year amortization.[11]

To put the minimum contribution requirements and maximum deduction limitations on a comparable basis, the bill amends the "normal cost" deduction limitation rules to allow a maximum deduction of normal cost plus amounts needed to amortize past service costs in ten equal annual payments (including principal and interest). Under this provision, initial past service costs could be amortized over ten years from the date established (past service cost established by plan amendment could be amortized over ten years from the amendment, and experience losses could be amortized over ten years from the date they are determined). The maximum deduction for any year would be the amount determined under ten-year amortization and no more than this amount could be deducted in any year even though less than this amount were contributed in a prior year.

Your committee recognizes that under the minimum funding rules an employer might have to contribute more than the maximum allowed

[11] Since the 10 percent figure includes interest as well as principal, it is estimated that, depending upon the interest rate, an employer usually may deduct amounts needed to fund accrued past service costs over 12–14 years.

[101] for deduction under the "level cost" or "normal cost" limits. For example, this could occur if the employer corrected a substantial funding deficiency for a prior year. Consequently, the bill provides that in such cases if the minimum funding standard requires a contribution to a tax-qualified pension trust which is greater than the maximum amount otherwise deductible, the amount contributed to satisfy the minimum standard is to be deductible. However, this rule does not apply to contributions to plans that are subject to the minimum funding standard but are not tax-qualified. Additionally, contributions must meet the requirements of sec. 162 before being deductible under sec. 404.

In order to put the minimum funding requirements and maximum deduction limits on a compatible basis, the bill also provides that the funding method and actuarial assumptions used to determine the amount deductible are to be the same as the method and assumptions used to determine the minimum funding required. In addition, the maximum amount deductible generally cannot be more than full funding limitation of the minimum funding standard; otherwise, deductions would be allowed for contributions greater than needed to fund the plan.

Present law generally allows deductions for contributions to overlapping combinations of pension, profit-sharing, and stock bonus plans of up to 25 percent of compensation paid or accrued to all the employees who are beneficiaries under the plans. In some cases, where there has been a previous contribution greater than the deductible limits, the deduction can be up to 30 percent of aggregate compensation. In accordance with the decision to limit contributions to defined contribution plans to 25 percent of employee compensation, the bill provides that maximum deductions for contributions to overlapping plans are to be 25 percent of aggregate compensation, and the provision for an additional 5 percent for carryovers is to be eliminated.

Under present law, contributions by an accrual basis taxpayer made by the time for filing his tax returns may be treated as paid in the year for which the return is due. This allows taxpayers time after the close of their taxable year to determine the amount of their contributions to be made to a plan. The bill extends this rule to cash basis taxpayers.

With regard to collectively bargained plans, the bill (as present law) provides that the maximum deduction limits are to be determined as if all participants in the plan were employed by one employer. Further, the bill provides that the amount contributed by each employer under a collectively bargained plan will not exceed the maximum deduction limitation if the anticipated employer contributions for the plan year are no greater than the limitation. With respect to a plan adopted by several corporations that are members of a controlled group, the maximum deduction limitations are to be determined as if all employers were a single employer, and deductible amounts are to be allocated in accordance with regulations to be prescribed by the Secretary of the Treasury.

Effective dates

The new minimum funding requirements and the new rules with respect to deductions generally are to apply to plan years beginning after the date of enactment of the bill. However, with respect to

[102] plans in existence on January 1, 1974, the new funding standards and deduction rules are to apply to plan years beginning after December 31, 1975. If a plan existing on January 1, 1974, is maintained by a labor organization exempt under section 501(c)(5) of the Code exclusively for the benefit of the employees of the organization, the new funding rules are to apply to this plan for plan years beginning after the later of (1) the last day of the second convention of the labor organization occurring after enactment of the bill (but not later than December 31, 1980) or (2) December 31, 1976.

If an existing plan is maintained under a collective bargaining agreement, then the new funding standard and deduction rules are to apply to plan years beginning after December 31, 1980, or the date on which the agreement terminates, whichever is earlier (but in no event sooner than plan years beginning after December 31, 1976). The date of termination is to be determined without regard to any extension agreed to after the date of enactment of the bill.[12]

Plans in effect on January 1, 1974, may elect to have the Internal Revenue Code provisions relating to participation, vesting, funding, and form of benefit apply to plan years beginning before the otherwise applicable effective date and all plan years thereafter. The election is to be made by the plan administrator and is to be irrevocable.

The provisions of the bill defining governmental plan, church plan, multiemployer plan, and plan administrator are to be effective on the date of enactment.

The provision of the bill establishing enrollment procedures for actuaries is to become effective upon enactment. The provisions relating to filing actuarial reports are to become effective at the same time as the general provisions relating to the new minimum funding rules.

Revenue effect

It appears clear that the new funding provisions will give rise to additional income tax deductions by employers in the immediate years ahead. However, the statistical data available do not provide any method for determining the size of this revenue effect. It is believed, however, that it will not represent a large revenue loss. In the longer run, it appears unlikely that the greater immediate funding expected under this bill will have any appreciable effect on revenues. Although funding occurs earlier under the bill than under present law, the income tax deductions taken by employers under the bill would for the most part ultimately be taken under the present funding rules.

D. Administration and Enforcement

(Secs. 1041, 1051, and 1052 of the bill, and secs. 7476 and 7802 of the Code)

Your committee's bill relies heavily on the tax laws in order to secure compliance with the new requirements that it imposes on employee pension, profit-sharing and stock bonus plans. The bill, in providing new standards of coverage, vesting, and funding continues the administration of these provisions in the Internal Revenue Service.

Many aspects of compliance have been discussed in conjunction with the various substantative provisions described in the bill. This includes,

[12] For statement relative to the termination of a collective bargaining agreement, see the discussion under the effective date with respect to "A. Participation" above.

[103] for example, the new excise taxes imposed with respect to underfunding.

In a number of other ways, however, efforts have been made to improve the provisions of existing law. The provisions of this type discussed here are the new office set up in the Internal Revenue Service to administer the new standards in this bill as well as the authorization of funds to provide for this administration. In addition, the bill deals with the problem raised as to the absence under existing law of a judicial review for letters of determination as to the qualification status of plans. Procedures are also set out whereby employees can question the qualification of plans.

1. INTERNAL REVENUE SERVICE

Present law

Under present law, the national office of the Internal Revenue Service is organized on a general activity basis rather than a tax or subject basis.[1] At the present time, there are six Assistant Commissioners of Internal Revenue in the national office whose activities are broken into the following categories: collection and taxpayer service, compliance (including auditing), inspection (internal security), planning and research, technical (rulings) and administration (housekeeping). Similarly, the field offices of the Service are organized on a similar line. Within each of these broad categories there are Service units whose jurisdictional breakdown is by subject matter under examination. For example, the Miscellaneous and Special Provisions Tax Division under the Office of Assistant Commissioner (Technical) contains an Actuarial Branch, a Pension Trust Branch and an Exempt Organization's Branch. However, various other aspects of national office employee benefit plan and tax exempt organization administration are under the Office of Assistant Commissioner, Accounts Collection and Taxpayer Service and the Office of Assistant Commissioner, Compliance.

General reasons for change

Concern has been expressed in the case of the administration of employee benefit plans (and also tax exempt organizations) as to whether the Internal Revenue Service with its primary concern with the collection of revenues is giving sufficient consideration to the purposes for which these organizations are exempt. Many believe that the present organization of the Service causes it to subordinate concern for the protection of the interests of plan participants (or the educational, charitable, etc., purposes for which the exemptions are provided).

On the other hand, the enormous growth in retirement plans during the last third of a century has proceeded largely under the tax regulations of the Internal Revenue Service. Moreover, clearly the greatest single protection for rank and file employees during this time has been the Internal Revenue Service's administration of the provision denying any special tax treatment for contributions or benefits discriminating in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. The thrust of this provision is to re-

[1] Reorganization Plan No. 1 of 1952 which went into effect on March 15, 1952. For a description of the present organization of the Internal Revenue Service, see Statement of Organization and Functions (C.B. 1970-1, 442).

[104] quire broader substantial participation in the plans than would be provided but for the Service's administration of the statute.

At the same time, it must be recognized that the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of exemption provisions. Similar concern has been expressed in the past over the Service's administration of the provisions of the tax law relating to exempt organizations.

Your committee believes that in the employee benefit plan and tax exempt organization area it should be easier to emphasize the basic objectives involved if the activities relating to these plans and exempt organizations were more closely coordinated, if the activities in these areas relating to auditing, rulings, etc. whether in the field or in the national office are brought together and if the top direction for these activities also has specialized in them. For the reasons outlined, the bill establishes a separate office in the Internal Revenue Service, headed by an Assistant Commissioner for Employee Plans and Exempt Organizations to deal primarily with plans that are (or claim to be) qualified under section 401 of the code and organizations that are (or claim to be) exempt from income taxes under section 501(a) of the Code. This includes pension, profit-sharing and stock bonus trusts and plans, religious, educational, and charitable organizations and foundations as well as the various other exempt organizations described in section 501(c) of the code. Similar functional units are to be established in the various regional and/or district offices. The committee has decided to authorize funds of $70 million a year to fund this new unit in the Internal Revenue Service.

Explanation of provisions

Office of Assistant Commissioner, Employee Plans and Exempt Organizations.—The bill establishes within the Internal Revenue Service a new office of Assistant Commissioner to be known as the Office of Assistant Commissioner, Employee Plans and Exempt Organizations. This office is to have the supervision and direction of the basic activities of the Internal Revenue Service in connection with pension, etc. plans (governed by secs. 401 through 415 of the code) and tax exempt organizations (exempt from tax under sec. 501(a) of the code). The bill authorizes the prescribing of the activities this office is to be responsible for in connection with organizations exempt from tax (under sec. 501(a) of the code) and plans which receive the special tax benefits of the qualified deferred compensation provisions of the tax laws (secs. 401 through 415 of the code).

In connection with deferred compensation plans it is intended that this office will be made responsible for, among other things, the question as to the qualification of the plan and the related trust and the exemption from tax of the trust. It also is intended that question as to the deductibility of contributions to a plan, the taxability of a beneficiary of an employees' trust and the taxation of employee annuities be included in the jurisdiction of this office. In addition, it is planned that this office would have responsibility over the minimum standards relating to funding of the plan and the excise tax for underfunding, including the enrollment and reports of actuaries.

[105] In connection with organizations exempt from tax (under sec. 501(a) of the code) it is intended that this office have the responsibilities as to an organization's exempt qualification, the taxes on unrelated business income of an organization exempt from tax, and the rules relating to the private foundation provisions of the Internal Revenue Code.

To carry out the provisions of this bill, it is intended that the principal activities referred to above will be transferred from the various Assistant Commissioners' offices to the new Office of the Assistant Commissioner (Employees Plans and Exempt Organizations). With these transfers it is intended that the Assistant Commissioner (Employee Plans and Exempt Organizations), under the direction and supervision of the Secretary, or his delegate, will have the authority to direct national and field office policy in connection with the basic activities of the Service relating to employee plans and exempt organizations.

Authorization of appropriations.—The responsibilities and functions allocated to this new office are to be funded by separate appropriations, authorization for which is made in this bill. Presently the costs of administering the provisions of the tax law relating to exempt organizations are about $20 million and the cost of administering the provisions relating to employee plans is about $22 million. This suggests a total of $42 million, but with the new activities provided in the case of pension plans and the expanded requirements under the 1969 Act with respect to exempt organizations, it is anticipated that significantly more revenue than this will be required to carry out these functions in the future. Accordingly, the bill authorizes $20 million for the remaining portion of the fiscal year ending June 30, 1974, and $70 million for succeeding fiscal years.

Effective date

These provisions are to be effective 90 days after the date of enactment of the bill.

Revenue effect

It is believed that this provision will not have any revenue effect.

2. TAX COURT DETERMINATIONS

Present law

Plans which meet the requirements of the Internal Revenue Code (that is, are exclusively for the benefit of employees, are nondiscriminatory in regard to coverage and benefits, do not engage in prohibited self-dealing transactions and meet certain other qualifications) receive special tax treatment designed to foster their growth. It is not necessary, in order to receive this special tax treatment, that a prior determination be obtained from the Internal Revenue Service as to the qualification of a plan. However, to assist employers in their development of plans or plan amendments, the Internal Revenue Service issues determination letters indicating whether or not proposed plans or amendments qualify for the special tax treatment. As a practical matter, since taxpayers generally want assurance in advance that their plans or amendments will qualify, in most cases they obtain prior determinations from the Internal Revenue Service when adopting a

[106] plan or modification. Such a determination relates to the qualification of the plan (sec. 401 of the code) and the tax-exempt status of the related trust (sec. 501 of the code).

Under the Internal Revenue Service's published procedures, this generally takes the form of a determination letter issued by a district director. The district director may request technical advice from the national office on issues arising from a request for a determination letter. Also, the applicant may request national office consideration of the matter if the district director does not act within 30 days from notice of intent to make such a request, or acts adversely.

Standards are set as to the type of situation in which the national office will entertain a request for consideration of a case. It will, for example, consider a case where the contemplated district office action is in conflict with a determination made in a similar case in the same, or another district. The procedure provides for a conference in the national office, if it is requested by the applicant.

General reasons for change

In most cases an employer is ultimately able to obtain national office consideration of a request for a determination by means of a request for technical advice by a district director or by appeal to the national office of a district director's determination or failure to make a determination. In some cases, the Service has refused to make a determination with respect to the status of a plan and related trust. In either case, however, the employer has exhausted his remedies after the action by the national office.

As a practical matter, there is no effective appeal from a Service determination (or refusal to make a determination) that a proposed pension plan fails to qualify for the special tax benefits. In these cases, although there may be a real controversy between the employer and the Service, present law permits the employer to go to court only after he has made contributions to the plan, deducted them, and had those deductions disallowed. The long time period and the related uncertainty, coupled with the threat of the ultimate loss of the tax deduction, almost always causes the employer to go along with the Service, even if he disagrees with the Service's position. In addition the determination letter procedure does not permit employees, or their unions, to question the qualification of plans.

Your committee believes that both employers and employees should have a right to court adjudication in the situations described above. The bill deals with the problem by providing that, in the event of an unfavorable determination (or failure to make a determination), the employer may ask the Tax Court for a declaratory judgment as to the status of a new plan, a plan amendment or a plan to be terminated. In addition, your committee has decided that interested employees should be allowed to participate in the consideration by the Service of an employer's request for a determination and any controversy connected with it. An employee who intervenes in the Service's determination procedure is to be entitled to receive a copy of the determination issued by the Service in connection with the proceeding. If the employee questions a Service determination with respect to the qualification of a particular plan, he may petition the Tax Court to issue a declaratory judgment as to the status of the plan.

[107] Your committee believes that this procedure is desirable because it will permit all interested parties to the controversy (the Government, the plan administrator, the employer, and his employees) to have an opportunity to participate in the administrative determination of the matter and to have an opportunity to contest the Service determination of the matter.[2]

While the committee decision permits employers and their employees to petition the Tax Court for a declaratory judgment in connection with a new plan, a plan amendment, or a plan termination, the committee also expects the Service to establish procedures whereby interested parties (including employees regardless of whether they are plan participants or plan beneficiaries) may question the continued qualification of a plan and a related trust and obtain a determination from the Service. In such a case, it is believed that the Service should afford the employer and other interested parties an opportunity to be heard before issuing a determination letter with respect to the plan and related trust. If the Service ultimately concludes that a plan is no longer qualified, then the Service is to proceed in the usual manner by notice of deficiency.

While this new declaratory judgment procedure is being made available to parties who desire to use it, there is no requirement that a party use this new procedure to determine the status of a plan. Further, there is no requirement, as a condition for qualification, that a request for a determination be made.

Explanation of provisions

In general.—The bill provides that the United States Tax Court is to have jurisdiction in the case of an actual controversy involving a determination by the Internal Revenue Service with respect to the initial qualification or continuing qualification of a retirement plan. This applies to pension, profit-sharing, and stock bonus plans (described in sec. 401(a)), annuity plans (described in sec. 403(a)), and bond purchase plans (described in sec. 405(a)).[3]

In order to satisfy the Tax Court that an actual controversy exists, an employer will have to place the plan into effect prior to the time that he petitions the Tax Court for a declaratory judgment. However, a new plan is to be treated as in effect even if it includes a provision that the funds contributed to it by the employer and employee may be refunded in the event that the plan is found not to be a qualified plan. If the contributions are refunded, all deductions for contributions would be disallowed and all income derived by the trust would be includable in income by the person who receives the payment. In the case of a plan amendment or plan termination, the action by the employer or plan trustee also may be put into effect on a conditional basis. Since the special tax benefits provided by the tax law are provided as

[2] The present Service procedure provides that appeals from a district director are to be considered by the national office in Washington, D.C., and as a result, if a party wishes to make an oral presentation, he must incur the cost of travel. The Service has instituted a regional appeals procedure in connection with the status of an organization exempt by reason of section 501(c)(3) and it is hoped that the Service will be able to institute a similar appeals procedure for employee benefit plan determinations.

[3] In providing the Tax Court declaratory judgment provisions of this bill with regard to employee plans, your committee does not intend that any inference be drawn as to the state of existing law with regard to the availability of declaratory judgment procedures or similar procedures in cases now before the courts.

[108] an incentive to employers to adopt plans which provide for broad coverage of employees and protection of participants and beneficiaries, these individuals are to be treated as interested parties (under regulations prescribed by the Secretary or his delegate), and thus may petition the Tax Court to declare that the plan as constituted does not satisfy the requirements of the tax law designed to protect the employees and their beneficiaries as intended by Congress. For example, a participant under a plan would be entitled to bring an action if he alleges that the vesting provisions under the plan do not satisfy the minimum vesting requirements of the tax law (sec. 411), and thus the plan is not entitled to the tax benefits provided for qualified plans unless the plan is amended to satisfy the minimum vesting requirements. Similarly, such an action might be brought with regard to the antidiscrimination, the participation and coverage, or other requirements of current law or as added by this bill.

The Tax Court is to have jurisdiction to make a declaration with respect to the initial or continuing qualification of such an employee retirement plan only with respect to a new plan, a plan amendment, or a plan termination. Any such declaration is to have theforce and effect of a final judgment or decree and is to be reviewable as such. The court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new matter which the Service may wish to introduce at the time of the trial. The Tax Court judgment, however, is to be based upon a redetermination of the Internal Revenue Service determination and not on a general examination of the provisions of the plan or related trust. The burden of proof rules are to be developed by the Tax Court under its rule-making powers.

The judgment of the Tax Court in a declaratory judgment proceeding is to be binding upon the parties to the case based upon the facts as presented to the court in the case for the year or years involved. This, of course, does not foreclose future action (within the limits of the legal doctrines of estoppel and stare decisis) if an examination of the operations of a plan indicates that the plan does not in operation meet the requirements for qualification.

Procedure.—It is anticipated that the normal rules of the Federal courts as they relate to declaratory judgments are to be applicable under the Tax Court declaratory judgment procedure. For this purpose, however, the filing of any pleading by a petitioner may be held to be premature, unless the petitioner establishes to the satisfaction of the Tax Court that he has complied with the requirements prescribed under regulations by the Secretary of the Treaury providing for notice to interested parties that a Tax Court declaratory judgment proceeding is being initiated. It is anticipated that the Treasury regulations will provide that a party requesting a determination letter with respect to the qualification or continuing qualification of an employee retirement plan must give notice to parties in interest at the time of the request for the determination in order to apply to the Tax Court for a declaratory judgment with respect to such a request for a determination.

Exhaustion of administrative remedies required.—For a petitioner to receive a declaratory judgment from the Tax Court under this

[109] provision, he must demonstrate to the court that he has exhausted all administrative remedies which are available to him within the Internal Revenue Service. Thus, in the case of an employer, or a plan administrators he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination by a district office to the national office of the Internal Revenue Service, or has requested or obtained through the district director technical advice of the national office. To exhaust his administrative remedies a party must satisfy all procedural requirements of the Service. For example, the Service may decline to make a determination if an employer fails to supply the Service with the necessary information on which to make a determination. In addition, the Service should decline to make a determination if it is not satisfied that the employer has taken reasonable steps to notify all employees who might have an interest in the action on request for a determination.

A petitioner is not to be deemed to have exhausted his administrative remedies in cases where there is a failure by the Internal Revenue Service to make a determination before the expiration of 270 days after the request for such a determination to be made. Once this 270-day period has elapsed, a petitioner who has exhausted his remedies may bring an action even though there has been no notice of determination from the Internal Revenue Service.

No petition to the Tax Court may be filed after 90 days from the date on which the Secretary or his delegate sends notice to a person of his determination (including refusals to make determinations) as to the qualification of the plan. This notice is to be sent to the person requesting the determination and to any other person who has participated under the Internal Revenue Service regulations in the administrative determination of the qualifications of the plan.

While the Service presently does not provide any procedure for employee objection to proposed determinations concerning the qualification of a plan, it is anticipated that the Service will adopt procedures similar to those procedures provided for employers making the request for the determination. These procedures would permit employees who have an interest in the requirements necessary for the plan to qualify to participate in the administrative determination of whether a plan is entitled to qualified status. An employee must exhaust these remedies before petitioning the Tax Court for a declaratory judgment. If there has been a failure to provide an employee with adequate notice of a request for a determination, then he need only exhaust those administrative remedies that are available to him at the time he receives adequate notice.

Tax Court Commissioners.—In order to provide the Court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the Commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide.

[110] *Effective date*

The amendments providing for petitioning of the Tax Court to issue declaratory judgments are to take effect on January 1, 1978.

Revenue effect

It is not believed that this provision will have any revenue effect.

E. Limitations on Contributions and Benefits

(Secs. 2001 and 2003 of the bill and secs. 72, 401, 404, 415, 1379, and 4972 of the Code)

Present law

Under present law generally, if an employer maintains a funded plan which does not meet the requirements for qualifications under the Internal Revenue Code, no deduction is allowed for contributions to the plan by the employer until the rights of the employees on whose behalf the contributions are made are no longer subject to a substantial risk of forfeiture (and then only if separate accounts are maintained for the employees) or are actually paid. At that time, a deduction generally is allowed the employer, but the employee then must take the contributions into his income. Also the earnings on these contributions are not tax exempt. In comparison with the nonqualified plan, under the qualified plan the employer may receive a deduction for contributions to the plan, the earnings on the contributions are tax exempt, and the employees generally do not have to take the contributions into income until benefits are actually distributed to them.

Under present law, different rules are provided for employer and employee contributions in the case of qualified plans for self-employed individuals (H.R. 10 plans), plans of "regular" corporations, and plans of electing small business corporations (subchapter S).[1] These are described below.

H.R. 10 plans.—The amount of annual deductible contributions to an H.R. 10 plan on behalf of a self-employed person cannot exceed the lesser of 10 percent of his earned income [2] or $2,500 (sec. 404(e)). In addition, nondeductible contributions may be made in certain cases, but these contributions on behalf of owner-employees may not exceed the lesser of 10 percent of earned income or $2,500. Allowable voluntary contributions of employees of owner-employees must be at least proportionate to allowable voluntary contributions for owner-employees (sec. 401(e)(1)(B)(ii)).

"Regular" corporate plans.—In the case of a "regular" corporate plan (except as discussed in footnote 1) there are no limitations on the benefits an employee can derive from a qualified plan. There are, however, limitations on the amount of the contribution that is deductible. Different limitations apply to profit-sharing and stock bonus plans and

[1] All the types of plans must, in addition to the rules described below, meet the general reasonable compensation tests (sec. 162). The statute does not specify limitations on the benefits which may be paid under a qualified pension plan. However, in Rev. Rul. 72–3, 1972–1 CB, 105 the Internal Revenue Service ruled that pension benefits from a qualified pension plan are intended as a substitute for compensation, and that in general a plan which provides benefits in excess of an employee's compensation is therefore not qualified.

[2] "Earned income" is generally defined as being equivalent to "net earnings from self-employment"—the kind of income that may be subject to self-employment taxes in lieu of FICA taxes (sec. 401(c)(2)).

[111] to pension plans. All those limitations are based on the aggregate covered payroll rather than being on an employee-by-employee basis.

In the case of profit-sharing or stock bonus plans, the amount of the contribution that is allowable as a deduction is not to exceed in the aggregate 15 percent of compensation to employees covered under the plan. Contributions in excess of the 15-percent limitation may be carried over to future years. In addition, within certain limits, to the extent that an employer does not make the full 15-percent contribution in one year he may increase the amount of his deductible contribution in a future year.

In the case of pension plans, the amount of the contribution that is deductible is not to exceed 5 percent of the compensation to employees covered under the plan, plus the amount of the contribution in excess of 5 percent of compensation to the extent necessary to fund normal pension costs and remaining past service costs of all employees under the plan as a level amount or as a level percent of compensation over the average remaining future service of plan participants. In the alternative, the taxpayer may compute the limit on his deductible contributions by limiting his deduction to his normal cost for the plan plus 10 percent of the past service cost of the plan (sec. 404(a)). In practice, these limitations have very little effect in limiting the size of contributions to regular corporate pension plans.

Where an employer contributes to two or more retirement plans which are governed by different limits on deductions (pension or employee's annuities on the one hand, and profit-sharing or stock bonus, on the other hand), the total amount annually deductible under the plans cannot be more than 25 percent of compensation otherwise earned by the plan beneficiaries. If any excess is contributed, it may be deducted in the following year; the maximum deduction in the following year (for carryover and current contributions together) is 30 percent of compensation. A carryover is available for additional excess contributions which are deductible in the succeeding taxable years in order of time.

Subchapter S plans.—The limitations on the deductibility of contributions to a subchapter S corporation plan are the same as those in "regular" corporate plans. However, a shareholder-employee (an employee who owns more than 5 percent of the outstanding stock of the corporation) must include in his gross income the amount by which the deductible contributions paid on his behalf exceed the lesser of 10 percent of his compensation or $2,500 (sec. 1379(b)).

Professional corporations.—Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. Consequently, their contributions to retirement plans were limited by the rules governing self-employed persons. In recent years, however, all States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate employees. The Treasury Department, in the so-called Kintner regulations, held

[112] that professional corporations were not taxable as corporations. A number of court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

General reasons for change

Many self-employed people, especially professionals, feel that they are discriminated against as compared with corporate executives and proprietary employees of corporations in regard to the tax treatment of retirement savings. This is because, at present, there is no comprehensive limit on the amounts the corporate employer can provide under a qualified plan on behalf of its executives and proprietary employees. Self-employed persons, on the other hand, are subject to the contribution limits described above.

In addition, many of the self-employed argue that, as a result of these contribution limits, it is difficult for them to provide adequately for their retirement, particularly as many professionals have a limited number of years of peak earnings, in which it is comparatively easy to set something aside. It is also argued that the $2,500 limit is no longer appropriate, since in the approximately 10 years since H.R. 10 was first enacted, there has been a substantial inflation factor in the economy. Furthermore, it is contended that the present law in the retirement plan area creates an artificial incentive for the incorporation of businesses which more traditionally, and perhaps more appropriately, have been conducted in unincorporated form. For all of these reasons, the committee believes that a substantial increase in deductible contributions for self-employed individuals is justified at the present time. Under the bill, the present limits would generally be increased to 15 percent of earned income, up to a maximum deduction of $7,500 per annum.

At the same time that some individuals have been questioning the relatively low level of tax deductible contributions for H.R. 10 plans, others have questioned the wisdom of permitting virtually unlimited pension benefits in corporate plans to be funded out of tax-free dollars.

Your committee recognizes the importance of tax incentives in creating a strong private pension system. At the same time, however, your committee believes it is appropriate to provide some limitations to prevent the accumulation of corporate pensions out of tax-sheltered dollars which are swollen completely out of proportion to the reasonable needs of individuals for a dignified level of retirement income. Moreover, by imposing limitations on corporate plans, and liberalizing the limitations which are imposed under present law on H.R. 10 plans, the bill takes a long step forward to achieving tax equity in this area. Thus, the bill provides, in general, that a qualified trust may not provide a defined benefit in excess of $75,000 a year, or 100 percent of the employee's average high-3 years of compensation (whichever is less) and that contributions to a qualified money purchase pension plan, profit-sharing plan or stock-bonus plan may not exceed $25,000 a year, or 25 percent of the employee's annual compensation (whichever is less). These provisions do not limit the size of the pension which the employee may receive from a non qualified plan, which

[113] is financed out of taxed dollars. The only effect of the provisions is to limit the size of the pension which is subsidized by the tax laws.

Explanation of provisions

1. *H.R. 10 plans—in general.*—The bill increases the maximum deductible contribution on behalf of self-employed persons to the lesser of $7,500, or 15 percent of earned income. (A similar, although not identical, rule is applied in the case of defined benefit pension plans.) However, no more than the first $100,000 of earned income may be taken into account in applying the percentage limits. The $100,000 ceiling on the earned income rate base means that a self-employed person (or a shareholder employee in a subchapter S corporation) with more than $100,000 income will have to contribute at a rate of at least 7½ percent on behalf of his employees if he wishes to take the full $7,500 deduction on his own behalf (in order to comply with the antidiscrimination requirements).[3] A self-employed person earning more than $100,000 who wishes to contribute $5,000 for himself will have to contribute at least 5 percent on behalf of his employees.

For purposes of these rules a self-employed person is allowed only one $100,000 contribution base, no matter how many plans he may establish for a trade or business. For example, a self-employed person with $200,000 of earned income could not cover himself under two plans, each of which also covered half of his employees, and use up his $7,500 limit by contributing at a rate of 3.75 percent under both plans; in other words, contributions for all employees would have to be at a 7.5 percent rate, if the self-employed individual was to be allowed to make a $7,500 deductible contribution on his own behalf.

The committee bill also contains a provision to permit self-employed individuals to set aside up to $750 a year out of earned income as a deductible contribution, even though it exceeds the otherwise applicable percentage limitation (15 percent of earned income). This provision will enable certain organizations of the self-employed, such as the Jockeys' Guild, to set up retirement plans for their members without having to confront complex record-keeping and administrative problems, and will also allow any self-employed individual who wishes to do so to save for his retirement, even though his earned income in a particular year is relatively low.

Subchapter S corporations.—Since Subchapter S corporations are not subject to normal corporate tax, and the stockholders of the corporation are taxed generally like self-employed partners. Your committee believes it is appropriate to retain section 1379 in the Code. However, the bill raises the limitations on contributions for Subchapter S stockholders to the same substantially increased deductible amounts (15 percent of earned income, or $7,500) which are allowed under the bill for self-employed individuals.

Defined benefit plans for the self-employed.—Under present law, most self-employed plans are defined contribution plans because of the limitations on contributions imposed on self-employed persons un-

[3] The limitations on nondeductible contributions on behalf of owner-employees in a self-employed plan are not increased, however.

[114] der present law. Your committee believes that the option of having defined benefit plans should be available to the self-employed and shareholder-employees of Subchapter S corporations. Accordingly, the bill provides that the Secretary or his delegate is to prescribe regulations which will allow self-employed plans (or plans benefiting shareholder-employees of a Subchapter S corporation), in effect, to translate the 15 percent-$7,500 limitation on contributions, to which they would otherwise be subject, into limitations on benefits which they could receive under a defined benefit plan. The bill also provides certain "guideline regulations" which the Secretary must follow in carrying out the purposes of the bill.

A defined benefit plan which follows the guideline regulations is to be subject to the limits on deductions for corporate defined benefit plans rather than the 15 percent-$7.500 limitation.

Under the formula provided in the bill, the basic benefit for the employee (that is, a straight life annuity commencing at the later of age 65 or 5 years from the time the participant's current period of participation began, with no ancillary benefits and assuming no employee contributions) is not to exceed the amount of the employee's compensation [4] which is covered under the plan (up to a maximum of $50,000) times the percentage shown on the following table.

Age at participation	*Percentage*
30 or less	6. 5
35	5. 4
40	4. 4
45	3. 6
50	3. 0
55	2. 5
60 or over	2. 0

The percentages in early years are higher to reflect the fact that contributions made during these time periods earn interest for a longer period prior to retirement than contributions made in later years. Thus, for purposes of applying the table, past service credits are not to be considered in determining at what age a self-employed individual's period of participation in the plan began. The Secretary or his delegate is to have authority to prescribe regulations in cases of plans which provide something other than the "basic benefit." Also, the regulations are to specify percentages for individuals who become participants at ages between those shown on the table. In addition, the Secretary or his delegate is given authority to prescribe new percentages, to be used in years beginning after December 31, 1977, based on changes in money rates and mortality tables occurring after 1973.

To illustrate how this formula would work, assume that a self-employed person enters a defined benefit plan at age 30, and participates in the plan for 5 years, with income covered under the plan of $20,000 per annum. At age 35, he leaves the plan, but at age 50, he again becomes a participant. For the first 5 years his covered income

[4] In the case of a self-employed individual the term "compensation" means earned income; in the case of a shareholder-employee the term means the amounts received as compensation from the Subchapter S corporation.

[115] is $30,000 per year, then $40,000 for the next 5 years, and finally $50,000 for the last five years prior to his retirement.

The calculation would work as follows:

Age	Compensation per year	Rate	Benefit earned per year	Total benefit
30–35	$20,000	6.5	$1,300	$6,500
50–55	30,000	3.0	900	4,500
55–60	40,000	3.0	1,200	6,000
0–65	50,000	3.0	1,500	7,500
Total				24,500

Thus, the maximum benefit which could be paid to the individual under the plan in the form of a single life annuity commencing at age 65 with no ancillary benefits would be $24,500 per year.

In order to receive the maximum benefit accrual rate under the formula in a later period, a self-employed individual might establish a plan for himself at an early age, but with a very low rate of accrual, or a very low compensation base on which the benefit accrual was measured. Thus, his employees during this period would only receive a low-benefit accrual. Later, when some of these employees had departed, the self-employed individual might seek to raise the rate of accrual. To prevent this sort of abuse situation, the bill requires that the regulations must provide that any increase in the rate of accrual or the compensation base [5] under the plan, would be treated, only with respect to such increase, as beginning a new period of participation for the self-employed individual. For example, assume that a plan was established by an individual at age 30, which provided for a 6.5 percent rate of accrual, but that the compensation base under the plan was only $10,000. Then, at age 40, the individual wishes to increase the annual benefit accrual to the maximum permissible amount. This would be computed by taking 6.5 percent of the first $10,000 of compensation, and 4.4 percent (the maximum rate of accrual for a self-employed individual who enters a plan at age 40) of additional compensation up to the $50,000 ceiling, for a total accrual of $2,410 per year for an individual having at least $50,000 of compensation.

The committee bill also provides that for purposes of the antidiscrimination rules, the maximum amount of compensation which is to be taken into account is to be $100,000. (This is the same ceiling provided in connection with contributions to a money purchase plan.) For example, if a self-employed person established a defined benefit plan for himself at age 50 (where a 3 percent rate would apply) and earned $100,000 per year, benefits under the plan for his employees could be earned at the rate of 1.5 percent of covered compensation, and the plan would not be considered to be discriminatory. In other words, the maximum benefit which could accrue per year for the self-employed person would be 3 percent of $50,000, or $1,500, which is equivalent to 1.5 percent on a $100,000 base. Thus, the self-employed person would be permitted to make contributions which would pur-

[5] Of course, an increase in the amount of compensation earned by the self-employed individual would not trigger a new period of participation.

[116] chase a 1.5 percent benefit for his employees. However, even if the self-employed person's earnings were $200,000, benefits earned for the employees under the plan could not drop below the 1.5 percent rate.

A plan which covers owner-employees may not take advantage of the regulations authorized in this provision, unless it provides benefits for all participants under the plan on a nonintegrated basis.

In order to assure reasonable comparability between defined benefit and defined contributions and combination of plans, the regulations are to provide for appropriate adjustments in the allowable amount of deductible contributions, or permissible rate of benefit accruals in cases where the same self-employed individual is a participant in two or more plans. For example, a $3,750 contribution to a money purchase pension plan (for an employee whose earnings is at least $50,000) has the effect of reducing the maximum allowable rate of accrual under a defined benefit plan by one-half. In addition, a change in the rate of accrual by reason of this rule is to be treated as a new period of participation for purposes of determining the maximum rate of accrual under the table provided for defined benefit plans.

For purposes of the above rules, all plans of a controlled group of partnerships (within the meaning of secs. 414(c) and 415(h) of the code) are to be aggregated for purposes of the limitations.

Excess contributions.—Under present law, if excess contributions are made on behalf of an owner-employee, these must be repaid with the earnings thereon within 6 months after the mailing of notice by the Internal Revenue Service; otherwise the plan will become disqualified with respect to that individual. In the case of an excess contribution which is willfully made, the plan will become disqualified with respect to the owner-employee, and he is barred from participating in a qualified plan for the 5 succeeding years. In contrast a shareholder-employee who is subject to the same deduction limits need not repay the excess contributions but must take those amounts into income.

This rule can work a hardship in cases where a relatively minor violation of the excess contribution rules could result in a complete disqualification of the plan with respect to an owner-employee. Moreover, the present rules will not work well in the context of a defined benefit plan, because it is difficult, if not impossible, to trace particular contributions to benefit accruals under the plan for particular employees. For these reasons, the bill repeals the provisions of present law outlined above.

At the same time, it is clear that there must be some rule to discourage excess contributions in order to prevent the tax-free accumulation of earnings on contributions in excess of those permitted under the law. Since the major abuse of overfunding is that it permits the tax-free accumulation of the earnings on the excess contribution, your committee's bill imposes an excise tax of 6 percent on excess contributions to plans for the self-employed. The tax is to be paid by the employer who maintains the plan.

In the case of a defined contribution plan (for example, a money purchase pension plan), excess contributions include amounts contributed by the employer in excess of the 15 percent of earned income, or $7,500 deduction limits on contributions on behalf of self-employed persons. In the case of a defined benefit plan, the tax is imposed where

[117] the plan is fully funded at the close of the employer's taxable year, and is imposed upon the amount that has not been deductible for the taxable year or any prior taxable year (i.e., the amount of the carry-overs). Also, in either type of plan, excess contributions include voluntary contributions by owner-employees in excess of the allowable amount of such contributions. As under present law, voluntary contributions on behalf of owner-employees may not exceed the lesser of 10 percent of earned income, or $2,500. Moreover, allowable voluntary contributions under the plan for employees other than owner-employees must be at least proportionate to allowable voluntary contributions for owner-employees. As under present law, excess contributions do not include amounts which are allocable under regulations to the purchase of life, health or accident insurance.

In the case of a plan funded through level premium insurance payments, the employer may contribute an amount based on an average of the allowable deductible contributions for an owner-employee for the three immediately preceding taxable years without triggering the tax on excess contributions, even though this amount is in excess of the deductible contribution which can be made for that employee for the taxable year in question. However, any such amounts will be treated as part of the owner-employee's distributable share of the partnership income for income tax purposes and as a voluntary contribution by the owner-employee for purposes of the excise tax on overfunding.

To encourage plans to repay the amount of any excess contributions (and in recognition of the cumulative advantages of excess contributions), the committee bill provides that the excise tax is to be cumulative. For example, assume that an employer made a contribution of $15,000 on behalf of an owner-employee in a year in which only a $5,000 contribution was allowable as a deduction. An excise tax of $600 would be imposed for that year.[6] If, in the following year no amounts were contributed to or repaid from the plan, but an additional deductible contribution of $5,000 were allowable for that year, an excise tax of $300 would be imposed ($10,000 minus the $5,000 deductible contribution allowable for year two, equals $5,000, times 6 percent, equals $300).

Regulations will provide for the situation where there are two or more plans benefiting the same self-employed individual, or where there are two or more partnerships or proprietorships under common control.

Premature distributions.—Under present law, in general, where amounts are distributed under a qualified plan to an owner-employee before he attains age 59½, section 72 provides that the tax imposed on such amounts shall be not less than 110 percent of the amount of the increase in his taxes due to the distribution. Where the premature distribution exceeds $2,500, then, for purposes of computing the penalty, it is averaged over the current year and the four preceding years.

The purpose of the provisions allowing a deduction for contributions to a qualified retirement plan is to allow money to be set aside on a

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[6] In a plan which permits voluntary contributions by owner-employees, the plan might treat part of excess employer contributions as a voluntary contribution, as under present law, thus reducing the tax on overfunding. However, under these circumstances, owner-employees would have to take the amount of the voluntary contribution into income.

[118] tax-sheltered basis for retirement purposes. Where the retirement plan contributions are withdrawn prior to the retirement years, this purpose is frustrated. The committee therefore believes that there should be a substantial deterrent to prevent an owner-employee from treating his retirement plan as a tax-free savings account which he can withdraw prior to retirement.

The provisions of present law do not fully serve this purpose. The amount of the penalty varies depending on the taxpayer's marginal rate of tax on his other income during the year in which he receives the premature distribution. Also, present law affords an opportunity for the owner-employee to minimize the penalty by arranging to receive the premature distribution in a year in which his other income is low, or his deductions are high.

To remedy this situation, the bill repeals the penalty provisions of present law and imposes instead an income tax of 10 percent on the amount of the premature distributions. This is in addition to any other income taxes payable on this distribution, and would not be offset by any tax credits (other than the refundable credits for overwithholding, overpayment of tax, and the gasoline tax credit). Also, this tax would not be treated as reducing the individual's tax liability under the minimum tax provisions.

As under present law, the penalty tax would not apply in the case of a distribution due to death or disability.

Withdrawing of voluntary contributions by owner-employees.—Under present law, amounts received from a retirement plan before retirement are tax free to all participants other than owner-employees to the extent of all nondeductible contributions made to the plan by the participants. Thus, all participants other than owner-employees may, if the plan permits it, withdraw their voluntary contributions prior to retirement. The bill extends this same treatment to owner-employees.

Time for making contributions.—Under present law, contributions to a self-employed plan must be made by the end of the taxable year in order to be deductible for that year. Often this can create difficulties for the self-employed person, who may not have at hand all the information necessary for him to determine how much he is permitted to contribute on his own behalf. In order to meet this problem, the bill provides that tax deductible contributions of self-employed plans (and all other qualified plans) may be made at any time up to the point when the Federal income tax return (corporate or individual, as the case may be) for that year is due (including any extension). This rule should provide the additional time necessary for the individuals involved to make the required calculations and determine the amount of the maximum deductible contribution which is permitted for the taxable year in question.

2. *Overall limitation—in general.*—As part of the process of moving toward parity in the tax treatment of corporate plans and H.R. 10 plans, the committee bill contains provisions imposing overall limitations on the contributions and benefits which are allowable under qualified plans and retirement accounts and annuities which receive

[119] favorable tax treatment.[7] This overall limitation must be satisfied in order for the favorable tax benefits under the plan, annuity, or account to be retained. H.R. 10 plans and plans of Subchapter S corporations are also subject to these rules.

Plans to which limitation applies.—The overall limitation applies to a trust which is part of a pension, profit-sharing, or stock bonus plan (described in sec. 401(a)), an annuity contract (described in sec. 403 (b)), an employee annuity (described in sec. 404(a)(2)), and an individual retirement account or annuity (described in sec. 408).

Defined benefit plans—limitation on benefits.—Under the committee bill, in general, the highest annual benefit which can be paid out of a defined benefit plan to a participant is equal to the lesser of (1) $75,000, or (2) 100 percent of the participant's average compensation from the employer during his highest 3 consecutive calendar years of aggregate earnings during the period he was an active participant in the plan[8] (or his average compensation during the period of his participation in the plan if this was less than 3 years) Compensation for this purpose includes the participant's earnings from his employment and includes bonuses and other taxable payments except for deferred compensations, stock options, and other distributions which receive special tax benefits.

The 100-percent limitation is simply a clarification of present law. The Internal Revenue Service has ruled that a pension is essentially a substitute for earning power during the retirement years (Rev. Rul. 72–3, 1972–1 C.B. 105). Your committee agrees with this interpretation and believes that no qualified pension plan should pay benefits which are higher than an employee's average earnings during his highest 3 years. The committee also believes that it is desirable to impose some dollar limitations on the size of a pension which may be paid out of tax-sheltered dollars and the $75,000 limitation which is imposed under the bill is generous enough to afford a reasonable standard of living.

To prevent the erosion of the value of an employee's pension due to inflation, the committee bill permits a qualified defined benefit plan, in accordance with regulations, to provide a cost-of-living adjustment for employees who have retired or terminated their service under the plan, over and above the 100 percent limitation or the $75,000 limitation. The adjustment to the $75,000 and the 100 percent ceilings will be provided annually by the Secretary or his delegate to reflect cost-of-living increases.

The procedures used in the regulations will be similar to those used in adjusting the old age and survivor's benefits under the social security law (but without regard to the timing or amount of any increase specifically authorized by action of the Congress).

Benefits paid in the event of early retirement would not have to be scaled down from the 100 percent of salary level on an actuarial basis. However, the $75,000 limitation must be scaled down in the event

[7] Nothing in the committee bill would prevent the payment of any amount of compensation or pension benefits on a nontax-sheltered basis, subject only to the rules of section 162 that in order for the employer to receive a deduction, compensation paid to employees must be reasonable, and the rules of section 404(a)(5) dealing with contributions to nonqualified trusts.

[8] If the individual was an employee of several corporations in a controlled group, his earnings from all members of the group would be aggregated for purposes of these rules.

[120] of early retirement prior to age 55, but not below $10,000. In general, the benefits payable under a defined benefit pension plan would not have to be reduced for pre-retirement ancillary benefits, such as medical, death, and disability. Only post-retirement ancillary benefits which are directly connected with the retirement benefit need be taken into account in computing the limitations. Thus, for example, the value of an annuity paying a sum certain, a post-retirement death benefit or a guaranteed payment for a period of years would be an ancillary benefit which needs to be taken into account.

Your committee believes that it is socially desirable to encourage joint and survivorship benefits. Accordingly, it has concluded that no adjustment should be made for the provision of such a benefit for the participant and his spouse to the extent that the benefit payable to the survivor is not greater than the benefit which would be payable if both the participant and his spouse were alive. To be a joint and survivors annuity, the benefit payable to the survivor must be for the full life of the survivor.

In the case of a contributory plan, upward adjustments in the benefit schedule would be permitted in accordance with regulations, to reflect the fact that part of the annuity had been purchased with the employee's own after-tax dollars.

The committee expects that all of these adjustments will be substantially equivalent to the adjustments now provided under present law for a plan which is integrated with social security.

As a further adjustment, the defined benefit otherwise allowable in accordance with the rules described above is to be reduced by multiplying the otherwise allowable benefit by a fraction, the numerator of which is the employee's years (or part thereof) of service with the employer and the denominator of which is 10. For example, if an individual who had 3 years of service had an average high-three years salary of $50,000 (and no other adjustments were required) his maximum benefit could not exceed 3/10ths of $50,000, or $15,000 per annum. This prevents a situation where an individual might receive an extremely high pension, even though he had only a few years of active service under a plan.

The purpose of providing an overall limitation is to prevent the accumulation of excessive pension benefits out of tax-free dollars. But the committee sees no useful purpose to cutting back on the benefits of the average working man who has a relatively limited amount of income. Accordingly, the bill specifically provides that notwithstanding the 100-percent limitation, or the required adjustments for certain ancillary benefits, a qualified defined benefit plan (or plans) of the employer may pay an annual retirement benefit of up to $10,000 per annum to any employee who has not been a participant in any defined contribution plan of the employer.

Defined contribution plans.—Under present law, there is no limitation on the amount which may be contributed to an employee's retirement account under a corporate defined contribution plan, although the employer may not, in any one year, deduct contributions in excess of 15 percent of the aggregate compensation paid to employees covered under a profit-sharing plan, or 25 percent of the aggregate compensation paid to employees under a combination profit-sharing and

[121] pension plan (except in the case of carryovers, where the present limit is 30 percent).

The committee bill retains these rules (with certain modifications, as discussed below). But the committee believes it is also appropriate to impose limitations on the annual additions which can be made to an individual employee's account under a defined contribution plan in order to achieve some measure of comparability with the limitations imposed under the bill on the benefits which may be paid under a defined benefit plan. For purposes of these rules, defined contribution plans include profit-sharing and stock bonus plans, as well as money purchase pension plans and target benefit plans.

Under the committee bill, the annual additions to an employee's account under a qualified plan or plans of the employer may not exceed the lesser of (1) $25,000, or (2) 25 percent of the individual's compensation from the employer during the year. The term "annual additions" means (1) the employer's contributions under the plan, (2) the lesser of one-half of all the employee's contributions or all the employee contributions in excess of 6-percent of compensation, and (3) any forfeitures which are added to the employee's account during the year.[9] For purposes of these rules, only a portion of the employee contributions is counted because the employee receives only one of the two tax advantages generally associated with contributions to a qualified plan—deferral of the taxes on the earnings on the contributions—but does not receive a tax deduction for the amount of the contribution when it is made. The option of excluding the first 6 percent of employee contributions recognizes the fact that many plans provide for small amounts of employee contributions and it would greatly increase the complexity of the provision if small amounts of contributions for which there were relatively small tax advantages had to be taken into account. The $25,000 limitation will be adjusted annually for the cost of living in accordance with regulations in the same manner as the $75,000 limitation.

As previously indicated, under present law the contributions allowable as a deduction in a combination profit-sharing and pension plan may not exceed 25 percent of the aggregate compensation to employees covered under the plan. However, where excess contributions are made, these may be carried forward and deducted in succeeding years, and the deduction limitation for those years is increased from 25 to 30 percent. The committee bill modifies this result by continuing to allow the carryover, but providing that the ceiling on deductible contributions remains at 25 percent.

In addition, under present law, in the case of a profit-sharing plan alone, the limitation on deductible contributions is 15 percent of the aggregate compensation paid to employees covered under the plan. In cases where the employer fails to utilize his full 15 percent allowance. the unused portion may be carried forward and used in succeeding years, up to 30 percent of aggregate compensation limit for the taxable year. The bill provides that the carryover of unused contribution limits in this case may not result in a situation where the employer

[9] The term "year" will be defined in regulations. Generally, in cases where there is only one plan, the "year" will be the plan year. In cases where there is more than one plan involved, the regulations will set forth the criteria for determining the relevant year.

[122] could deduct more than 25 percent of aggregate covered employee compensation for the year.

Combination plans.—Where a corporation has 2 or more plans, or 2 or more different types of plans, the limitations, of course, must operate as an overall ceiling on the maximum benefit the employee can obtain under all the plans. Otherwise, it would be possible to escape the limitations by the simple device of establishing as many plans as were needed to provide the benefits desired. Additionally, rules are needed where an employee is employed by two or more related corporations of the same employer, some of whom have separate retirement plans. In such a case the committee bill provides that all the plans are to be subject to the overall ceiling. The overall ceiling would be computed, in general, by aggregating similar plans (defined contribution or defined benefit) and reducing the limitation on one type by the benefits or contributions of the other.

For purposes of these rules, all of the defined benefit plans of an employer (whether or not terminated) are treated as one plan, and all of the defined contribution plans (whether or not terminated) are treated as one plan. If an employer maintains a defined benefit and a defined contribution plan each plan would be subject to the limit; in addition the two plans must be combined in computing the overall limitation.

To achieve this purpose, the bill establishes a formula (to be applied each year by each employee) under which a defined benefit plan fraction for the year is added to a defined contribution plan fraction. If the sum of these fractions exceeds 1.4, then one or more of the plans will be disqualified. Of course, the employer is free to adjust either the benefits accruing under the defined benefit plan or the annual additions to a defined contribution plan for particular employees to prevent this from happening. The committee anticipates that many plans will include "fail safe" provisions, which automatically freeze either the rate of benefit accrual, or the amount of annual additions, to a level necessary to prevent the overall limitation from being exceeded for any employee. A plan is to be permitted to contain such a provision without violating the requirement that a qualified plan must provide for fixed and determinable benefits.

The numerator of the defined benefit plan fraction is the "projected benefit" of the participant under the plan determined as of the close of the year and the denominator is the maximum benefit which would be permitted under the plan under the limitations established in the bill. For purposes of computing the projected benefit, it is assumed that the participant's compensation for all future years will equal his compensation during the year in question. It is assumed that all other relevant factors considered in computing the benefit, such as provisions of the plan, social security benefit levels, and cost-of-living will remain constant as of that year.

The numerator of the defined contribution plan fraction is the total amount of annual additions to the participant's account through the close of the year in question and the denominator of this fraction is the maximum amount of additions which could have been made for that

[123] participant, under the provisions of the committee's bill for the year in question and all prior years of service with that employer.[10]

For example, assume that an employee is employed at age 40 and immediately becomes a participant in a defined benefit plan which accrues a benefit annually equal to 2 percent of his high three years of compensation (adjusted for the cost-of-living). His annual rate of compensation is $150,000. At age 45, he becomes a participant in a defined contribution plan of his employer.

In the case of this employee, his projected benefit under the defined benefit plan, assuming he works until the normal retirement age of 65, would equal 50 percent of his average high three years of compensation or $75,000. Since $75,000 is the maximum amount of the annual benefit which is payable from a qualified plan under the provisions of the committee bill (assuming no increase in the cost-of-living) contributions could be made for the employee under the defined contribution plan, if the defined contribution fraction did not exceed four-tenths.

Assuming that the defined benefit plan were amended to provide that future accruals would equal 1 percent of compensation (or $1,500 per year in the case of this employee), his projected benefit under the defined benefit plan would then equal $45,000, 30 percent of his high three years of compensation (which equals 60 percent of his $75,000 limitation). This would mean that 80 percent of his overall limitation could be provided under the defined contribution plan.

For purposes of these rules, plans of all corporations, partnerships, or proprietorships which are under common control will be aggegated. Generally, the question of common control will be determined under sec. 1563(a) of the Code (and secs. 414(b) and (c) of the Code), except that a 50-percent control test will be applied for purposes of these rules, instead of the 80-percent test imposed under that section. Also to be aggregated are any sec. 403(b) annuity plans or individual retirement accounts (established under the provisions of this bill) in which the individual is a participant. For purposes of these rules, the participant will be treated as having 100 percent control of these plans. For example, a sole proprietor maintaining an H.R. 10 plan for himself who is also a participant in a section 403(b) plan would aggregate the two plans as he has control over both plans.

In the event of a merger between two employers of the same employee, the overall limitation is not less than the aggregate benefits he has already accrued under the plans of both employers if there

[10] In order to prevent a situation where a plan in existence before the effective date of the provisions might start off under these provisions with a deficit, the committee bill provides that for purpose of the defined contribution plan fraction, additions to the account prior to January 1, 1976, will be treated as not being in excess of the additions which would have been allowable for those years under the provisions of the committee bill.

Since many defined contribution plans permit employees to make "catch-up" contributions to take into account the fact that an employee did not make the maximum contribution for a past year, the computations necessary to compute the defined contribution fraction as of January 1, 1976, may be made on a cumulative basis. In recognition of the fact that plans may have to be amended to satisfy these new limitations and that existing plans often permit 10-percent employee contributions on a cumulative basis, the bill provides that employee contributions are not to be taken into account if made prior to January 1, 1976, if not in excess of the maximum amount of contributions permissible under the plan as in effect on October 2, 1973, to the extent that the contributions are 10 percent (or less) of the employee's salary, computed on a cumulative basis. The maximum amount of contributions permissible under the plan as in effect on October 2, 1973, is intended to include the maximum amount of contributions permissible under amendments to a plan approved by the Internal Revenue Service before October 2, 1973, and actually put into effect before the end of the year 1973.

[124] was no common control before the merger. In other words, the employee will not be forced to give up benefits he has already earned prior to the merger.

If it is determined upon application of the bill formula that the limitations contained in the bill have been exceeded, then the determination as to which plan or plans must be disqualified will be made by the Internal Revenue Service in accordance with regulations. The regulations are to provide that no terminated plan may be disqualified until all other plans have been disqualified (since there might be no recovery of taxes in the case of plans which had terminated in a year for which the statute of limitations had already run). Also, to prevent undue hardship, the regulations are to provide that plans still in existence generally are to be disqualified on a basis which will affect the fewest number of employees.

Additional benefits.—The bill contains a provision which makes it clear that benefits or contributions in addition to those allowable in connection with qualified plans may be paid or accrued on behalf of an employee, so long as this is not done on a tax deferred basis. For example, an employer would be free to provide additional defined benefits under a so-called "pay as you go" plan, which means, in general, that the benefits are paid by the employer as they fall due, and the plan is not funded. Here, the employer would receive his deduction at the time when the employee was required to take the benefits into income.

Similarly, the employer would be free to make defined contributions into a taxable trust or bank account on behalf of the employee and these amounts could be set aside for pension purposes. However, the employer would not be entitled to a deduction (except as provided in sec. 404(a)(5)) until the employee's rights to these amounts are no longer subject to a substantial risk of forfeiture at which time the employee would be required to take them into income.

Special rule where records are not available.—In the case of existing plans, it may be that the employer will not have adequate records to determine the amount of additions which have been made for his employees under a defined contribution plan. Likewise, the employer may have no way to determine the amount of additions which would have been allowable for his employees under the provisions of the committee bill, had those provisions been in effect for the years in question. Accordingly, the Secretary or his delegate is authorized to prescribe regulations establishing reasonable assumptions which may be used by the employer in determining the amount of additions and allowable additions for years prior to the effective date of these provisions.

Likewise, in the case of plans which may be established in the future, the employer will be aware that no contributions or additions have been made on behalf of his employee, but may not have adequate records to establish the amounts of allowable additions which could have been made. Thus, the Secretary or his delegate is authorized to establish reasonable assumptions which may be used by the employer

Effective dates and transition rules

In general, the amendments with respect to H.R. 10 plans, including the provisions increasing the amount of the deductible contributions

[125] which may be made on behalf of the self-employed, are to apply to taxable years beginning after December 31, 1973. However, the rules facilitating the use of defined benefit plans for the self-employed, as well as the rules modifying the treatment of excess contributions under H.R. 10 plans and the rules with respect to the taxation of premature distributions, are to apply to taxable years beginning after December 31, 1975.

The new rules with respect to corporate limitations will apply to contributions made or benefits accrued in years beginning after December 31, 1975.

However, the committee was concerned that the limitations imposed on the bill should not have the effect of cutting back the pension of anyone under the provisions of an existing plan. Accordingly, the bill contains a transition rule for any individual who is, on October 2, 1973, an active participant in a defined benefit plan. Under the terms of this provision, an employee may receive an annual benefit which does not exceed 100 percent of the individual's annual rate of compensation on October 2, 1973 (including bonuses whether or not they were taken into account in the base for benefits under the plan as in effect on that date). However, the benefit may not exceed the annual benefit which would have been payable to the participant on retirement if all the terms and conditions of the plan in effect on October 2, 1973, (without regard to any amendments to the plan actually adopted after that date even though such amendments may, for other purposes, be given retroactive effect) had remained in effect until the employee's retirement, and his compensation taken into account under the plan for any period after October 2, 1973, had not exceeded his annual compensation on that date.

If the plan provides for a postretirement cost of living adjustment on October 2, 1973, such an adjustment may also be taken into consideration in determining the allowable benefits for a participant under the "grandfather" provision. Any future increases in the bill's basic benefit limitation under the bill's cost of living adjustment provision, however, are applicable only to the generally applicable limits and not to the limits under the transitional "grandfather" clause. As a result, in future years many individuals are likely to elect to use the regular benefit limits despite the fact that they are eligible to use the "grandfather" provision, because the adjusted regular limits may permit a higher allowable benefit limit.

Individuals who wish to use these transitional provisions must elect to do so in a time and manner to be prescribed under regulations. Generally, the election will be made by the plan administrator in the year in which the employee retires. Once made, the election will be irrevocable.

Revenue effect

By increasing the maximum amount that self-employed persons will be allowed to deduct as contributions to H.R. 10 plans to 15 percent of earned income up to $7,500 a year, a revenue loss is estimated that will amount to $175 million annually. A revenue gain of $10 million is estimated to be the result of the provision that applies certain limitations on the contributions and benefits under retirement plans. The net

[126] result of these two provisions that are designed to equalize tax treatment for pension plans is a revenue loss of $165 million. These estimates assume 1973 levels of income and employment.

F. Employee Savings for Retirement

1. Individual retirement accounts (sec. 2002 of the bill and secs. 219, 402, 408, 409, 4973, 4974, and 6693 of the code)

Present Law

Generally, an employee is not allowed a deduction for amounts contributed from his own funds to a retirement plan. While an employer's qualified plan may allow employees to contribute their own funds to the plan,[1] no deduction is allowed for these contributions (except to the extent that tax excludable contributions made in connection with salary reduction plans may be viewed as employee contributions). However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.[2]

General reasons for change

While in the case of many millions of employees, provision is made for their retirement out of tax-free dollars by their participation in qualified retirement plans, many other employees do not have the opportunity to participate in qualified plans. Often, plans are not available because an employer is not willing to incur the costs of contributing to a retirement plan since, in general, the employer contributes funds which are in addition to the compensation otherwise paid his employees. Employees who are not covered under a qualified plan are disadvantaged by the fact that earnings on their retirement savings are subject to tax, and grow more slowly than the tax-sheltered earnings on contributions to a qualified plan.

Your committee's bill deals with this problem by making available a special deduction for amounts set aside for retirement by employees who are not covered under a qualified plan (including an H.R. 10 plan), a government plan, or a tax exempt organization annuity plan (sec. 403(b)). Individuals in this status, in computing their income tax, will be permitted to deduct up to $1,500 a year or 20 percent of compensation, whichever is less, for contributions to an individual retirement account. The earnings on this amount will also be tax free. As in the case of H.R. 10 plans, the amounts set aside plus the earnings are to become taxable to the individual generally after he has reached retirement age, when he receives benefits from the account.

Explanation of provisions

In general.—Under your committee's bill, a retirement savings deduction is to be allowed individuals for contributions to an individual retirement account, an individual retirement annuity, or a qualified

[1] Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation. I.R.S. Publication 778, p. 14 (Feb., 1972).

[2] At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person: no deduction was allowed for half of the contributions (presumably, that half "contributed by" the self-employed person). This limitation (sec. 404(a)(10)) was repealed for taxable years after December 31, 1967.

[127] retirement bond. The maximum annual deduction is to be $1,500, or 20 percent of compensation, whichever is less. Amounts allowed as a retirement savings deduction are to be deductible from gross income (instead of from adjusted gross income) so that any taxpayer, even a taxpayer who does not itemize but uses the standard deduction, is to be allowed a retirement savings deduction. In this manner, this program will be available to the widest possible group of taxpayers. Individual retirement accounts may be established by individuals, by employers for the benefit of their employees, and by labor unions for the benefit of their members. This will widen the availability of the retirement savings deduction.

If nondeductible contributions are erroneously made to an individual retirement account during the year (*e.g.*, because contributions are larger than the amount deductible), the individual generally will be able to withdraw the excess contribution without penalty. If the excess contribution is not withdrawn, generally it is to be subject to a nondeductible 6 percent excise tax in each year in which it remains in the individual retirement account.

Except in the case of excess contributions, amounts generally are to be withdrawn from an individual retirement account only after reaching retirement age. To encourage an individual to retain these amounts for retirement, the bill generally imposes a penalty tax of 10 percent of the amount received on premature distributions occurring before age 59½ or disability. Upon reaching age 59½, however, a participant may withdraw his funds even if he continues to work. In addition, the bill generally requires that funds in a retirement account are to be withdrawn from the account starting no later than the year in which the participant reaches age 70½. If insufficient withdrawals occur from that time on, a nondeductible excise tax is to be imposed on the excess accumulation that should have been withdrawn.

Generally, all amounts received from an individual retirement account will be taxed in full as ordinary income, since neither the contributions nor the earnings thereon will have been subject to tax previously. No capital gains or special lump-sum distribution rules are to apply to receipts from these accounts. However, the individual may use the general five-year averaging provisions (sec. 1301).

Your committee recognizes that individuals may wish to change the assets in which their contributions are invested. To facilitate this, the bill allows a limited tax-free "rollover" between individual retirement accounts. Also, a tax-free rollover is allowed from qualified plans to an individual retirement account.

Deduction for contributions to individual retirement account, etc.—Under the bill, an eligible individual is to be allowed a maximum retirement savings deduction of up to $1,500 per year or 20 percent of compensation includible in gross income, whichever is less, for contributions to an individual retirement account, individual retirement annuity or qualified retirement bond. Your committee intends that, for this purpose, compensation generally is to include only compensation for personal services, and is not to include earnings from property (such as interest and dividends). Additionally, since self-employed persons are to be allowed the retirement savings deduction (if they do not participate in an H.R. 10 plan), compensation in-

[128] cludes earned income (as defined in sec. 401(c)(2)). If the individual's compensation is not includible in his gross income (*e.g.*, as income earned from sources outside the United States) it is not to be treated as compensation for purposes of the retirement savings deduction.

The retirement savings deduction is to be available to each eligible individual. Consequently, an individual's marital status and whether he or she files a joint tax return will not affect contributions for the retirement savings deduction. If both husband and wife are eligible, they can each make contributions to his or her own individual retirement account, etc., and each is to be eligible for a deduction of up to $1,500 (or $3,000 total on a joint return). In addition, the bill also provides that community property laws of a State or other jurisdiction are not to apply with respect to the retirement savings deduction. For example, if husband and wife live in a community property State and the husband earns $7,500, the husband may contribute up to $1,500 (20 percent of $7,500) to an individual retirement account, etc., even though half of the income is owned by the wife under State law. Also, if the husband earns $15,000 and his wife earns no income, only $1,500 may be contributed and deducted by the husband under the retirement savings deduction and no contribution may be made by his wife.

The retirement savings deduction is to be allowed as a deduction from gross income.

For an individual to be allowed a retirement savings deduction, contributions are to be made to an individual retirement account, etc., within the taxable year for which the deduction is claimed. Thus, if a taxpayer is on a calendar year, contributions are to be made no later than December 31 of the year for which he wishes to take a deduction.[3] Contributions must be made in cash (currency, checks, etc.), and contributions in property are not to be deductible.

Deduction not allowed for active participants in qualified, etc., plans.—Your committee intends that the deduction for retirement savings (and contributions to individual retirement accounts, etc.) generally is to be available only where an individual does not participate in any other tax-supported retirement plan. Therefore, the retirement savings deduction is to be allowed an individual only if he is not an active participant in a qualified plan (sec. 401(a)), a qualified annuity plan (sec. 403(a)), a qualified bond purchase plan (sec. 405), a government plan, or a section 403(b) annuity at any time during the taxable year for which the deduction is claimed.[4]

Generally, for purposes of the retirement savings deduction, an employee is to be considered an active participant in a plan if, for the year in question, benefits are accrued under the plan on his behalf (as in a defined benefit pension plan), the employer is obligated to

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[3] If, at the end of the year, he is not sure of the total amount that he can deduct, the individual can make a slightly larger contribution than otherwise allowable, and will have until the time for filing his tax return for that year to withdraw the excess without penalty.

[4] An individual who is an active participant in a tax-exempt organization annuity plan (sec. 403(b)) is not to be entitled to a retirement savings deduction. An individual is to be considered an active participant in a section 403(b) annuity plan even if, during the period in question, his rights under the annuity contract are forfeitable. Consequently, if contributions are made on behalf of an individual under a section 403(b) annuity contract in anticipation that his rights will later be nonforfeitable, he cannot make contributions to an individual retirement account, etc., and he is not to be entitled to the retirement savings deduction for the taxable year in question.

[129] contribute to the plan on the employee's behalf (as in a money purchase pension plan), and the employer would have been obligated to contribute to the plan on the employee's behalf if any contributions were made to the plan (as in a profit-sharing plan). An individual is to be considered an active participant in a plan if he is accruing benefits under the plan even if he only has forfeitable rights to those benefits. Otherwise, if an individual were able to, *e.g.*, accrue benefits under a qualified plan and also make contributions to an individual retirement account, when he later becomes vested in the accrued benefits he would receive tax-supported retirement benefits for the same year both from the qualified plan and the retirement savings deduction. However, to avoid substantial administrative problems, if an individual becomes a participant in a plan and under that plan is given past service credit for prior years of service with the employer, he will not be considered to have been an active participant in the plan in the years for which the past service credit is given.

An individual generally is not to be considered to be an active participant in a plan after he has separated from service with a vested interest in the plan. Also, an individual is not to be considered an active participant in a plan after his employer has completely terminated contributions under the plan, even though the trust continues to provide benefits for the individual.

For purposes of the retirement savings deduction, a government plan is a plan established by the Federal Government or a State (including the District of Columbia) or local government (or an agency or instrumentality of the same) for its employees. For example, the Federal Civil Service Retirement Plan is a government plan. However, Social Security and Railroad Retirement plans are not to be considered government plans. Even if a government plan is not tax qualified, an individual who is an active participant in the plan is not to be able to participate in an individual retirement account, etc.

If an employee is given the option to elect not to be covered by a qualified, etc., plan and he so elects, generally he will not be treated as being an active participant in the plan for purposes of the retirement savings deduction. For example, if an employer offers a qualified plan that requires matching employee contributions, but the employee elects not to participate in the plan, he is not to be considered as an active participant in the plan. However, where an employee who opts out of a qualified plan can elect later to become an active participant in it and can receive benefits for all prior years (for which he opted out) upon payment of, *e.g.*, all mandatory contributions plus interest for the prior periods, the employee is to be treated as being an active participant in the plan for the prior years with respect to which he pays the required amount and accrues benefits. Otherwise, an individual could receive a retirement savings deduction for a number of years and also, at his own discretion, later become covered by a qualified plan for the same years.

Excess contributions to individual retirement account, etc.—Under the bill, generally only deductible amounts are to be contributed to individual retirement accounts or to buy an individual retirement annuity or a qualified retirement bond, and no nondeductible employee

[130] contributions are to be made.[5] However, your committee recognizes that the contributions made on behalf of an employee to an individual retirement account, etc., may be larger than the individual's allowable retirement savings deduction. For example, an individual who has contributed to a retirement account may change jobs in mid-year and become an active participant in a qualified plan of his new employer during that year. In this case, a retirement savings deduction is not to be allowed and the contributions made to an individual retirement account will be excess contributions.

In such a case, the individual may avoid penalties on the excess contribution if he receives a timely distribution from the individual retirement account (or annuity) of the excess contribution, plus the income earned on that excess amount to the date of distribution. In general, a distribution will be timely if it is received from the account or annuity no later than the time (including extensions) for filing the employee's tax return for the year in question.[6]

If timely distribution of excess contributions (and income thereon) is made from an individual retirement account or annuity, the excess contribution that is returned is not to be included in gross income, since the taxpayer has not taken a deduction for this amount. However, any net income attributable to, and distributed with, the excess contribution is to be included in the individual's income in the year received, since it will not have been previously taxed as income to him.

Your committee believes that generally it is necessary to provide a direct incentive to avoid excess contributions to individual retirement accounts and annuities and to stimulate timely withdrawals of excess contributions.

Therefore, under the bill a nondeductible excise tax is to be imposed on contributions to individual retirement accounts and annuities in excess of the amounts deductible as retirement savings, unless these amounts (with earnings) are timely distributed from the account. This tax is to prevent the unwarranted tax deferral that would exist from income on excess contributions, and is to be 6 percent of the amount of the excess contributions. The excise tax is to be paid by the individual who made the excess contributions.

If an excess amount is contributed to an individual retirement account (or annuity) in one year and the excess is not eliminated in later years, the excise tax is to be owed on the excess amount for the year of contribution and for each successive year until the excess is eliminated. (The amount of the excess is to be determined as of the end of the individual's taxable year.) However, an individual may eliminate an excess contribution in later years if he does not take his maximum allowable deduction for retirement savings in the later years. Under the bill, if an individual takes less than the maximum amount allowed as a retirement savings deduction in any year after the excess contribution is made, the difference between the maximum allowed deduction and the amount taken is to reduce a prior excess contribution.[7]

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[5] However, as discussed below, nondeductible "rollover contributions" are to be available to individual retirement accounts in certain circumstances.

[6] The time for filing is intended to be the due date for filing the original return (plus extensions) and is not to include the time for filing amended returns. The time for distributions of excess purchases of qualified retirement bonds is slightly different, as described below.

[7] However, contributions less than the maximum in prior years are not to reduce the excess contribution; otherwise, the limits on contributions could be effectively circumvented.

[131] For example, in 1975, an individual earns $7,000 and contributes $1,500 to an individual retirement account. His maximum available deduction is $1,400 (20% of $7,000), so there has been an excess contribution of $100. If he received the $100 (plus income earned thereon) by the time he files his tax return for 1975, he would not be subject to the excise tax. However, if he does not receive payment by that time, he will owe an excise tax of $6 (6 percent of $100). In 1976, he earns $7,500 and contributes $1,500 to his individual retirement account. Since there is an excess contribution in his account (as a result of the 1975 excess contribution), the individual has until the time for filing his tax return for 1976 to receive a distribution of $100 (plus income earned on the contribution) from the retirement account. If the $100 is returned by this time, the individual will not receive a deduction for 1976 for the full $1,500 (but will only receive a deduction for $1,400), and is to take into income the earnings paid out from the account in the year received. If the individual does not receive the excess contribution (plus earnings) in this manner, he is to owe a 6 percent excise tax for 1976, since at the end of that year there still will be an excess in the account attributable to the 1975 contribution. In 1977, he earns $7,500 and contributes $1,400, although he could take a maximum retirement savings deduction of $1,500. In this case, the excess contribution is to be reduced by the difference between the maximum deduction available and the deduction taken, which is $100 ($1,500 less $1,400). Consequently, the excess attributable to the 1975 contribution is to be eliminated and no excise tax is to be owed for 1977.

If the individual is no longer eligible to participate in an individual retirement account or retirement annuity, so he cannot forego a contribution to the account (or cannot withdraw part of the previous year's contribution to reduce the excess contribution), to avoid the 6 percent excise tax he may withdraw the excess contribution (subject to the 10 percent additional tax if he receives the distribution before age 59½ or disability). The amount received in this case is to be included in full in the individual's gross income since, like all amounts in an individual retirement account, this amount will have no basis.

Your committee intends that the retirement savings deduction is to be used for retirement purposes and is not to be available for accumulating income on a tax-free basis after retirement. Therefore, under the bill, no contribution is to be made to an individual retirement account, etc., and no retirement savings deduction is to be allowed for a taxable year in which the individual becomes age 70½ (and for any later year). This conforms to the general requirement (discussed below) that distributions must be made from an individual retirement account, etc., no later than the year in which a participant attains age 70½. If a contribution is made for an employee who has attained age 70½, it is to be treated as an excess contribution subject to the 6 percent excise tax.[8]

Contributions to individual retirement accounts, etc.—miscellaneous.—Under the bill, an employer (including a self-employed person) may establish an individual retirement account for the benefit of some or all of his employees and make contributions to the account on their

[8] The contribution also may become subject to the excise tax on excess accumulations, described below.

[132] behalf either in the form of additional compensation or a salary reduction plan. However, this is to be available only for employees who are not covered by qualified, government, or exempt-organization plans. Any employees who are not covered under such plans (including those excluded from coverage due to length of service requirements or because of age) may be covered under an employer-sponsored individual retirement account or, alternatively, may establish their own individual retirement accounts.

Amounts contributed to an individual retirement account, etc., by an employer for an employee generally are to be included in the employee's gross income as compensation, whether or not these amounts are deductible. However, if an employee pays his employer amounts out of after-tax dollars to be contributed to an individual retirement account, etc., on his behalf by the employer, this amount is not to be included in the employee's income. Amounts that constitute employee compensation and are contributed to an individual retirement account, etc., by the employer are to be subject to tax under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). However, these contributions are not to be subject to withholding if it is reasonable for the employer to believe at the time of contribution that the employee will be entitled to a deduction for the payment. In this regard, generally it will be reasonable for an employer to make a lower withholding only when the amount contributed to the individual retirement account, etc., is based on periodic withholding from compensation otherwise paid the employee. Otherwise, the employer generally will not be able to reasonably estimate the amounts to be contributed to the account, etc., and will not be able to base his lower withholding on the estimate of such contributions.

Since the deduction for contributions to individual retirement accounts is to be available to the self-employed as well as employees, the bill will also benefit people such as jockeys, who in years of low earnings are limited in what they can contribute to an H.R. 10 plan by the 15 percentage-of-income limitation if they wish to contribute in excess of $750.

Individual retirement accounts—requirements.—Under the bill, an individual retirement account generally is to be a domestic trust created or organized by a written instrument for the exclusive benefit of an individual or his beneficiaries. The governing instrument is to provide that the trustee will not accept more than $1,500 per year on behalf of any individual, and is to provide that the individual's interest in the account is nonforfeitable, without exception.

The balance in an individual retirement account generally may be invested in any assets that are acceptable investments for a qualified plan. The account balance could, for example, be invested in insurance annuity contracts, in a savings account with a savings and loan institution or a credit union, or in stock of a mutual fund. However, account assets generally are not to be commingled with other property except in a common trust fund.

Under the bill, no assets of an individual retirement account are to be invested in life insurance contracts and the trust instrument must so provide. Thus, the account cannot purchase life insurance protec-

[133] tion under any retirement income, endowment, or other contract which includes a life insurance element. The individual retirement account is to be used to provide retirement income and life insurance is an asset designed for a different purpose—to provide funds for survivors. In addition, the individual retirement account is to receive only amounts that are deductible under the retirement savings deduction. If life insurance protection were purchased with contributions to an individual retirement account, the amount paid for the insurance would not be deductible by the participant and an allocation would have to be made each year between the deductible and nondeductible amounts, substantially complicating the administration of an individual retirement account. Consequently, your committee believes that if life insurance protection is to be acquired, it should be done through the many other methods now available, and not through the individual retirement account.

The trust instrument also is to provide that the entire interest of a participant will be distributed by the end of the year in which he reaches 70½ or that distribution will begin by that time and (in accordance with regulations to be issued) will be distributed over the life of the participant (or lives of the participant and his spouse), or over a period of years not exceeding the life expectancy of the participant or the participant and his spouse. This is substantially the same requirement as now applies to distributions from H.R. 10 plans.

The bill also generally requires, with respect to distributions, that the trust instrument must provide that if a participant (or his surviving spouse) dies before receiving the entire interest in the account, the entire remaining interest will be distributed within five years of death or used to purchase an immediate annuity payable to the beneficiaries. This also is substantially the same requirement as now applies to distributions from H.R. 10 plans.

Under the governing instrument, the trustee of an individual retirement account generally is to be a bank (described in sec. 401(d)(1)).[9] In addition, a person who is not a bank may be a trustee if he demonstrates to the satisfaction of the Secretary of the Treasury that the way in which he will administer the trust will be consistent with the requirements of the rules governing individual retirement accounts. It is contemplated that under this provision the Secretary of the Treasury generally will require evidence from applicants of their ability to act within accepted rules of fiduciary conduct with respect to the handling of other people's money; evidence of experience and competence with respect to accounting for the interests of a large number of participants, including calculating and allocating income earned and paying out distributions to participants and beneficiaries; and evidence of other activities normally associated with the handling of retirement funds. Additionally, your committee expects that the Secretary generally will give weight to evidence that an applicant is subject to Federal or State regulation with respect to its activities, where this regulation includes, e.g., suitable rules of fiduciary conduct.

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[9] The bill amends section 401(d)(1) to provide that Federally insured credit unions are to be considered "banks" for purposes of determining who can be a trustee of an individual retirement account, etc.

[134] It is anticipated that the Secretary probably will not allow individuals to act as trustees for individual retirement accounts.

Although the bill generally requires that a trustee administer an individual retirement account trust, the bill also provides that a custodial account may be treated as a trust, and that a custodian may hold the account assets and administer the trust. Under the bill, a custodial account may be treated as a trust if the custodian is a bank (described in sec. 401(d)(1)) or other person, if he demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which he will hold the assets will be consistent with the requirements governing individual retirement accounts. Again, it is contemplated that the Secretary will require substantial evidence (as described above) to determine if a person other than a bank may act as custodian.

The bill provides that the trustee of an individual retirement account (or issuer of a retirement annuity) is to report annually to the Secretary of the Treasury regarding contributions to the account or annuity and regarding other matters as prescribed by regulations. Your committee intends that the regulations will include a requirement that the trustee or issuer file annual information returns with the Internal Revenue Service (with copies to each individual for whose benefit a retirement account or a retirement annuity is maintained) on the amount of contributions to and distributions from the account or annuity. Under the bill, there is to be a penalty of $10 for each failure to report, unless due to reasonable cause.

Individual retirement annuities—requirements.—Under the bill, retirement savings also may be invested in annuity contracts, called individual retirement annuities. An individual retirement annuity is to be an individual annuity contract that is issued by an insurance company in the name of the person who pays for the annuity (or on whose behalf payments are made). The individual's rights in the contract are to be nonforfeitable, without exception. In order to assure that payments under the contract will be used for retirement, the terms of the contract are to specifically provide that it is not transferable. Similarly, it is intended that the terms of the contract will prohibit the owner of the contract from using it as security for a loan.

To conform to the limits on the retirement savings deduction, the contract also is to provide that the annual premium is not to be greater than $1,500.

Additionally, as with individual retirement accounts, it is intended that the annuity contract is not to include any life insurance element. Any refund of premiums is to be applied (before the close of the calendar year following the refund) toward payment of future premiums or toward the purchase of additional benefits, and the annuity contract is to so provide.[10]

To assure that retirement savings are used for retirement purposes, the annuity contract is to include provisions requiring distribution of

[10] This applies only with respect to refunds of premiums that were deductible and, therefore, properly paid. With respect to premiums in excess of the amount deductible under the retirement savings deduction, as discussed above it is intended that the excess premiums may be repaid to the individual within the time for filing his tax return for the year in question. If no deduction was taken, no income is to be recognized on receipt of this excess premium. However, earnings on the excess premium are to be distributed along with it, and the earnings are to be reported as income in the year received.

[135] the annuity beginning at the close of the year when the contract owner reaches age 70½. (This provision is similar to the analogous provision regarding individual retirement accounts and H.R. 10 plans.) Also, the contract is to include provisions with respect to distribution after the death of the contract owner (and his spouse) that are similar to the provisions to be included for individual retirement accounts.

Employer- and union-established individuals retirement accounts.—Under the bill, employers and labor unions are to be able to establish individual retirement accounts for their employees or members. In this case, the same rules that govern individual retirement accounts generally are to apply to an employer- or union-established individual retirement account. For example, the interest of the participants in the account are to be nonforfeitable without exception and the trust instrument is to so provide. Under the bill, additional requirements also are to be met by employer- and union-established individual retirement accounts.

An employer or union may establish a single individual retirement account trust for a number of employees or members. However, there is to be a separate accounting for each participant's interest in the individual retirement account, and the trust instrument is to provide for such an accounting. Although there is to be separate accounting for each of the participants, this does not mean that the contribution on behalf of each participant must be held separately from the other assets in the retirement account, but the assets of the account may be held and invested together for all participants.

Under the bill, the trust instrument of an employer- or union-established individual retirement account also is to provide that assets are to be held exclusively for the benefit of the participants or their beneficiaries. The exclusive benefit rule governing individual retirement accounts established by an employer or a union is the same rule that governs qualified plans and trusts (sec. 401), and all of the requirements that must be met under the existing exclusive benefit rules also are to be met by these individual retirement accounts. For example, under the present exclusive benefit rule, the trust instrument must make it impossible for corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the participants or their beneficiaries; this same rule is to apply to individual retirement accounts. Additionally, the exclusive benefit rule is to apply to individual retirement account investments in the same way as it applies to qualified plan investments.

It is intended that where an employer has both a qualified plan and an employer-sponsored retirement account, the qualified plan must meet the nondiscrimination standards without regard to the individual retirement account.

Taxation of individual retirement accounts, prohibited transactions, etc.—Generally, the bill provides that an individual retirement account is to be exempt from Federal income taxation.[11] However, if the retirement account has unrelated business taxable income, it is to

[11] As with annuities geenrally, the owner of an individual retirement annuity is not to be currently taxed on the annual increased value of the annuity, but is taxed on receipt of annuity payments. Also, as with Series E bonds generally, the income earned on the qualified retirement bonds is generally not taxable until redemption (or "maturity," if earlier).

[136] be subject to tax on this income under section 511 of the Internal Revenue Code. All of the rules relating to unrelated business income (including those in sec. 512 respecting unrelated business taxable income, sec. 513 respecting unrelated trade or business, and sec. 514 respecting unrelated debt-financed income) that apply for purposes of section 511 are to apply with respect to individual retirement accounts.

The bill also applies the existing prohibited transaction rules (sec. 503(b) and sec. 503(g)) to individual retirement accounts. Under the bill, if an individual engages in a prohibited transaction with his individual retirement account trust, his account is to become disqualified as of the first day of his taxable year in which the prohibited transaction occurs.[12]

With respect to an individual retirement account established by an employer or a union, if a participant in the account engages in a prohibited transaction with the individual retirement account trust, that individual's account in the trust is thereupon to be treated as a separate individual retirement account trust and this deemed separate trust is to become disqualified as of the first day of the individual's taxable year in which the prohibited transaction occurs.

For example, if an employer with 100 employees establishes an individual retirement account for all his employees and one employee violates the prohibited transaction rules by borrowing money from the retirement account trust, then the whole retirement account trust is not to be disqualified. However, that portion of the trust which constitutes the separate account of the employee who engaged in the prohibited transaction is to be disqualified. In this way, individuals will have a substantial incentive to avoid engaging in prohibited transactions, and if a prohibited transaction occurs, only the individual who engages in that transaction (or the individual who is related, *e.g.*, by marriage, to the person who engages in the transaction) will be penalized.

If an individual retirement account is disqualified, the participant is then to be taxed as if he had received a distribution (on the first day of his taxable year in which the prohibited transaction occurred) of the fair market value of all the assets in his account. Since his basis in his account is to be zero, the entire amount received will be ordinary income. In addition, if the deemed distribution occurs before the individual is age 59½ or disabled, the 10 percent additional tax (described below) on premature distributions is to apply. (Otherwise, a participant who wanted a premature distribution would have an incentive to engage in a prohibited transaction.) The individual is to be taxed currently on all income earned in his account after the disqualification occurs, since the account will cease being an individual retirement account.

With respect to individual retirement annuities (which are nontransferable and cannot be hypothecated), the bill prohibits the owner of the contract from borrowing money from the insurance company issuing the contract, under or by use of the contract. If any prohibited

[12] The bill provides that an individual is to be treated as "creator" of the account for the purpose of applying the prohibited transaction rules. Under sections 503(b) and 503(g), certain transactions between a trust and its "creator" (and persons attributed to the creator) are prohibited.

[137] borrowing occurs (regardless of the amount involved) the contract is to lose its qualification as an individual retirement annuity as of the first day of the taxable year of the contract owner in which the borrowing occurs. In this case, the owner is to include in income for that year the fair market value (which may not be the same as the cash surrender value) of the contract as of the first day of that year. Since the owner's basis in the contract is to be zero, the entire amount deemed distributed is to be taxable to him as ordinary income. In addition, the 10 percent additional tax (described below) on premature distributions may apply to this deemed distribution. (If the annuity contract is sold, exchanged or hypothecated, in violation of its terms, it is intended that the same consequences will occur as with a prohibited borrowing from an insurance company.)

An employer who maintains an individual retirement account also is not to engage in prohibited transactions (as defined in sec. 503(b) and 503(g)) with the retirement account. Otherwise, the employer—who may have substantial control over the trust—would be able to engage in dealings with the trust to the detriment of the employees who participate in it. Therefore, the bill also treats the employer as the creator of an individual retirement account trust which he maintains for purposes of the prohibited transaction rules.

Your committee believes that it would be inappropriate for a prohibited transaction involving the employer, or persons attributable to the employer (and not involving any account participant),[13] to result in a penalty to any participant. Consequently, the bill provides that if an employer (or persons related to him) engages in a prohibited transaction with a retirement account maintained by him, the employer is to lose all deductions for compensation to the extent of the contributions to the retirement account in his taxable year in which the prohibited transaction occurs, and for all prior open years.

For example, if the employer contributed to the account (under a salary reduction type plan) $10,000 in each of 1975, 1976, and 1977 and if he engaged in a prohibited transaction in 1977, his deduction for the $10,000 contribution in 1975, the $10,000 contribution in 1976, and the $10,000 contribution in 1977 would be disallowed (if all these years were open). No deduction for these amounts would be allowed under any provision of the Internal Revenue Code (including but not limited to sec. 162).[14]

Distributions from individual retirement accounts, etc.—Generally, the proceeds from an individual retirement account (individual retirement annuity and qualified retirement bond) are to be fully taxable to the individual when distributed. Since contributions to the account, etc., will be made with tax-free dollars and income of the account, etc., will not be taxed as earned, the individual's basis in the account, etc., is to be zero.

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[13] Where the employer is also a participant (such as a self-employed person who participates in the account), the consequences attendant upon "employer" status are to occur.

[14] Where contributions are made to an employer-established individual retirement account both by the employer and individual participants, the employer is to lose deductions for compensation paid in open years to the extent of the total contributions to the account in those years. For example, in 1975, the employer makes $2,500 of contributions to the individual retirement account which he maintains and the employer engages in a prohibited transaction with the trust in that year. Also in 1975 individual participants contribute $2,500 to the individual retirement account. In 1975 the employer pays more than $5,000 of compensation to his employees. For 1975, the penalty on the employer for engaging in the prohibited transaction is a disallowance of $5,000 of deductions for compensation paid.

[138] The amounts distributed from a retirement account, etc., are not to be eligible for capital gains treatment, and the special averaging rules applicable to lump-sum distributions (under sec. 72) also are not to be available. This should encourage the individual to take down the amounts ratably over the period of his retirement. However, the individual is to be permitted to use the general averaging rules (sec. 1301).

If an individual borrows money, using his interest in the account as security, the portion used as security is to be treated as a distribution from the account to the individual. This treatment is also consistent with your committee's intention to encourage retirement savings since in this case if the employee uses his account as security for a loan he has no funds left for retirement.

For purposes of the estate and gift taxes, the amounts in individual retirement accounts, individual retirement annuities, and qualified retirement bonds are not to be excluded from tax (secs. 2039(c) and 2517). This too is consistent with your committee's intention that the funds be used during the individual's retirement period.

If an annuity contract is distributed from an individual retirement account, it is not to be included in income when received if the annuity contract generally meets the rules governing individual retirement annuities. In this case, the participant essentially will have received an individual retirement annuity contract and all the individual retirement annuity rules (including those with relation to borrowing under or by use of the contract) are to apply to the distributed contract.

Your committee intends that savings accumulated through an individual retirement account, etc., are to be used for retirement purposes and should not be distributed before the participant reaches age 59½ or is disabled; [15] this follows present law governing H.R. 10 plans. Under the bill, if there is a premature distribution, the individual's income tax otherwise due is to be increased by 10 percent of the total amount of the premature distribution that is included in his gross income for the taxable year. For example, if an unmarried individual with taxable income (after all exemptions and deductions) of $20,000 receives a premature distribution of $3,000, his income tax for the year of receipt would be $6,690 ($5,230 on $20,000 of taxable income, plus $1.160 on the $3,000 premature distribution, plus a $300 penalty tax on the premature distribution).

The 10-percent additional tax is to apply to any premature "deemed distribution" that occurs on account of a prohibited transaction involving a retirement account or retirement annuity.

The 10-percent additional tax generally is not to be offset by any tax credits (other than the refundable credits for overwithholding, overpayment of tax, and the gasoline tax credit). Also, this tax is not to be treated as reducing the individual's tax liability under the minimum tax provisions (sec. 56).

The 10-percent penalty tax on premature distributions is not to apply in the event of death or disability. However, your committee expects that the Internal Revenue Service will require that the custodian must receive proof of disability if making distributions under the

[15] Disability is to be determined under the same rules that apply to H.R. 10 plans (sec. 72(m)(2)).

[139] disability provision. Generally it is intended that the proof be the same as where the individual applies for disability payments under social security.

(The 10-percent penalty tax also is not to apply to a distribution of excess contributions made within the time for filing the individual's tax return for the year in which the excess contributions occur.)

Your committee also intends that the amounts contributed to an individual retirement account are to be used for retirement purposes, and are not to be retained in the account, beyond the maximum age for payout. If sufficient payments are not timely made from the retirement account (or retirement annuity), then an excise tax is to be imposed on the amount of the under-distribution.[16] The payments needed to avoid this excise tax are to be provided by regulations and are to follow the rules (described above) with respect to payment no later than the year in which the participant attains age 70½ (or payment on the death of a participant or his spouse). If the amount paid out is less than the minimum required, there is to be a nondeductible 50 percent excise tax on the difference between the minimum payout required for the year in question and the amount actually paid out. The tax is to be paid by the individual to whom the minimum payments should have been made. For example, if the minimum annual amount that is to be distributed from a retirement account is $100, and only $60 is distributed by the end of the taxable year (of the payee), then an excise tax of $20 (50 percent of $40) is to be paid by the payee.

Tax-free rollovers.—To permit flexibility with respect to the investment of an individual retirement account, the bill provides that money or property may be distributed from an individual retirement account to the person for whose benefit the account is maintained without payment of tax, provided this same money or property is reinvested by the individual within 60 days in another qualifying individual retirement account maintained for this benefit. Rollover transfers to an individual retirement account are, of course, subject to the same limits and rules as other individual retirement accounts (such as, the rules relating to premature distributions or prohibited transactions). The transfer may be desired because the individual desires to shift his investments, for example, from, or to, an annuity contract, a mutual fund, or a savings account.[17]

Before releasing the account, the committee anticipates that the trustee will be required by the Internal Revenue Service to receive a declaration of intention from the individual as to the proposed reinvestment (except in the case of an individual who was entitled to receive a distribution because of his retirement at age 59½, or because of disability). The custodian is also to be required to notify the Service that a distribution of assets from the account had been made and the reason for making the distribution.

Also, since annual contributions to an individual retirement account cannot be larger than $1,500 except for rollover contributions, it is expected that the trustee who receives a rollover contribution will require a declaration from the individual that the payment is a rollover contribution.

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[16] As discussed below, slightly different rules apply to the qualified retirement bonds.

[17] Amounts cannot be rolled over to an individual retirement account from a disqualified (through prohibited transactions, etc.) retirement account (or disqualified retirement annuity). Similarly, excess contributions to a retirement account, etc. cannot be rolled over.

[140] If property other than money is received as a distribution, to be eligible for the tax-free rollover, the same property received is to be contributed to the retirement account. For example, if an individual receives stock in a distribution from a qualified plan, the same stock that is received is to be contributed to the individual retirement account, to avoid taxation on the original distribution.

The bill also allows a tax-free rollover from a qualified plan to an individual retirement account. In this case, the plan participant would have to receive his entire interest in the plan and the distribution would have to occur on account of his separation from service and within one taxable year to qualify for a tax-free rollover.

In the case of a tax-free rollover from a qualified plan, the amount contributed to an individual retirement account is to be the same amount of money (or the same property) received from the qualified plan less the amount considered contributed to the qualified plan by the individual as an employee contribution. (The amount of contribution to an individual retirement account is to be reduced by the amount of employee contributions because all amounts in the retirement account are to have a zero basis, and it would be inappropriate to apply this zero basis rule to employee contributions.)

As with a rollover between individual retirement accounts, the same property (other than money) received from a qualified trust is to be contributed to the retirement account. However, in this case, the fair market value of the property contributed is to be no greater than the total value of the rollover contributions which can be made to the individual retirement account. For example, if an individual receives securities worth $5,000 and cash of $5,000 from a qualified plan, and $5,000 of this amount represents employee contributions, then all of the securities are to be contributed to the retirement account to qualify for the tax-free rollover.

If the rollover contributions to a retirement account are greater than the amount allowed, then the 6 percent excise tax is to apply to the excess contributions.

To prevent too much shifting of investments under this provision, the bill provides that an individual can transfer amounts between individual retirement accounts only once every three years. However, he may rollover amounts received from a qualified plan to an individual retirement account within that three year period.

Qualified retirement bonds.—In addition to the various types of investment described above in which deductible employee retirement savings can be placed, the bill also provides that these amounts may be invested annually in a special retirement bond, to be issued by the Federal Government. The bonds are to be issued under the Second Liberty Bond Act and are to provide for the accumulation of interest until the time of redemption.

The bonds are to be issued in the name of the individual on whose behalf they are purchased for retirement (the "registered owner") and are not to be transferable, under any circumstances, except to his executor in the event of his death (or to a trustee for his benefit in the event he becomes incompetent to manage his own affairs). For example, the bonds could not be pledged for the payment of debts, and could not be assigned to a trustee in bankruptcy. Also, the bonds

[141] could not be awarded to the individual's spouse as a result of a divorce settlement. As with other investments made through the retirement savings deduction, the employee's right in these bonds are to be nonforfeitable, without exception.

In conformity with the general provisions for individual retirement accounts and retirement annuities, the bill provides that the bonds generally are only to be cashed after the individual has reached the age of 59½ years, or if he becomes disabled. If he dies, the bonds could be redeemed by his estate. There would be one further exception to cover the case of an individual who purchased the bonds, believing that he would be eligible for the deduction for that year, only to discover later that he was not eligible. For example, an individual might purchase the bond early in the year, and later become a participant under a qualified retirement plan sponsored by his employer. To meet this situation, the bill provides that the bond may be redeemed at any time within 12 months of its purchase without penalty (and without payment of interest).[18] This provision could also be used by individuals who purchased the bond, but discovered within a year that they needed the money for other purposes. In this case the Internal Revenue Service is to be notified that the bond has been redeemed and, therefore, would be on notice that no deduction would be allowed because of its purchase. Consistent with the general rules for individual retirement accounts and retirement annuities, the bill provides that the bonds are to cease to bear interest when the individual reaches age 70½. In addition, during that year the individual is also required to take any of these bonds he is still holding into income, even if he does not cash them in. It is anticipated that these rules will be set forth on the face or back of the bonds.

Also, for similar reasons, the bill provides that if the registered owner dies before age 70½ or before the bonds are cashed in, the bonds are to cease to bear interest five years after the death of the registered owner or when the registered owner would have attained age 70½, whichever is earlier.

When the bonds are redeemed, the full proceeds of the bonds, including any interest earned on them, is to be treated as ordinary income to the individual, whose basis in the bonds would be zero.[19] However, if the individual chose to do so, he could treat this income under the general averaging provisions of the tax law (sec. 1301).

As noted above, if the bond is redeemed within 12 months after the date of its issuance, the proceeds would not be included in gross income if no deduction is allowed on the purchase of the bond.

Effective date

The deduction for retirement savings is to be available for taxable years beginning after December 31, 1973. All other provisions with regard to the individual retirement account, etc. are to take effect on January 1, 1974.

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[18] If the bond was not cashed within the 12 months grace period, the individual would still not receive the deduction, in those cases where he was not eligible for it. However, when he cashed in the bond at a retirement age, the proceeds of the bond would constitute income to him (since his basis in the bond would be zero under the bill).

[19] The provisions of sec. 72 (relating to annuities) and sec. 1232 (relating to bonds) are not to apply to qualified retirement bonds.

[142] *Revenue effect*

This provision allowing an individual not covered by a qualified retirement plan, government plan, or section 403(b) plan to deduct annually the lesser of $1,500 or 20 percent of compensation for contributions by him or on his behalf to a tax-exempt retirement account, annuity, or bond plan established by him (or to certain trusts established by employers or associations of employees) is estimated to involve a revenue loss amount to $225 million for 1974 and rising to $355 million for 1977 (at 1973 income levels).

2. SALARY REDUCTION PLANS AND OTHER MATTERS (SECS. 1015 AND 2005 OF THE BILL AND SEC. 414 OF THE CODE)

Present law

Generally, an employee is not allowed to deduct amounts which he contributes from his own funds to a retirement plan. While an employer's qualified plan may allow employees to contribute their own funds to the plan,[1] no deduction is allowed for these contributions. However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.[2]

In the case of a salary reduction plan or a cash or deferred profit-sharing plan, however, the Internal Revenue Service has permitted employees to exclude from income amounts contributed by their employers to the plan, even where the source of these amounts is the employees' agreement to take salary or bonus reductions or forgo salary increases. In the case of a cash or deferred profit-sharing plan, the employee generally has the election to take a bonus currently in cash or deferred by payment into the plan. In the case of a salary reduction plan, the employee generally agrees with his employer to reduce his salary or forgo a salary increase which is contributed into a pension plan for his benefit. In either case, if the plan met certain nondiscrimination requirements, the Internal Revenue Service in the past had taken the position that, under certain circumstances, the payment into the plan would be treated as an employer contribution, not taxable to the employee until benefits were received from the plan. The maximum amount that could be so treated generally was 6 percent of compensation.[3]

On December 6, 1972, the Service issued proposed regulations (37 Fed. Reg. 25938) which would change this result in the case of qualified pension plans by providing that amounts contributed to such a plan in return for a reduction in the employee's basic or regular compensa-

[1] Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation. I.R.S. Publication 778, p. 14 (Feb. 1972).

[2] At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person; no deduction was allowed for half of the contribution (the half regarded as "contributed by" the self-employed person). This limitation (sec. 404(a)(10)) was repealed for taxable years after December 31, 1967.

[3] In the case of employees of tax-exempt charitable, educational, religious, etc., organizations and employees of public educational institutions, a specific statutory provision provides for employer contributions of up to 20 percent of compensation, times years of service, reduced by amounts previously contributed by the employer for annuity contracts on a tax excluded basis to the employees (sec. 403(b)). The regulations under the statute allow the employer contributions to be made under these salary reduction plans. Antidiscrimination provisions that apply generally to qualified plans do not apply to those tax sheltered annuities. The committee bill does not affect the tax treatment of these contributions (although limits are applied to them).

[143] tion, or in lieu of an increase in such compensation, will be considered to have been contributed by the employee and consequently will be taxable income to the employee.

The proposed regulations would not affect the tax treatment of contributions to certain qualified profit-sharing plans, where the contributed amounts could be received as a bonus; however, it was indicated that there would be reconsideration of the rulings permitting exclusion of such profit sharing contributions. (Rev. Rul. 56–497, 1956–2 C.B. 284; Rev. Rul. 63–180, 1963–2 C.B. 189; Rev. Rul. 68–89, 1968–1 C.B. 402.) Public hearings have been held on these proposed regulations but regulations in final form have not yet been issued.

General reasons for charge

A number of difficult issues of policy have recently arisen in connection with salary reduction pension plans and cash or deferred profit-sharing plans. On the one hand, it is argued that these types of plans provide a vehicle which allows an employer who could not afford the cost of a conventional pension pension plan to provide pension benefits for at least those of his employees who agree to take the salary reduction. Also, it is argued, there is hope that once a salary reduction plan has been established, the employer may eventually shift to a plan where there are employer contributions with no offsetting reductions in pay for the employees.

On the other hand, many feel that it is difficult to distinguish, for purposes of tax policy, between a contribution made by the employer, at the employee's option in return for a reduction in his pay, and a contribution made by the employee after receiving his pay check from his employer, which is clearly nondeductible under present law. Also, because the salary reduction type plan covers only those employees who elect to be covered (at a cost in terms of their take-home pay), this often means that many employees will not be covered, whereas it is generally desirable that as many employees as possible be covered under the private pension system. Thus, it has been suggested by some that salary-reduction plans should be subject to stricter coverage requirements than those imposed in the past by the Internal Revenue Service.

The committee believes that it is impossible to deal with these issues in a satisfactory way without the opportunity for extensive consideration. Moreover, it believes that salary-reduction and cash or deferred profit-sharing plans should not be discouraged until there has been an opportunity for legislative consideration as to what their status should be. Accordingly, the committee bill provides that the proposed regulations should be withdrawn for one year, to give the committee a further chance for study.

Explanation of provisions

Salary reduction plans.—Under the committee bill, the proposed Treasury regulations with respect to salary reduction plans are to be withdrawn. No proposed regulations are to be issued in this area before January 1, 1975. At that point, if Congress has not acted, Treasury may, at its discretion, issue a new set of proposed regulations, which may or may not be similar to the regulations which are to be with-

[144] drawn. However, if regulations are issued, they may not become final prior to March 16, 1975, and may not be retroactive for income tax purposes prior to January 1 of that year.

Until new regulations are issued in final form, the law is to be administered in accordance with the legal principles which were applied before January 1, 1972. In other words, salary reduction plans which already hold favorable ruling letters will continue to remain qualified during 1974, and contributions to those plans will be treated as tax-excludable to the employee on the same basis which would have been the case in 1971. Also new salary-reduction plans may apply for and receive favorable ruling letters if such letters would have been issued based on similar facts in 1971. However, the Internal Revenue Service may wish to provide that ruling letters issued to new plans in this area are limited to the period ending with the issuance of new final regulations.

Cash or deferred profit-sharing plans are to be treated in a similar manner. During the period until new regulations are issued in final form, the qualified status and the tax treatment of contributions to such plans is to be governed under principles set forth in Rev. Rul. 56-497, 1956-2 C.B. 284, Rev. Rul. 63-180, 1963-2 C.B. 189, and Rev. Rul. 68-89, 1968-1 C.B. 402. However, if Congress does not decide otherwise, Treasury and the Service may, if they so decide, change their pre-1972 position on the law in this area, by regulations, so long as such changes do not become final before March 16, 1975, and are not retroactive prior to January 1, 1975.

For purposes of the social security taxes and the Federal withholding taxes, the regulations are not to be retroactive.

So-called "cafeteria plans", in which the employee may have a choice between cash and certain fringe benefits, some of which may be taxable and some which may normally be nontaxable (e.g., health insurance, group term life insurance within the permissible limits) are to be in the same legal situation during the period until new regulations are issued in final form as salary reduction plans. Your committee sees no difference between this type of plan and salary reduction plans, and concludes that they should receive similar treatment. Here too the committee bill requires a temporary preservation of the pre-1972 status quo, and the tax treatment of fringe benefits selected under this type of plan is to be governed by the principles which were being applied by the Internal Revenue Service prior to 1972 to salary reduction plans. In the absence of Congressional action, Treasury and the Internal Revenue Service will be free to take any action which is deemed appropriate, but the regulations may not be issued in final form prior to March 16, 1975.

The committee wishes to make clear that absolutely no inference is to be drawn from this action that Congress either agrees or disagrees with pre-1972 interpretation of the law by Treasury and the Internal Revenue Service concerning salary-reduction plans, cash or deferred profit-sharing plans or cafeteria style plans, or that it agrees or disagrees with the interpretation embodied in the proposed regulations concerning salary-reduction plans which are to be withdrawn under the bill. There is also to be absolutely no inference that if Congress does

[145] not act in this area within a year that it would or would not be appropriate to reissue these regulations, or that it would or would not be appropriate to extend the principles thereof to cover cash or deferred profit-sharing plans or cafteria style plans.

Designated contributions.—Under present law, contributions which are designated as employee contributions are generally treated as employee contributions for purposes of the Federal tax law. For example, this is the case with respect to employee contributions under the Federal Civil Service plan. Your committee's bill contains a provision to clarify this rule for the future. This provision provides that amounts that are contributed to a qualified plan are not to be treated as an employer contribution if they are designated as employee contributions.

This provision gives effect to the source of the contributions, as designated in the plan. For example, if the appropriate committees of the Congress were to report legislation regarding employee contributions under the Federal Civil Service plan so that the present employee's contributions would become employer contributions under the Federal Civil Service plan (and that legislation were to be enacted), then those contributions would constitute employer contributions to the plan, which would be excludable from the employee's income when made. The same rule would apply to State and local governmental plans which now designate contributions as employee contributions, if the appropriate governmental bodies change the provisions of their plans.

However, some State and local government plans designate certain amounts as being employee contributions even though statutes authorize or require the relevant governmental units or agencies to "pick up" some or all of what would otherwise be the employee's contribution. In other words, the governmental unit pays all or part of th employee's contribution but does not withhold this amount from the employee's salary. In this situation the portion of the contribution which is "picked up" by the government is, in substance, an employer contribution for purposes of Federal tax law, notwithstanding the fact that for certain purposes of State law the contribution may be designated as an employee contribution. Accordingly, the bill provides in the case of a government pick-up plan, that the portion of the contribution which is paid by the government, with no withholding from the employee's salary, will be treated as an employer contribution under the tax law.

Effective date

The provisions dealing with salary reduction plans and treatment of contributions designated as employee contributions are to take effect upon enactment.

Revenue effect

There is no revenue effect from these provisions since they are consistent with present law, in the case of designated contributions, and simply postpone for one year any possible reinterpretation of present law in the case of salary reduction plans.

G. Lump Sum Distributions

[146] (Sec. 2004 of the bill and secs. 72, 402, and 403 of the code)

Present law

Retirement benefits generally are taxed under the annuity rules (sec. 72) as ordinary income when the amounts are distributed, to the extent they do not represent a recovery of the amounts contributed by the employee. However, an exception to this general rule under the law in effect before the Tax Reform Act of 1969 provided that if an employee's total accrued benefits were distributed or paid in a lump-sum distribution from a qualified plan within one taxable year on account of death or other separation from service (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than as ordinary income.

The capital gains treatment accorded these lump-sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of $50,000, particularly in view of the fact that a number of lump-sum distributions of over $800,000 have been made.

To correct this problem, the Tax Reform Act of 1969 provided that part of a lump sum distribution received from a qualified employee's trust within one taxable year on account of death or other separation from service (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. Insofar as the distributions are considered as being attributable to post-1969 years, the portions of the benefits which represented employer contributions were accorded ordinary income treatment while the portions which represented appreciation, interest, or dividends on the amounts accumulated continued to be given capital gains treatment. Of course, no tax was imposed with respect to the employee's own contribution. The use of capital gains treatment was continued for the entire taxable portion attributed to 1969 and earlier years.

The 1969 Act provided a special seven-year "forward" averaging treatment for the portion of the lump-sum distribution treated as ordinary income. A regular employee (or his beneficiary) is eligible for this seven-year averaging treatment if he has been a participant in the plan for five or more taxable years or if his beneficiary received the lump-sum distribution because of death.

In the case of retirement plans for the self-employed ("H.R. 10 plans", the Self-Employed Individuals Tax Retirement Act of 1962) the entire lump-sum distribution (excluding the employee contributions) are taxed as ordinary income, but with five-year forward averaging.[1] No change was made in this provision by the Tax Reform Act of 1969.

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[1] The self-employed are eligible for this special averaging if the lump-sum distributions are received on account of death, disability or if received after age 59½. As with regular employees, the distributions must also be received within one taxable year, and only if the self-employed person had been a plan participant for five or more taxable years preceding the taxable year of the distribution. However, unlike regular employees, the self-employed are not entitled, under present law, to the special averaging simply because of a separation from service.

[147] Self-employed who elect to be taxed under this special averaging rule cannot for the same taxable year use the regular income averaging rules (sec. 1301 *et seq.*) as to this income or other ordinary or capital gain. However, the self-employed generally find this special averaging more advantageous than the regular five-year averaging rule generally available because the latter may be used only to the extent that the income averaged exceeds 120 percent of that taxpayer's average income in the four prior years. Unlike the self-employed, however, the regular employee may use his special seven-year averaging for the ordinary income portion of his lump-sum distribution while using the regular averaging provisions for the capital gain portion of the distribution as well as for any other income he may have.

Reasons for change

The Treasury has had great difficulty in formulating regulations to carry out the 1969 Act provisions for regular employees in determining the precise break-down between ordinary income and capital gain in a lump-sum distribution. It has also had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the amount of tax imposed on account of the "ordinary income" element of post-1969 lump-sum distributions. Recently, the Treasury withdrew its earlier proposed regulations on the second point and substituted new ones which, in general, would produce lower tax liabilities than those determined under the earlier set of proposed regulations. The new regulations also would produce lower tax liabilities than under current long-term capital gain rates in many cases, and this could mean that they would result in revenue losses, rather than revenue gains, in comparison to the law which would have applied in the absence of any special action with respect to this provision in the Tax Reform Act of 1969.

More important, the new proposed regulations appear to share with the old proposed regulations the problem of excessive complexity. It is frequently maintained that lump-sum distributees are unable to compute their taxes, and that accountants and tax lawyers have been refusing to attempt the computations.

To eliminate undue complexity but maintain the revenue at least as high as that which would result under the proposed regulations under the 1969 Act provision, the committee chose to introduce a new and simplified method of computing the tax due on lump-sum distributions. The substance of the 1969 change in the tax treatment would be preserved, however. Under the bill, all pre-1974 portions of lump-sum distribution would be taxed as capital gain, rather than as ordinary income. The effect of the January 1, 1974, cutoff date under this bill is to provide long-term capital gains treatment for that portion of future distributions that relates to years after 1969 and before 1974; under the 1969 Act, portions of the distributions allocable to those years would have been taxed as ordinary income.

Under the simplified computational rules, ordinary income portions of lump-sum distributions from qualified plans are to continue to benefit from special "forward" averaging. The portion of the distribution representing pre-1974 value is to receive capital gains treatment, as

[148] stated above. The portion of the distribution attributable to post-1973 value in excess of the employee contributions is to be subject to tax as though it were ordinary income of the taxpayer, but his only income, and with 10-year averaging.

This ordinary income treatment for the post-1973 value of the lump-sum distribution is computed completely separately from the taxpayer's other income. This separate computation is used because it was found that taxpayers were, in effect, being treated quite differently depending upon the presence or absence of other income in the year of distribution—something which they sometimes had in their power to control.

The 10-year averaging is provided in order to give roughly the equivalent of what the tax would be were the individual to live 10 years after retirement and receive his interest in the plan over that period. In this case, a tax is completed on $\frac{1}{10}$th of the distribution computed as if the taxpayer had no other income or deductions. After the tax is computed, the result is multiplied by 10, and this amount is then added to the employee's tax liability on his other income. His tax liability on this other income takes into account not only his tax on wages, salary, or investment income, etc,, but also the capital gains tax on the portion of the lump-sum distribution attributable to pre-1974 value. The tax liability on this other income does not in any way, however, take into account the portion of the lump sum distribution treated as ordinary income.

In making the ordinary income computation on the post-1973 value, a special minimum distribution allowance is provided to insure that the tax on relatively small lump-sum distributions will generally be not more than it would be under present law. This allowance is phased out for lump-sum distributions over $20,000.

A major problem with the rule arrived at under the 1969 Act was the difficulty in determining the value of the distribution attributable to years before 1970 for which capital gains treatment was continued by that Act. To meet that problem, the committee bill provides that where a lump-sum distribution relates to active participation which began before 1974 and ended after that time, the distribution is to be apportioned between the pre-1974 participation (eligible for capital gains treatment) and post-1973 participation (treated as ordinary income under a separate 10-year averaging computation) on the basis of the amount of time in which the employee was an active participant in each period. This method will significantly simplify the computation previously required.

Table 1 presents a comparison showing the average effective tax rates applicable for taxpayers in various situations and with various amounts of lump-sum distributions, with the methods of computing post-1973 taxable value as capital gain, under present law (with the proposed regulations), and under the committee bill.

[149] TABLE 1.—COMPARISON OF INCOME TAX TREATMENT OF LUMP SUM DISTRIBUTIONS UNDER THE COMMITTEE BILL WITH CAPITAL GAINS TREATMENT AND WITH THE TREATMENT PROVIDED IN 1969 (AS SHOWN BY PROPOSED REGULATIONS)

		Average effective income tax rates (percent)		
Assumed adjusted gross income, other than lump-sum distribution [1]	Assumed lump-sum distribution [2]	Capital gains treatment (1973 law) [3]	1969 treatment as shown by proposed regulations [4]	Rates which apply under Ways and Means Committee bill when all but employee contributions are ordinary income
$5,000	$2,500	7.4	5.1	7.0
	5,000	7.7	5.3	7.0
	10,000	7.4	5.6	7.0
	50,000	8.5	10.6	16.3
	60,000	8.7	11.3	17.8
	100,000	10.5	13.2	20.9
$10,000	5,000	8.1	5.7	7.0
	10,000	9.2	5.9	7.0
	20,000	9.5	8.9	7.3
	50,000	10.4	12.0	16.3
	100,000	12.2	15.4	20.9
	200,000	15.8	19.5	26.2
$25,000	12,500	15.6	11.5	7.1
	25,000	15.7	13.9	9.7
	50,000	16.7	16.1	16.3
	125,000	18.8	20.0	22.2
	250,000	22.3	23.2	28.8
	500,000	25.6	27.2	40.4
$50,000	25,000	24.6	19.6	9.7
	50,000	24.8	21.0	16.3
	100,000	25.5	22.2	20.9
	250,000	27.0	25.2	28.8
	500,000	29.1	28.4	40.4
	1,000,000	31.2	32.5	53.1
$100,000	50,000	25.0	30.1	16.3
	100,000	28.2	31.4	20.9
	200,000	30.7	33.8	26.2
	500,000	32.0	37.0	40.4
	1,000,000	33.8	38.8	53.1
	2,000,000	35.1	43.9	61.5

[1] Income other than lump-sum distributions consists of income taxed at ordinary rates and which is not subject to either the maximum tax on earned income or the minimum tax on items of tax preference. To avoid problems of maximum tax on earned income, ordinary income in excess of $50,000 is considered as coming from sources other than earnings. Taxable income is computed from AGI by deducting the larger of the standard deduction or itemized deductions equivalent to 15 percent of AGI and from personal exemptions of $750 each. Taxpayer is considered to be married and filing a joint return. No additional itemized deductions are considered to accrue to the taxpayer due to the receipt of lump-sum distribution.

[2] Net of taxpayer's basis.

[3] 50 percent inclusion of capital gains in AGI. Taxpayer is eligible for either alternative tax of 25 percent on 1st $50,000 of capital gains or normal 5-year income averaging. Four prior year base period income is assumed to be the same as taxable income excluding distribution for the current year, except for $5,000 AGI class which is assumed to have a base of $1,462.50 and the $10,000 AGI class which is assumed to have a base of $5,850.

[4] 70 percent of distribution assumed to be capital gains; 30 percent ordinary income.

The committee concluded that in the interest of simplification it was desirable to provide the same averaging treatment for lump-sum distributions for both the self-employed and the regular employees. As a result, the distinction of present law that accords 5-year averaging to distributions to self-employed and 7-year averaging to distributions to regular employees is eliminated and the 10-year averaging treatment referred to above is made available in both cases.

Under the committee bill, the portion of eligible distributions attributable to pre-1974 value is to be taxed as capital gain to the self-employed in the same manner as in the case of regular employees. Also in both cases, the bill will allocate distributions between capital gain and ordinary income on the basis of the portion of the time the employee was a participant prior to 1974 and after 1973.

[150] Many of the requirements for lump-sum treatment are the same under present law for regular employees and the self-employed.[2] However, there also are differences in present law in granting eligibility for lump-sum treatment in the case of regular employees and the self-employed, and because of basic differences in their status it was necessary to retain some of them. One difference is that regular employees may claim the special averaging treatment if the distribution is on account of their separation from service, whereas the self-employed cannot. It was necessary to maintain this distinction because there is no comparable concept of "separation from service" for the self-employed.

On the other hand, the committee bill does remove a difference in treatment between the self-employed and regular employees by permitting the latter, as well as the self-employed, the right to claim the special averaging treatment in instances of distributions to those who have attained age 59½ whether or not there is a separation from service. However, both classes of persons are to be eligible for this special treatment only once after attaining age 59½.[3]

The committee bill also removes another difference in treatment between these two classes of persons by providing that the self-employed, as well as regular employees, may claim the normal five-year averaging (provided under sec. 1301 of the code) for their other taxable income, including any capital gain portions of their lump-sum distributions. (The regular five-year averaging rule is provided under present law for cases in which taxable income in any taxable year increases markedly from taxable income in prior years).

Explanation of provisions

Under the simplified computation of the tax on lump-sum distributions, the post-1973 portion of a distribution is to be taxed as ordinary income (but with 10-year "forward" averaging), thus maintaining the recognition in the Tax Reform Act of 1969 that the taxable portions of these distributions are basically deferred compensation, and generally should be taxed as is other compensation; that is, as ordinary income. Ten-year averaging is provided to recognize the fact that the distribution represents compensation which generally is received spread out over the taxpayer's life beginning with the time he retires. Ten-year averaging, insofar as the size of the tax is concerned, achieves this result. It is believed that it would be unfair to use the high tax rate that would be applicable if the distribution were treated as received wholly in one year. As a result of the averaging, the distribution would be taxed roughly as if it were received in 10 equal parts in 10 years. The decision to tax this income separately from all other income (to the extent it is not treated as pre-1974 income eligible for capital gains treatment) was made on the basis that most distributees

[2] In the case of both regular employees and the self-employed, in order to qualify for the ten-year averaging, the entire distribution made to them must be made within one taxable year and they must have been participants in the plan for at least five years prior to the year in which the distribution was made. This latter rule does not apply to distributions made in the event of death.

[3] The special averaging will continue to be made available to distributions on account of the disability of a self-employed person (in general if the disability is an impairment which would result in death or can be expected to be of long-continuing and indefinite duration). Regular employees may claim the special averaging for distributions on account of disability only if the disabled employee has attained age 59½ or is separated from service, as, for example, on account of the disability.

[151] will have little or no other taxable income in the years following their retirement.

The decision to use 10-year averaging is attributable to the fact that 10 years represents the approximate life expectancy of a person age 65 and therefore is approximately the period over which the income would be spread if not received in the form of a lump-sum distribution.

The portion of the distribution attributable to pre-1974 service is to be taxed as capital gain and taxed along with any other income the taxpayer may receive. For this income, the committee believed it was appropriate to preserve the pre-1969 treatment (at current capital gains rates) to the fullest extent possible. The portion which constitutes a return of employee contributions continues to be nontaxable as a return of basis.

Under the computation, the capital gain portion is included in the amount of the taxable distribution prior to the deduction of the minimum distribution allowance and the application of the 10-year averaging rule. After a total tax is determined under the 10-year averaging rule, the tax on the ordinary income element is the portion of that total tax determined according to that portion of the plan participant's total time in the plan that was spent after 1973. The capital gain is added to the taxpayer's other income and this total (minus regular deductions, exclusions, etc.) is taxed under usual rules. (See the examples at the end of this section.)

A further simplification from prior law in the computation is the determination of the amounts to be attributed to pre-1974 employment (capital gain taxation) and to post-1973 employment (10-year averaging with ordinary income taxation). That attribution is to be made on the basis of the amount of time in which the distributee was an active participant in each period. Thus, if a distributee was an active participant from January 1, 1971, through December 31, 1980, three-tenths of the taxable portion of his distribution would be taxed as capital gain while seven-tenths would be taxed as ordinary income and averaged over 10 years.

Although the breakdown between capital gain and ordinary income is normally to be made on the basis of the number of calendar years in which the participant was active in the plan before and after December 31, 1973, the Secretary is authorized to issue regulations describing circumstances under which participants may use plan years instead of calendar years. This is intended to further simplify the computation for those plan participants whose information concerning their participation is prepared and given them by plan administrators in terms of plan years, rather than calendar years.

In order to treat all distributees equally, all computations of the tax on the ten-year averaging ordinary income portion are to be made on the basis of the tax schedule for unmarried individuals.[4] In addi-

[4] Distributees, in computing the tax on their other income (including the capital gain element of the distribution), may use any appropriate tax schedule. They are not restricted to the schedule for unmarried individuals.

[152] tion, community property laws are generally to be ignored for these purposes.[5]

In computing the tax on the ordinary income element, a special minimum distribution allowance is to be provided to give assurance that the tax on relatively small lump-sum distributions will not be appreciably more than under present law. In the computation, the amount of the taxable distribution (the total distribution less the participant's payments) is to be reduced by the minimum distribution allowance before the tax is computed. The allowance is half of the distribution up to $20,000. Above that level, it is phased out on a $1.00 for $5.00 basis, with the result that it is entirely eliminated for distributions of $70,000 or more.

Of course, no change is made respective to the $5,000 exclusion from gross income provided in section 101(b) of the Code for amounts paid by employers because of the death of the employee.

To protect against tax avoidance possibilities the bill provides that distributions made during the current taxable year and the five previous taxable years of the recipient are to be included in the ten-year averaging computation for purposes of determining the tax rate on the last distribution. When the total tax is determined, however, the amount of this tax attributable to any earlier distributions (determined as illustrated in the examples following this discussion) is to be subtracted and the tax on the final distribution is the remainder. Generally all distributions made within the current and five prior taxable years to the same recipient are to be subject to this five-year lookback rule. Lump-sum distributions made prior to 1974 need not be aggregated under this rule.

Aggregation of distributions for this purpose is required of all lump-sum distributions in the current and five prior years with respect to the same recipient.[6] In the case of receipt of subsequent distributions by the plan participant in the six-year period, this would mean the aggregation by the participant of all those distributions would be required. In the case of a plan participant receiving a distribution from his or her own retirement plan and also receiving a distribution as a beneficiary, those distributions would also have to be included in the aggregation. Moreover, it is not intended that a recipient of one distribution could escape the inclusion of another distribution he is entitled to claim by directing that it be made instead to a beneficiary.

Aggregation is required only of lump-sum distributions. If a recipent is entitled to special averaging for a distribution, but does not elect the special averaging, he is not required to aggregate that distribution with a subsequent lump-sum distribution for which he does

[5] Prior to the computation of the separate tax on the ordinary income portion of the distribution, under the committee bill an amount must be subtracted from the income of the retiree. In community property states, the amount subtracted will, of course, generally be only one-half of the ordinary income portion of the lump-sum distribution. The other half of this lump-sum distribution must be subtracted from the income of the spouse which may be reported on a separate tax return. After the computation of the separate tax with respect to the ordinary income portion, this tax is added to the tax of the retiree alone as otherwise computed, and not to that of the spouse where she is computing her tax on a separate return. The capital gain portion of the lump-sum distribution in a community property state is to continue as under present law to be included one-half in the income of the retiree and one-half in the income of the spouse.

[6] Requiring aggregation of all lump-sum distributions with respect to the same participant, rather than with respect to the same recipient, was rejected because of the difficulty recipients would have in determining the amount of previous lump-sum distributions to different recipients, as well as the tax paid by those earlier recipients.

[153] elect the special averaging since the former distribution is excluded from the definition of a lump-sum distribution.

The distribution of an annuity contract is to be taken into account in the taxation of lump-sum distributions although the contract itself is not to be treated as a taxable lump-sum distribution. If an annuity is distributed to a recipient in the same six-taxable-year period in which a lump-sum distribution that is not an annuity distribution is made to the same recipient, the value of the annuity (only for purposes of computing the tax on other lump-sum distributions) is to be added to the amount of cash or value of the other property distributed and a tax is to be calculated on the sum. From that amount is to be subtracted the tax calculated on the value of the annuity alone (reduced by the minimum distribution allowance applicable to the total). The remainder is the tax on the taxable portion of the aggregated lump-sum distribution.[7] The value of the annuity, for these purposes, is to be the present value of the payments anticipated under the annuity contract, computed with regard to the life expectancy of the recipient.

The effect of treating annuity distributions as lump-sum distributions is only to increase the tax rate payable on the taxable distribution.

Annuity distributions, standing alone, remain nontaxable, as under present law. Furthermore, their inclusion in the computation is not to increase the capital gains tax payable on account of pre-1974 value of the aggregated distributions.

Of course, trusteed annuities, the rights to which have not been distributed, are not to be included in the lookback rule computation.

The committee bill does not change the present tax treatment of distributions of employer securities. Therefore, appreciation of the value of employer securities between the time the securities were allocated to the participant's account and the time of the distribution would not be taxed upon the distribution, but would be taxed as capital gains upon an eventual sale of those securities by the recipient. (This rule would continue to apply regardless of whether the employee has completed five years of participation in the plan.) This appreciation, unlike distributions of annuity contracts, would not be included in the aggregated distributions for purposes of the tax computation.

A recipient of a distribution could not use this special ten-year-averaging method unless he combines all amounts received in any taxable year that might be eligible for this special averaging system into a single lump-sum distribution. For example, if an employee has been working for separate employers at any time during his working career and receives in one taxable year distributions from two or more employers of the entire amounts (or, in the case of an annuity purchase, is credited with the entire amount) due him under the plans of those particular employers, that employee must treat all the distributions to him in that year as a single lump-sum distribution in order to claim the ten-year averaging.

For a distribution to be eligible for the special lump-sum distribution treatment an employer must distribute to an employee (or, in the case of an annuity, distribute to that employee's credit) all of the bal-

[7] If the distribution of an annuity is the final lump-sum distribution in any six-taxable-year period, a tax is determined based on the tax rate applicable to the total of the aggregated distributions, including the annuity distributions. The tax deemed payable on account of the annuity distributions is subtracted, as above described, a credit is given for the tax earlier paid on account of the cash distributions, and the remainder is the tax due for the final taxable year in the six-year period on account of the distributions. Of course, this does not increase the basis of annuity contract.

[154] ance due the employee from all the employer's pension plans, all the balance from that employer's profit-sharing plans, or all the balance from that employer's stock bonus plans. This prevents the tax avoidance which would otherwise occur as the result of successive distributions in subsequent years from different plans of the same employer.

Although the number of separate distributions is limited as described above, elections to use this special ten-year averaging may be made freely for all permitted lump-sum distributions until the employee has attained age 59½. After that time, only one election may be made with respect to that employee. This would permit a widow to make an election for the special averaging for a distribution on account of her deceased husband while making another election in a subsequent year for her own retirement distribution although both she and her husband had attained age 59½ at the time of the distributions. However, an employee who receives a lump-sum distribution on his own account after age 59½ and elects the special averaging treatment may not thereafter make the same election for another distribution on his own account in another taxable year. The effect of this is to prevent most retiring taxpayers from avoiding the aggregation required under the five-year rule by electing the special averaging for years that are six or more years apart.

Despite the limitation of one election with respect to individuals who have attained age 59½, if such an individual makes an election to use ten-year averaging for one distribution, and then later receives an annuity distribution within the six-year aggregation period, the annuity and the prior distribution (or distributions) must be aggregated.

It is contemplated that a taxpayer will make his election on the income tax return for the taxable year in which the distribution was made. The election, however, is not to be irrevocable, and can be changed so long as the income tax return could be amended or a refund claim could be filed. (Normally, a refund claim must be filed within three years after the return is filed.)

Individuals, estates and certain trusts may elect to use this special lump-sum distribution treatment.[8] Of course, the normal constructive receipt and anticipatory assignment of income rules would be applicable to distributions to trusts, as under present law. Thus, if a lump-sum distribution is made to a nontestamentary trust having a beneficiary other than the employee as the primary beneficiary, the distribution would generally be taxable to that employee.

As a result of this and the specific language of the bill, an individual could not avoid the aggregation rules by making distributions to multiple trusts for the benefit of the same beneficiary. Similarly, the aggregation rule could not be avoided by reciprocal trusts.

A trust would not be permitted to make the election, and thereby claim the special averaging treatment, if its use has affected the includibility of the distribution in the gross estate of the employee for purposes of that employee's estate tax. However, the fact alone that the amount of a distribution is excluded under section 2039(c) of the Code does not bar the trust from making the election unless the use of the trust as a medium, whether intentionally or unintentionally, occasions estate tax avoidance.

[8] However, an estate or a trust will be prohibited from making the election if an election has already been made—by another trust or by the individual himself—with respect to that same individual after he has attained age 59½.

[155] The plan participant would be treated as the recipient of a distribution, for purposes of the aggregation rules, if he causes a lump-sum distribution to be made to a trust for the benefit of his wife, but with the income or right to the income reserved to himself, or in any other situation in which the participant would be treated as the substantial owner of the trust under the present tax rules, even if the grantor of the trust is the employer or plan.

The tax paid on a lump-sum distribution under this special averaging treatment rule is neither to be a tax preference item (in the sense of section 56 of the Code), nor is it to be used as a part of the tax paid that reduces the minimum tax on tax preference items.

First example.—On December 31, 1975, A terminates his services and receives a lump sum distribution of $65,000 from a qualified plan. The distribution includes employer securities with a fair market value of $25,000 and a basis of $10,000. A has been participating in the plan since January 1, 1966. The plan is noncontributory. A is married; both A and his wife are 50. Their only other income is A's salary of $15,000 and his salary from a second job ($5,000). Their itemized deductions are $3,000. Their average base period income from the preceding four years (1971 through 1974) is $14,000.

The tax on the portion of the distribution which is not treated as a long-term capital gain is computed as follows:

Net distribution ($65,000 total distribution less $15,000 unrealized appreciation on employer securities)	$50,000
Less: Minimum distribution allowance: 50 percent of first $20,000	10,000
Reduced by: 20 percent of net distribution in excess of $20,000	6,000
	4,000
Distribution less allowance	46,000

The tax on $\frac{1}{10}$th of the distribution less allowance computed from the tax rate schedule for single taxpayers is $816.00.

Multiply this amount by 10: $8,160.00.

Then, multiply by the fraction,

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}} = \frac{2}{10} 0.2$$

which yields $1,632.00.

Thus, the tax on the ordinary income portion of the distribution is $1,632.00.

The amount of the distribution taxed as a long-term capital gain is the amount of the net distribution multiplied by the fraction,

$$\frac{\text{Years of participation before 1974}}{\text{Total years of participation}} = \frac{8}{10} 0.8$$

Net distribution	$50,000
Capital gains element	40,000

The capital gains element is taxed along with other income (exclusive of the ordinary income element) in the normal way. The tax on the taxable income of $35,500 ($15,000 salary from first job, plus $5,000 from second job, plus $40,000 capital gains element of lump sum distribution, less $20,000 capital gains exclusion, less $3,000 item-

[156] ized deductions, less two $750 personal exemptions) is calculated using the tax rate schedule for married taxpayers filing joint returns. In this case the alternative tax on capital gains is not available, but the regular-five-year income averaging provisions are.

Ordinary tax	$10,130.00
Tax—Using regular income averaging [1]	8,828.00

[1] As indicated above, average base period income is $14,000.

Selecting the tax computation method which yields the smallest amount of tax, A uses the regular five-year income averaging method and has a tax of $8,828.00.

Finally, A combines the tax on the capital gains portion of the distribution and his salary, with the tax on the ordinary income portion of the distribution:

Tax on salary and capital gains portion of distribution	$8,828.00
Tax on ordinary income portion of distribution	1,632.00
Total 1975 income tax	10,460.00

A's basis in the employer's securities is $10,000.

Second example.—On December 31, 1976, A receives a distribution from a qualified plan with respect to his second job. In this case the distribution is a nontransferable annuity contract, the value of which is $6,000; and a cash distribution of $4,000 financed solely by the employer. A had participated in the plan since January 1, 1967. Mr. and Mrs. A's only other income in 1976 is A's salary of $25,000 and interest of $3,000 on the $40,000 cash received in the prior lump sum distribution. They have itemized deductions of $2,100. Mr. and Mrs. A's 1976 tax is computed as follows:

First, compute the tax on the portion of the distribution which is not treated as a long-term capital gain and which is taxed separately.

Step 1:

1976 cash distribution	$4,000
1976 annuity contract	6,000
Prior year net distribution	50,000
Total	60,000
Less: Minimum distribution allowance: 50 percent of first $20,000	$10,000
Reduced by: 20 percent of net distribution in excess of $20,000	8,000
Total	2,000
	58,000

Ten times the tax on one-tenth of $58,000 (from the rate schedule for single taxpayers) is $10,680.

Step 2:

1976 annuity	$6,000
Minimum distribution allowance from Step No. 1	2,000
Total	4,000

Ten times the tax on one-tenth of $4,000 (from the rate schedule for single taxpayers) is $560.00.

Step 3: $10,680.00—$560.00=$10,120.

Step 4:

[157] Determine ordinary income and capital gains elements of A's distribution and his prior year distribution. The ordinary income element of A's latest distribution is determined by multiplying the cash distribution of $4,000 by:

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}}=\frac{3}{10}=0.3$$

Thus, A's ordinary income element is $1,200. $10,000 of Mr. A's prior distribution of $50,000 was ordinary income.

Thus, the tax on the ordinary income element is the fraction of the tax from Step No. 3 which the ordinary income elements of the 1976 and prior year distributions bear to the entire distributions.

$$\left.\frac{\$1{,}200+\$10{,}000}{\$4{,}000+\$50{,}000}\right\}\times\$10{,}120=\$2{,}098.96$$

Step 5:

The tax on the ordinary income element of A's 1975 distribution from their 1973 income tax income return was $1,632.00. Subtracting that from the tax calculated in Step No. 4 yields the tax on the ordinary income element of A's latest distribution:

$$\$2{,}098.96-\$1{,}632.00=\$466.96$$

Second, compute the tax on all other income, including the capital gains portion of the distribution.

Step 6:

In Step No. 4, the ordinary income element of the distribution was calculated as $1,200. Therefore, the long-term capital gains element is:

$$\$4{,}000.00-\$1{,}200.00=\$2{,}800.00$$

Step 7:

The capital gains element is taxed along with other income in the ordinary manner.

Capital gains element	$2, 800
Less: 50 percent of net long-term capital gain	1, 400
Total	1, 400
Salary	25, 000
Interest	3, 000
Adjusted gross income	29, 400
Less: Itemized deductions	2, 100
Less: Personal exemptions (2×$750)	1, 500
Taxable income	25, 800

The tax on $25,800 is calculated using the tax rate schedule for married taxpayers filing joint returns. In this case, neither the alternative tax on capital gains nor the regular five-year income averaging provision is available.

Ordinary tax	$6, 308. 00

Third, A combines the tax on the capital gains portion of the distribution and his other income, with the tax on the ordinary income portion of the distribution.

[158] *Step 8:*

Tax on capital gains portion of distribution and on other income	$6,308.00
Tax on ordinary income portion of distribution	466.96
Total 1976 income tax	6,774.96

If in the examples above, A has attained age 59½, he may elect to treat only one of the distributions as a lump sum distribution qualifying for ten-year averaging. In computing the tax liability on the distribution which he elects to qualify for ten-year averaging, A will not aggregate any distribution (except in the case of a distribution of an annuity contract) made after attaining age 59½ which is not treated as a lump sum distribution for purposes of the ten-year averaging.

Effective date

These lump-sum distribution provisions are to apply to distributions made in taxable years beginning after December 31, 1973. The aggregation required under the five-year lookback rule is not to include distributions made prior to that effective date.

Revenue effect

The revised tax treatment of lump-sum distributions from retirement plans is expected to result in the long run in annual revenue gains amounting to $60 million a year based on 1973 levels of income.

H. Miscellaneous

1. Registration with Social Security

General reasons for change

The mobility of labor in the United States has been steadily increasing. From the standpoint of the economy, this is generally viewed as a desirable factor since it enables us to overcome labor shortages in limited areas or specific industries. It also tends to decrease frictional unemployment. However, those employees who move from job to job have had difficulty in earning vested retirement benefits, and even where these benefits are earned, they have faced difficulties in collecting the benefits upon retirement.

Your committee understands that, upon retirement, employees who frequently changed employment during their working years may have difficult problems in locating their former employers and the retirement plans in which they may have vested benefits. At times, this results from their former employers (or the plans) having changed name or address, or having merged with other organizations. At other times, the employees themselves may not have been able to maintain the records needed to enable them to contact their former employers. Alternatively, they may have forgotten that they had vested rights in plans with former employers.

To resolve this problem, the bill provides that the Social Security Administration is to maintain records of the retirement plans in which individuals have vested benefits, and is to provide this information to plan beneficiaries.[1]

[1] The bill also provides for a tax-free transfer of funds between a qualified plan and individual retirement accounts, which should meet any additional need for "portability".

[159] *Explanation of provisions*

Under the bill, the administrator of every funded plan of deferred compensation (except for nonqualified governmental plans and nonqualified church plans) is to file an annual statement with the Secretary of the Treasury regarding individuals who have a right to a deferred vested benefit under the plan and who, during the year, separated from service covered by the plan. The Secretary of the Treasury is to provide this information to the Secretary of Health, Education, and Welfare; in this way it is contemplated that the plan administrator can file this statement together with other annual returns for the plan filed with the Secretary of the Treasury. (It is also contemplated that similar registration requirements will be established under the Labor Department. Consequently, to avoid the problem of duplicate reports, the bill provides that regulations issued by the Secretary of the Treasury respecting this provision will not be effective for plan years beginning after 1975. Your committee expects that the Secretary of the Treasury also will approve regulations issued by the Secretary of Labor.)

The annual statement is to include the name of the plan, the name and address of the plan administrator, and the name and taxpayer identifying number (generally the Social Security number) of every individual who has separated from service covered by the plan in the plan year for which the statement is filed and who is entitled to a deferred vested benefit under the plan. The statement also is to include information on the nature, amount and form of the individual's deferred vested benefit as of the time he left employment. In addition, the statement is to include other information required by the Secretary of the Treasury. However, the statement need not include information about persons who separated from service if they were paid retirement benefits, such as annuities, from the plan during the year of separation. In addition, each covered plan is to notify the Secretary of the Treasury of any change of name of the plan or change of name or address of the plan administrator, any plan termination, or any plan division or merger or consolidation with any other plan.

The plan administrator also is to furnish each individual included in the annual registration statement with the information in that statement regarding his plan rights. In addition, the plan administrator is to furnish satisfactory evidence to the Secretary of the Treasury, upon filing the annual registration statement, that he has furnished individual plan participants with a statement of their rights under the plan. It is expected that a declaration under penalty of perjury of delivery or mailing to each named individual will ordinarily be sufficient evidence.

With respect to multiemployer plans, it may be difficult for plan administrators to determine when a plan participant has separated from service. Consequently, the Secretary of the Treasury is to establish regulations providing for annual registration statements by multiemployer plans.

Upon the request of the plan participant (and in accordance with regulations), the Social Security Administration will furnish him any information which it has relating to his vested retirement plan benefits. In addition, when a person applies for Social Security retirement, disability, death, or hospital insurance benefits, on determining whether these benefits are due, the Social Security Administration will

[160] also inform the claimant of any information which it has relating to the vested retirement plan benefits of the participant. The Social Security Administration is not to attempt to verify the accuracy of the information it receives with respect to plan rights, nor to determine the present value or status of any plan rights, but is only to report the information that it receives and records.

Your committee understands that the value of plan rights will often change between the time that a report is made and the time a participant (or his beneficiaries) are informed of their rights by the Social Security Administration. However, your committee believes it is important for a plan to go on record as to these rights as of the time of separation from service. Additionally, it is expected that the Social Security Administration will make it quite clear, at the time it informs applicants of their rights, that the information given is what was received from the plan and that changes in rights may have occurred after the time the information was received from the plan.

In order that persons who have left employment with vested rights before the effective date of this provision may benefit from the provision, the bill provides that the Secretary of the Treasury also may, pursuant to regulations, receive reports from covered plans relating to the deferred vested retirement benefits of any plan participant who has terminated his employment with the employer in plan years before the effective date of the provision. These reports would be filed by plan administrators on a voluntary basis.

If a plan administrator fails to file the annual registration statement, he is to be subject to a penalty of $1 per day for each participant with respect to whom there has been a failure to file; the maximum penalty is $5,000 per plan year. However, plan administrators will not be subject to the penalty upon failure to file due to reasonable cause. A penalty also is to be imposed on a plan administrator who does not file with respect to changes in plan status. The penalty is to be $1 per day, up to a maximum of $1,000; however, no penalty will be owed if failure to file was due to reasonable cause.

If a plan administrator willfully furnishes a false or fraudulent statement of vested rights to individual participants or willfully fails to furnish the required statement, he will be subject to a penalty of $50 per participant.

Effective date

The provisions of the bill which require an annual registration statement with respect to persons separating from service with vested benefits (and with respect to the certificate of rights furnished to each such person) are to with respect to plan years beginning after December 31, 1975.

2. REQUIREMENTS FOR QUALIFICATION OF TRUSTS BENEFITING OWNER-EMPLOYEES

Under present law (section 401(d) of the code), if a trust provides benefits for employees some or all of whom are owner-employees, the

[161] trust may qualify for tax benefits only if the trustee is a bank.[1] The committee believes that this provision is too restrictive, and that other entities could handle the task as well.

For that reason, the committee bill (section 1022) would permit a "person" other than a bank to be the trustee of such a trust without causing the trust's disqualification. The bank or other person performing as such a trustee must be able to satisfy the Internal Revenue Service that he will hold the trust assets in a manner consistent with the general eligibility requirements for tax qualification. Furthermore, the provision in present law allowing someone (including the employer) other than the trustee or custodian to have authority to control the investments of the plan account, whether by directing the investment policy or by exercising a veto power over investments, is retained under the committee bill.

This provision generally applies to plan years beginning after the date of enactment. However, in case of a plan in existence on the date of enactment, the provision applies to plan years beginning after December 31, 1975.

3. CUSTODIAL ACCOUNTS AND ANNUITIES

Present law permits custodial accounts to qualify for tax benefits as if they were trusts, provided that the custodian is a bank, and provided also that the custodial account meets the requirements that a trust would have to meet for qualification. Furthermore, the custodial account's assets must be invested solely in open-end mutual funds or solely in annuity, endowment, or life insurance contracts (and certain other conditions must be met) (sec. 401(f)(1)).

The committee believes that allowing entities other than banks to be custodians of custodial accounts that might be qualified would enhance competition and open the field to other types of enterprises that wish to engage in it and are suited for it. Accordingly, the committee bill permits a person other than a bank to be custodian of such a custodial account. In addition, in order to permit the participation of the insurance industry, the committee bill allows an annuity contract to be treated as a trust that is eligible for qualification, provided that the annuity contract meets the same requirements a custodial account must meet, just as it treats a custodial account as eligible for qualification. The bank or other person holding the assets of the custodial account or holding the annuity contract must satisfy the Internal Revenue Service that it will hold the assets in a manner consistent with the general eligibility requirements for tax qualification. (For example, any distributions prior to age 59½ to owner-employees would have to be reported to the Internal Revenue Service.)

Just as the bank is treated as the trustee of a qualified custodial account under present law, so also would another entity holding the assets of a qualified custodial account or holding a qualified annuity contract be treated as the trustee under the proposed amendment.

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[1] This subsection of present law, and the proposed amendment, would be inapplicable for trusts created before October 10, 1962, that did not qualify for tax benefits on October 9, 1962. Those trusts would not be entitled to use either a bank or another person as trustee of a trust benefiting owner-employees.

[162] This provision is to take effect as of January 1, 1974.

4. SECTION 403(B) ANNUITY PLANS

Under present law, contributions to a section 403(b) plan (a plan funded by employers for the benefit of teachers or employees of tax-exempt organizations) may be invested only in insurance contracts. The committee believes that it would be desirable to provide more flexibility in this area, and, accordingly, the committee bill provides that these contributions may also be placed in qualified custodial accounts if those funds are to be invested in mutual funds. The committee bill, however, would make these custodial accounts subject to certain requirements of the code, such as those pertaining to reporting, unrelated business income, and prohibited transactions.

This provision is to take effect as of January 1, 1974.

5. REPORTING AND PUBLICATION OF RETURNS

In order that many of the new rules governing qualified plans may be enforced, new reporting and publication requirements are needed.

The bill restates present law by requiring employers (or plan administrators) who establish or maintain deferred compensation plans to file annual information returns. Also, the bill provides that the Secretary of the Treasury may provide reporting requirements with respect to the retirement savings deduction and individual retirement accounts, etc.

The bill opens to public inspection the employer's application for a determination that a plan is qualified and that the trust under the plan is exempt (including papers submitted in support of these applications). Additionally, determination letters issued by the Internal Revenue Service dealing with qualification or exemption of plans and trusts are to be open to public inspection. Annual returns with respect to qualified plans are also to be open to public inspection. However, under the bill information contained in these papers and documents from which the compensation of any participant (or other person) may be ascertained is not to be open to public inspection. (However, all other information in these documents is to be available to the public, including information such as the numbers of individuals covered and not covered in a plan, listed by compensation range.) These rules are to enable plan participants and beneficiaries to obtain the full information needed to enforce their plan rights, pursuant to the new rules established in the bill, and are also to protect the confidentiality of information regarding the financial status of specific individuals.

The bill establishes a penalty for failure to file annual returns; the penalty will be $10 for each day that a return is late, up to a maximum penalty of $5,000 for any one failure to file. However, this penalty will not be owed if failure to file is shown to be due to reasonable cause. For this purpose, your committee's intent is that a failure to provide material items of information called for on a return be treated as a failure to file a return.

The provisions of the bill making applications, determination letters and other documents open to public inspection are to go into effect for

[163] applications filed or documents issued after December 3, 1975. The provisions of the bill requiring annual returns to be filed are to become effective for plan years beginning after the date of enactment. The provisions regarding reporting with respect to individual retirement accounts are to become effective on January 1, 1974.

6. CERTAIN PUERTO RICAN PENSION PLANS

Present law

Under present law a pension trust, to be a qualified trust under section 401 of the code, must be created or organized in the United States. Thus, a Puerto Rican pension trust which qualifies for tax exemption under the laws of Puerto Rico (13 L.P.R.A. § 3165) is not exempt from U.S. tax on its income from U.S. sources.

General reasons for change

Puerto Rican pension trusts which satisfy the requirements of the Puerto Rican tax law are unable to diversify their portfolio by investing in U.S. securities without paying U.S. income tax on the income derived from such investments since they are not able to qualify for exemption under the U.S. tax law. On the other hand, since the requirements for qualification under U.S. and Puerto Rican law are roughly comparable, a Puerto Rican pension plan is able today to establish a trust in the United States which satisfies both the U.S. and the Puerto Rican tax provisions. Since the Puerto Rican Government has established requirements in its tax law for when a trust forming part of a pension plan for participants who are residents of the Commonwealth of Puerto Rico is entitled to be treated as a qualified trust, your committee believes it is appropriate to eliminate the distinction under U.S. law as to the place of organization or creation of a trust entitled to be qualified under U.S. law, if that trust is created or organized in Puerto Rico and if the trust has satisfied the requirements for qualification under the Puerto Rican tax laws.

Explanation of provision

Your committee's bill provides that for purposes of exemption from U.S. tax under section 501(a) of the code, a trust which is part of a pension, profit-sharing, or stock bonus plan all of the participants of which are residents of the Commonwealth of Puerto Rico is to be treated as an organization described in section 401(a) of the code, if the trust forming part of the plan is exempt from income taxes (13 L.P.R.A. § 3165) under the laws of the Commonwealth of Puerto Rico.

Effective date

The provision is to be effective for taxable years beginning after December 31, 1973.

7. DEDUCTION FOR CERTAIN EMPLOYER CONTRIBUTIONS FOR SEVERANCE PAYMENTS REQUIRED BY FOREIGN LAW

Present law

Under present law contributions to a nonqualified trust are deductible (sec. 404(a)(5)) in the year in which an amount attributable to

[164] the contribution is included in the gross income of the participant, but in the case of a plan in which there is more than one participant only if separate accounts are maintained under the plan for each participant. Generally, amounts attributable to the contribution under such a plan would be includable in a participant's income in the taxable year that the participant's rights become nonforfeitable

General reasons for change

The laws of a number of foreign countries require an employer who is engaged in a trade or business in that country to make payments to its employees at the time the employer separates from the service of the employer. This type of requirement of foreign law generally results in a plan which is in the form of a defined benefit plan and for which separate accounts are not maintained for the participants. The requirement of separate accounts for the participants as a condition of deductibility is generally necessary for employees who are subject to U.S. taxes in order that separate accounting is maintained for the amount that is required to be included in the employee's gross income.

In the case of employees who are nonresident alien employees of the employer employed in a trade or business in a foreign country, their gross income from their employment is from sources outside the United States and is not subject to U.S. tax. Accordingly, your committee has decided that the requirement of separate accounts is an unnecessary requirement in the case of nonresident alien employees who are employed in a trade or business receiving benefits required by

Explanation of provision

Your committee's bill provides that for taxable years beginning after December 31, 1973, an employer in determining for purposes of section 404(a)(5) the taxable year in which any contribution is includable in the gross income of nonresident alien employees of such employer, paragraph (5) of section 404(a) is to be applied as not requiring that separate acounts be maintained for the nonresident alien employees if three conditions are satisfied. First, the employer is engaged in trade or business in a foreign country. Second, with respect to that trade or business, the employer is required by the laws of that foreign country to make payments, based on periods of service, to its employees or their beneficiaries after the employee's death, retirement, or other separation from service. Third, the employer establishes a trust (whether organized within or outside the United States) for the purpose of funding the payments required by the foreign law. A nonresident alien individual is treated for this purpose as including an amount in gross income, even if the income is from sources outside the United States and is not subject to U.S. tax.

Effective date

This provision is to be effective for taxable years beginning after December 31, 1973.

8. STUDY OF GOVERNMENTAL PLANS

Under present law, the Civil Service Retirement System and most employee retirement plans of State and local governments are quali-

[165] fied under the Code. It appears, however, that many governmental plans, including the Federal plan, may be unable to meet the new participation, vesting, and funding standards that would be contained in the committee bill. The committee bill, therefore, would require the committee to study the extent to which governmental plans in fact do not meet the new standards and to make recommendations as to the extent to which those plans, or some of them, should be required to conform to the new standards.

Although governmental agencies do not pay taxes, and hence would not lose any tax deductions for current employer contributions if their plans should fail to qualify, one consequence of governmental plans' ceasing to qualify would be that the employees covered by those plans would have to take into income benefits funded by employer contributions (including any increments in those benefits) as those benefits vested (become nonforfeitable), rather than later, upon distribution of the benefits. In addition, it appears uncertain whether the trust funds of nonqualifying governmental plans would be taxable on the interest and appreciation earned by the funds.

A certain consequence of a failure of a governmental plan to qualify would be that lump-sum distributions would not be eligible for the special averaging treatment permitted under certain circumstances if such distributions are made from qualified plans. In addition, the exclusion from the gross estate of the value of an annuity receivable by certain beneficiaries to the extent attributable to employer contributions would be lost if the plan were not qualified, and so also would be lost the employee's right to elect to make an annuity a joint and survivor annuity (thus making payments become payable to a beneficiary at or after the employee's death) without thereby incurring gift tax liability.

In general, the committee would seek to determine whether requiring governmental plans to adhere to the new standards (to the extent they do not already do so) would entail unacceptable cost implications to governmental entities. With regard to funding, it has been argued that governmental plans should be exempt from funding standards since the taxing power can be viewed as a practical substitute for these standards. On the other hand, there have also been reports that in the case of a number of governmental units, such generous pension promises have been made, and so little funds have been set aside currently, that the practical likelihood of imposing sufficient taxes to pay those benefits may be open to question.

The committee, in determining whether any governmental plan is adequately funded, would consider the taxing power of the particular governmental unit involved, as well as the new funding standards.

This provision (requiring the described study by the Ways and Means Committee) would take effect upon the date of enactment of the committee bill. The provision calls for the committee's recommendations stemming from the study to be submitted to the House not later than December 31, 1976.

9. RETROACTIVE REMEDIAL CHANGES TO QUALIFIED PLANS

Employers may now retroactively cure defects in employee benefit plans (which do not meet the requirements for tax qualification) by

[166] making remedial amendments by the 15th day of the third month after the end of the taxable year of the employer in which a plan is newly established. Retroactive remedial changes however may not be made with respect to plan amendments.

The time allowed for remedial changes may be too short for a plan to be cured to qualify as of the year in which it is established. This occurs because many plans are established at the end of the year and thus only 2½ months are available to cure a plan. Additionally, plan amendments (which may be as significant as newly established plans) may not be retroactively cured. As a result of these limitations, plans may not be qualified, to the detriment of employers and employees.

The bill provides that retroactive remedial amendments may be adopted to cure a plan regardless of whether failure occurs on establishing a new plan or because of an amendment to an existing plan. The bill also extends the time to adopt a retroactive remedial amendment to the time (including extensions) for filing the employer's return for the taxable year for which the plan or amendment was adopted or put into effect, or to a later time designated by the Service. It is expected that the regulations will provide for extension for reasonable cause, such as the filing of a bona fide request for a determination by the Service that a plan or plan amendment is qualified.

This provision is to become effective on the date of enactment.

10. RULES FOR CERTAIN NEGOTIATED PLANS

Present law

Under present law, special rules are provided for contributions paid by an employer to a plan providing welfare and pension benefits if the plan was established before 1954 as a result of an agreement between a union and the Government during a period of Government operation of the major part of the productive facilities of the industry in which the employer is engaged (sec. 404(c)). Under this provision, contributions are not deductible under the deferred compensation provisions of the code but are deductible solely under section 162 as trade or business expenses. Present law also provides that this provision is to have no effect with respect to contributions to a trust on or after any date on which the trust is exempt from tax under section 501(a).

General reasons for change

This provision was enacted in recognition of the special circumstances surrounding the establishment of the United Mine Workers Welfare and Pension Plan Trust, i.e., the fact that the plan was negotiated during a period that the U.S. Government was a party to the agreement establishing the plan and was in control of a substantial number of the coal mines in the country.

It has been called to the committee's attention that changes in the coal mining industry and in the administration of the welfare and pension trust have made it desirable to establish two separate trusts—one for the payment of welfare benefits and the second for the payment of retirement benefits. Your committee believes that this is a desirable objective and that the pension trust should be allowed to satisfy the requirements for qualification of pension plans in order to obtain the

[167] favorable tax benefits associated therewith. Of course, the plan would also have to meet the standards relating to coverage, vesting and funding provided in this bill.

Your committee is aware that a number of recent court cases have required the coverage and payment of pension benefits to individuals whose participation in a qualified pension plan would cause the pension plan to be disqualified. Accordingly, your committee believes that rules should be provided so that the pension plan may qualify without forcing the plan administrator to relitigate issues which have been resolved by the courts.

Explanation of provision

In order to facilitate the restructuring of the welfare and pension plan into two separate plans, your committee's bill provides special rules in the case of any individual who, before July 1, 1974, was a participant in the United Mine Workers Plan. First, an individual who was self-employed (within the meaning of sec. 401(c)(1)) such as a coal hauler is to be treated with respect to his service under the plan as not a self-employed individual but as an employee of a participating employer under the plan. This provision will enable the plan to meet the requirement of being a plan of an employer for the exclusive benefit of his employees with respect to certain self-employed individuals who have traditionally been covered under the plan. Second, in order to be certain that the self-employed individuals covered under the plan do not establish separate H.R. 10 plans on their own behalf, the bill provides that earnings derived from service covered by the plan are not to be treated as being earned income (within the meaning of sec. 401(c)(2)). Third, an individual who was a participant before July 1, 1974, is to be treated as an employee of a participating employer under the plan for service covered under the plan before July 1, 1975. This provision is designed to enable non-participating employers whose employees were covered under the plan to agree to become participating employers and thus maintain coverage for their employees. Of course, individuals who retire prior to July 1, 1975, are to be treated as if they were employed by a participating employer even though the employer does not agree to become a participating employer or if the employer is no longer in existence.

The bill further provides that section 277 (relating to deductions incurred by certain membership organizations in transactions with members) is not to apply to any trust described in section 404(c). This provision is added to enable the welfare trust to pay benefits to members and deduct the payments from any investment income it may have. Since questions have been raised as to the scope of section 277, your committee concluded that it could not wait until resolution of this issue because it is felt that there is great urgency for the Mine Workers to make the desired changes in their Welfare and Pension Plan. Your committee's decision is not to be construed as any indication as to the scope of section 277 and its applicability to other non-exempt trusts which may be paying similar types of benefits to its members. Similarly, it is not to be construed to furnish any indication regarding the applicability of section 277 to the United Mine Workers plan prior to the effective date of the new provision. Instead, this decision should be

[168] viewed as a further attempt to effectuate the policy which led the Congress to enact section 404(c).

Since the desire of the United Mine Workers is to establish the pension plan as a qualified plan under section 401(a), the bill provides that section 404(c) is not to apply to the pension plan once it becomes a qualified plan except for the purpose of determining which individuals are to be treated as employees of a participating employer under the plan.

Effective date

The amendments made by this section of the bill are to apply to taxable years ending on or after June 30, 1972.

V. EFFECT ON REVENUES OF THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on revenues of this bill. Apart from the revenue effect of the minimum vesting and funding provisions, the bill is expected to decrease revenues by about $460 million a year after the provisions become fully effective (approximately 3 years in the future) but at 1973 levels of income. The new minimum vesting standards could involve a revenue loss of possibly as much as $265 million a year after 1975 but probably the revenue loss will be only about half this amount. Data are not available which would make a reliable estimate as to the revenue impact of the new minimum funding requirements. It is believed, however, that the revenue effect in this case will be relatively modest. The Treasury Department agrees with this statement.

In compliance with clause 27(b) of rule XI of the Rules of the House of Representatives, the following statement is made relative to the vote by the committee on the motion to report the bill. The bill was ordered reported by a voice vote.

VI. SUPPLEMENTAL VIEWS OF HON. JAMES C. CORMAN AND HON. SAM GIBBONS

We share the hope and expectation of the other Ways and Means Committee members that H.R. 12855 will provide real protection for the pension rights of working Americans. Further, we hope this bill will place some limits on the amount of money which can be set aside for retirement, with special tax treatment, by high-income persons.

However, we would be remiss if we did not point out that this legislation is by no means the final answer to the vast array of issues relating to the pension system. In fact, there is a great and pressing need for further action in such areas as these: (1) placing additional limits on the use of pension and profit-sharing plans as tax shelters, and (2) reassessing the relation of the social security system to the private pension system and the costs and benefits of the Government roles in each one.

Each year the Federal Government loses about $4 billion in tax revenues because of the special tax treatment which is allowed for pension, profit sharing, and related plans designed to provide Americans with retirement benefits.

These tax benefits are intended basically to induce corporations, including professional organizations, and other businesses to set up retirement plans for their employees.

However, Mr. Frederic Hickman, Assistant Secretary of the Treasury for Tax Policy, admits that pension and profit-sharing plans have in fact become "the quintessential tax shelter." He calculates that the upper 8 percent of workers (including executives) receive 50 percent of the tax benefits involved, while the bottom 50 percent of wage earners receive only 6 percent of the benefits.

Mr. Hickman also indicates that the tax shelter features of these retirement plans are particularly valuable to higher income persons, who would normally pay high rates of income tax.

Following is a chart (chart 1) that indicates how important tax benefits are in the formation of a pension.

CHART 1

Tax Subsidy Element in Pensions

(ALL IN CONSTANT DOLLARS)

IF THE EMPLOYER CONTRIBUTES 15% OF SALARY

	EXECUTIVE		EMPLOYEE	
	WITH TAX BENEFITS	WITHOUT TAX BENEFITS	WITH TAX BENEFITS	WITHOUT TAX BENEFITS
STARTING TAXABLE SALARY	$ 30,000	$ 34,500	$ 10,000	$ 11,500
ENDING TAXABLE SALARY	100,000	115,000	18,000	20,700
AFTER-TAX PENSION	25,990	12,312	8,005	5,765
"TAX SUBSIDY"	53%		28%	

Assumptions: Participation age 35 to age 65; 6% interest; 2½% inflation; joint returns; executive has outside income equal to deductions.

Prepared by the Treasury Department.

Obviously, the $4 billion a year which is lost in pension-related tax breaks must be made up by increased tax burdens on other taxpayers. It should also be noted that the coverage of pension plans extends to only something like 42 percent of the private, nonfarm work force, so that many workers receive no benefit at all from these tax losses to the Government.

[170] It's clear that one of the greatest reasons for excessive executive salaries is the tax avoidance which can be managed by earmarking large portions of these salaries for pension or profit-sharing plans. With some executive salaries hovering at the $100,000 to $300,000 level, it's easy to see why these executives put up such a strong resistance to any limitation on tax deductible contributions to their pension funds.

This is an area ripe for immedate remedy.

There is absolutely no justification for as generous a limit on these tax deductible contributions as is contained in H.R. 12855. No candidate for public office could possibly defend the U.S. Government for subsidizing a $75,000 a year pension for corporate executives, and we certainly should not be enacting laws that we cannot defend in public.

Unfortunately, a motion to reduce this limitation to the still-generous sum of $60,000 a year lost in committee on a rollcall vote of 14 nays to 9 yeas.

Another effect of our special tax treatment of retirement plans is to create a huge reserve of investment assets which operate outside of our tax system. The book value of these assets was $154 billion in 1972. By 1980, their value is expected to increase to $225 billion. The implications of this fact for our economy, especially for our stock market and our capital markets, should not be taken lightly.

It is essential that we monitor the effects of H.R. 12855, including the results of our tax incentives to pension plans, very closely. Careful analysis of the costs and benefits of this legislation is needed if we are to be able to judge the prudence of our efforts in this area. Also, we should be especially sensitive to any Federal measures which may prove unduly hard on small businesses or may further aggravate the trend toward bigness and concentration in our economy.

In addition, if we are to continue to use our tax system to subsidize private pension benefits, we'll need a lot more progress in distributing the tax benefits involved more equitably among all workers.

It is claimed that the new individual retirement account provided for in this bill will advance us toward this goal. This new creation should be watched very carefully to see whether it will in fact benefit low- and middle-income workers without pension plan protection—or whether it will become another tax shelter for those with high incomes who are well able to provide for their retirement without any additional help from the Federal Government.

We look forward to further consideration of the tax issues relating to pension reform when the committee takes up tax issues in the near future.

THE ROLE OF SOCIAL SECURITY

It became clear during the committee's consideration of H.R. 12855 that sufficient thought had not been given to the respective roles that will be played in the future by the social security and the private pension systems in providing retirement income security for working Americans. This is a general problem in that further decisions are going to have to be made on how Federal tax dollars, or tax benefits, can best be used for this purpose, if they are to be so used.

[171] The committee did not take action on the thorny issue of "integration," but instead postponed further consideration of the problems of fairness which are involved until social security issues are taken up later in the year. It cannot be stressed too strongly that remedial action is needed in this area.

Integration is a particularly disturbing equity problem. Often involved are the attempts of those in charge of pension plans to exclude from the coverage of these plans those who earn less than the social security wage base—which is now $13,200 a year.

Chart 2 illustrates how integration can be used to eliminate or drastically reduce the private pension base for lower paid employees.

CHART 2

INTEGRATION

Private pension and profit sharing plans may be confined to wages above the social security base.

Employee	Salary	Less S. S. Base	Private Pension Base
A	$ 8,000	$ 10,800	$ -0-
B	12,000	10,800	1,200
C	130,000	10,800	119,200

Prepared by the Treasury Department. (*1973 social security wage base was used.*)

Chart 3 shows how integration affects the amount of employer contributions to a pension plan.

[172]

CHART 3

INTEGRATION

Private pension and profit-sharing plans may be confined to wages above the social security base.

		CONTRIBUTIONS 5% Money Purchase Plan	
Employee	Salary	Without Integration	With Integration
A	$ 8,000	$ 400	$ -0-
B	12,000	600	75
C	130,000	6,500	7,425
		$ 7,500	$ 7,500

Prepared by the Treasury Department (December 1973).

Admittedly, the social security system provides basic retirement benefits for American workers. However, well over half of the work force makes less than $13,200 a year. If the purpose of our special tax benefits for pension plans is to induce businesses to operate pension plans for the benefit of their employees, is it appropriate to provide these full generous tax benefits to those who exclude their lowest paid employees from the protection of their pension plans—while reaping the tax benefits involved for themselves?

Should taxpayers be called upon to finance increased social security benefits to keep up with inflation and also be made to bear the tax loss which results from our special tax treatment for such "integrated" pension plans?

Studies by the Joint Economic Committee have shown that it is sometimes the person who pays the least in social security taxes who gets the most favorable treatment under present social security formulas. In view of this double inequity, it is time that Congress stopped letting the Internal Revenue Service regulate "integration" and made a thorough investigation of the problem. We look forward to early action by the Ways and Means Committee on this.

JAMES C. CORMAN.
SAM M. GIBBONS.

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[S 4749]

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PENSION REFORM

Mr. JAVITS. Mr. President, the Congressional Research Service at the Library of Congress has completed a comparative analysis of the Senate-passed and House-passed versions of H.R. 2, the pension reform bill. In view of the tremendous interest in this legislation I ask unanimous consent that the text of the Congressional Research Service analysis be printed in the RECORD.

There being no objection, the analysis was ordered to be printed in the RECORD, as follows:

PRIVATE PENSION REFORM LEGISLATION, 93D CONGRESS, MARCH 1974—COMPARISION OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2 (By Peter Henle, Senior Specialist, Labor Economics Division; Raymond Schmitt, Analyst in Social Legislation, Education and Public Welfare Division; and Ann M. Marley, Analyst in Taxation and Fiscal Policy, Economics Division)

INTRODUCTION

The following tabulation compares the major provisions of the Senate-passed and the House-passed versions of H.R. 2, private pension reform legislation.

Action on this legislation was taken first in the Senate, culminating with passage of H.R. 4200 on September 19, 1973. This bill was the product of joint effort by the Labor and Public Welfare and Finance Committees. The Labor and Public Welfare Committee had reported out S. 4, on April 18, 1973 while the Finance Committee had reported out S. 1179 on August 21, 1973. A compromise bill worked out by the two committees was introduced on the floor of the Senate September 18 as a substitute for S. 4, the pending measure. Following the adoption of several amendments, the bill was passed 93-0 and its text incorporated in H.R. 4200, a minor House-passed bill to continue certain servicemen's and former servicemen's survivor annuity benefits.

On the House side, the Education and Labor Committee had before it H.R. 2 which was reported out of committee on September 25, 1973. The Ways and Means Committee, to whom the Senate-passed H.R. 4200 was referred, considered pension reform legislation beginning in October and reported out a new bill, H.R. 12481, on February 5, 1974. Subsequently, as the two committees worked to develop conforming bills, the Education and Labor Committee on February 19, 1974 approved the text of a new bill which was introduced the following day as H.R. 12906; similarly, the Ways and Means Committee reported out a new bill (H.R. 12855) on February 21, 1974.

On February 26, 1974 the bills from the two House committees were joined as a substitute for the text of H.R. 2, the pending House business. The Education and Labor Committee bill, H.R. 12906, became Title I and the Ways and Means Committee bill, H.R. 12855, became Title II. Few amendments were adopted, and the House passed H.R. 2 on February 28, 1974 by a vote of 376-4.

Subsequently, on March 4, 1974, the Senate passed H.R. 2, after substituting for its text the language of the previously passed H.R. 4200.

PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSION OF H.R. 2

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Short Title	
Retirement Income Security for Employees Act.	Employees Benefit Securtly Act of 1974.	Employees Benefit Securtly Act of 1974.
	Administering Agency	
Generally, most of the titles of the Act would be jointly administered by the Labor and Treasury Departments although the roles would vary. The Labor Department would have the principal role in administering reporting, disclosure, and fiduciary standards as well as the plan termination insurance and portability programs. The Treasury Department, on the other hand, would be largely responsible for vesting and funding. The Treasury Department would exclusively administer the tax provisions relating to retirement savings, increases in the present deductions under plans for the self-employed (Keogh plans), and limitations on benefits and contributions.	Primarily the Secretary of Labor, although the Secretary of the Treasury is assigned certain functions under the Act. Secretary of Labor to prescribe rules and regulations necessary to carry out the provisions of Title I (fiduciary responsibility and disclosure, vesting, funding, and plan termination insurance). Vesting and funding regulations, however, must be approved by the Secretary of Treasury.	Primarily the Secretary of the Treasury, although the Secretary of Labor is assigned certain functions under the Act. Secretary of Treasury to prescribe rules and regulations necessary to carry out the provisions of Title II (vesting, funding, contributions of self-employed, retirement savings for individuals not covered by any plan, limitations on benefits and contributions, taxation of certain lump-sum distributions, and salary reduction plans). Vesting and funding regulations must be approved by the Secretary of Labor.
	Participation and vesting	
	Coverage	
All private pension plans regardless of their tax qualification status and size. (sec. 201, 221).	All private pension plans established or maintained by employers or employee organizations affecting or engaged in commerce. However, all government and church plans are exempt. (sec. 201).	All private plans seeking to obtain or retain their tax qualification status. However, all government and church plans are exempt. (sec. 1011).
	Participation Requirement	
Plan may not require as a condition to be eligible to participate, a period of service of more than one year, or the attainment of age 30, whichever occurs later. (sec. 201).	Plan may not require as a condition to be eligible to participate, a period of service of more than three years, or the attainment of age 25 and one year of service, whichever comes first. However, a defined benefit plan may exclude any employee who commences employment at an age within 5 years of the normal retirement age under the plan. (sec. 202).	Same as Title I. (sec. 1011).
	Definition of Year of Service	
Regulations concerning the definition of year of service are to be promulgated by the Secretary of Treasury after consultation with the Secretary of Labor. Beginning with 1982, would include any year in which an employee worked at least 5 months with at least 80 hours of work each month. (sec. 221).	To be defined primarily by regulations developed jointly by Secretaries of Labor and Treasury but subject to guidelines set forth in the bill—including guidelines for seasonal employees. Year of service to take into account the customary working period (such as hours, days, weeks, months, or years) in any industry where, by the nature of the employment, the work period is substantially different from industry generally. (sec. 206).	Essentially the same as Title I. (sec. 1011).
	Vesting Requirement	
Employees must be vested in at least 25 percent of his accumulated benefits, by the end of the fifth year of service. This minimum percentage would then increase 5 percentage points in each of the next five years (at least 50 percent vested by the end of the tenth year of service) and by 10 percentage points in each of the following 5 years (so that the employee must be fully vested not later than the completion of his 15th year of service). Once an employee becomes eligible to participate, up to five years of participation service are to be credited to years of service for vesting eligibility. (sec. 221).	These alternatives are provided: (1) Employee must be vested in at least 25 percent of his accumulated benefits by the end of the fifth year of service; the minimum percentage to increase 5 percentage points in each of the next 5 years (at least 50 percent vested by the end of the tenth year of service) and by 10 percentage points in each of the following 5 years (so that the employee must be fully vested not later than the completion of his 15th year of service). (2) Fully vested (100 percent) by the end of the 10th year of service. (3) Rule of 45—that is, at least 50 percent vested when age plus service equal 45 years (provided that there is at least 5 years of service); the minimum percentage to increase by 10 percentage points in each of the following 5 years. (sec. 203).	Same as Title I. (sec. 1012).
	Application of vesting requirement to service prior to effective date of Act	
With certain exceptions, service prior to effective date is included, both for calculating the years of service required to qualify for vesting and for determining the years of accumulated benefits to be vested. (sec 221).	With certain exceptions, service prior to the effective date is included, both for calculating the years of service required to qualify for vesting and for determining the years of accumulated benefits to be vested. However, service by an employee prior to January 1, 1969, is required to be taken into account only if the employee has served at least 5 years with that employer (or under a multiemployer plan) after December 31, 1968. (sec. 203).	Same as title I. (sec. 1012).

[S 4751] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Treatment of Breaks-in-Service	
In computing years of service to apply the vesting standard, only three of the five years of service need be consecutive. Generally service before and after breaks are to be aggregated for vesting and participation. (sec. 221).	In determining an individual's participation and vesting status after a break in service, a plan may exclude prior service of an employee who has a break in service of 1 or more years until the individual completes up to 1 year of work upon returning. However, where a rehired employee had completed at least 4 consecutive years of service before the break, his prior years of service must be taken into consideration for purposes of computing his years of service unless the break is for 6 years or more. However, if a rehired employee acquired a nonforfeitable right to at least 50 percent of his accrued benefits prior to the break in service, all his prior service must be taken into consideration in computing his years of service, regardless of the duration of the break. (sec. 206).	Same as title I. (sec. 1011).
	Transition Rules for Existing Plans	
No provision.	Plans in effect on January 1, 1974 would be required to provide only 50 percent of the otherwise applicable vesting requirement during the first year that the bill's vesting standards become effective, with this percentage rising by 10 percent annually until the full requirement has to be provided after five years. (sec. 203).	The same as Title I but applies to plans in effect on December 31, 1973. (sec. 1012).
	Vesting of Employer Contributions in Contributory Plans	
Vesting requirement does not apply to benefits arising from employer contributions if employee withdraws his contributions upon termination of employment or active participation in plan. (sec. 221).	No pension plan to which employees contribute shall provide for forfeiture of a participant's accrued benefit derived from employer contributions (whether or not otherwise forfeitable), solely because the employee withdraws his own contributions. (sec. 203).	Same as Title I. (sec. 1021).
	Social Security Offset	
No provision.	Social security offset plans are not prohibited if (1) in the case of individuals currently receiving benefits, the pension benefit is not decreased by any subsequent increase in social security benefits or (2) in the case of a participant terminating with a vested benefit, such benefit is not decreased by subsequent increases in social security benefits. (sec. 204).	Same as Title I. (sec. 1021).
	"Highly Mobile" Employees such as Engineers or Scientists	
Secretary of Labor is to develop modifications of Federal Procurement Regulations to insure that such employees under Federal contracts will be protected against forfeiture of their retirement benefits. In addition, the antidiscrimination provisions of the tax law are modified to allow an employer to establish a separate plan for highly mobile employees with lower benefits but with more liberal vesting than under his plan for other employees. (sec. 282).	No provision.	Essentially the same as Senate-passed bill, except that either House of Congress may disapprove proposed changes in procurement regulations. (sec. 1012, 1024).
	Effective Date	
Upon enactment for new plans; for existing plans, beginning with plan years commencing after December 31, 1975. If, on request, the Secretary of Labor determines that the vesting requirement would impose "substantial economic hardship" on individual plans, the effective date may be postponed up to six years. (sec. 221).	Upon enactment for new plans; for plans in existence on January 1, 1974 beginning with plan years after December 31, 1975. For plans maintained under collective bargaining agreements, the vesting requirements take effect with plan year beginning with termination of existing collective bargaining agreement or December 31, 1980, whichever occurs first (but in no event earlier than December 31, 1976). (sec. 207).	Essentially the same as Title I. (sec. 1017).
	Funding	
	Coverage	
All private pension plans regardless of tax qualification status and size. Excludes all government and church plans. Special rules provide an exemption for certain insured plans, and for profit-sharing, stock bonus, nd money purchase plans. (sec. 241).	All private pension plans except governmental or church plans, a plan of a fraternal association, profit-sharing or savings plans, plans funded through insurance contracts, plus certain others. (sec. 301).	All tax-qualified plans with essentially the same exceptions as Title I. However, government and church plans must meet requirements of present law.

[S 4752] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Basic Requirement	
Annual contributions to pension fund must be sufficient to 1) equal each year's "current service costs", and 2) amortize "past service costs" in no less than equal payments over no more than 30 years. The funding requirement does not apply merely to vested benefits, but to all accrued plan benefits. (sec. 241).	Annual contributions to pension fund must be sufficient to equal "current service costs", and to amortize the "past service costs" over no more than 30 years (existing plans given 40 years). The funding requirement applies to all accrued plan benefits (both vested and nonvested unfunded past service liabilities). (sec. 302).	Same as Title 1. (sec. 1013).
	Treatment of Plan Amendments	
Plan amendments which increase past service costs by as much as 5% may be treated as a separate plan for purposes of the funding requirement and amortized within 30 years. Benefits created by other plan amendments must be amortized over 15 years or the average remaining service life of the covered participants, whichever is shorter. (sec. 241).	Plan amendments must be amortized within 30 years. (sec. 302).	Same as Title I. (sec. 1013).
	Treatment of Experience Gains and Losses	
Experience losses or gains resulting from changes in asset valuation or other developments not foreseen in advance must be amortized over 15 years or the average remaining service life of the covered participants, whichever is shorter. (sec. 241).	Experience losses must be amortized within 15 years. (sec. 302).	Same as Title I. (sec. 1013).
	Special Hardship Provisions	
Employer may obtain a waiver for his required annual contribution from the Secretary of the Treasury. Any amounts waived must be amortized over no more than ten years and no more than 5 waivers may be granted in any ten-year period. The plan may not be amended to increase benefits as long as any waived amounts remain unpaid. (sec. 241).	When a plan fails to meet the funding requirements for five consecutive plan years, the administrator shall amend the benefit schedule to reduce the value of the accrued liabilities to such an extent as is necessary to bring the plan's funding schedule into conformity with the funding requirements. (sec. 303).	If an employer is unable to satisfy the minimum funding standard without substantial business hardship and if the application of the funding standard would be adverse to the interests of plan participants, the Secretary may waive the funding requirements. However, the minimum funding standard may not be waived more than five of any 15 consecutive years. (sec. 1013).
	Treatment of Multi-Employer Plans	
Multi-employer plans permitted a longer funding period of forty years. Moreover, with respect to any multi-employer plan for which the Secretary of Labor finds that even this requirement would impose "substantial economic hardship" on the plan, the 40-year period may be extended to as much as 50 years. (sec. 241).	Multi-employer plans permitted a longer funding period of forty years for past service costs and increases caused by plan amendments. Moreover, they may be given an additional 10 years to fund past service liabilities if the plan would experience a "substantial hardship". Further, experience losses may be amortized within 20 years. (sec. 302).	Same as title I. (sec. 1013).
	Effective Date	
For new plans, the funding requirement would take effect on enactment. For existing plans, the requirement would take effect beginning with plan years after December 31, 1975. For plans for which implementation of the funding requirement would impose "substantial economic hardship", as determined by the Secretary of Labor, the effective date may be postponed for a period of up to six additional years. (sec. 241).	For new plans, the funding requirement would take effect on enactment. For plans in existence on January 1, 1974, funding requirements take effect with plan years beginning after December 31, 1975. In the case of a plan maintained pursuant to a collective bargaining agreement, funding requirement takes effect on the earlier of (a) the date on which the collective bargaining agreement terminates or (b) December 31, 1980—but in no event earlier than December 31, 1976. (sec. 305).	Same as Title I. (sec. 1017).
	Plan termination insurance	
	Administering Agency	
A Pension Benefit Guaranty Corporation would be established as a government corporation within the Department of Labor. It would be administered by a three-member board of directors, with the Secretary of Labor as Chairman. Other board members would be the Secretaries of Treasury and Commerce. The Corporation is permitted to borrow up to $100 million from the Treasury. (sec. 402–403)	Essentially the same as Senate-passed bill except that board of directors would be comprised of Secretary of Labor as Chairman and two other officers or employees of the Labor Department. The Corporation is directed to establish two trust funds, a Single Employer Primary Trust Fund and a Multiemployer Trust Fund. The Corporation may also establishing an Optional Trust Fund for single employers. The Corporation is permitted to borrow up to $100 million from the Treasury. (sec. 401, 404)	No provision. [Ways and Means Committee Report No. 93–807 on H.R. 12855 states that although the Committee regards the development of an adequate program of plan termination insurance as essential to protect the rights of covered employees, the bill makes no provision for such termination insurance since provision is included in the Education and Labor Committee bill.].
	Coverage	
All qualified plans regardless of size except money-purchase, profit sharing, stock bonus, governmental, fraternal society and church plans. (sec. 421)	Mandatory coverage—all plans subject to the funding requirement with more than 25 participants (of whom at least ten have acquired vested benefits). Voluntary coverage may be obtained by plans subject to the funding requirement, but which are not subject to mandatory coverage. However, they must meet underwriting standards set by the Corporation. (sec. 409)	No provision.

[S 4753] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Basic Protection	
Insurance of all vested benefits, including vested ancillary benefits in the event of plan termination; includes vested benefits acquired both before and after enactment. (sec. 422).	Insurance of benefits which are nonforfeitable according to the minimum vesting schedule in section 203 in effect for such plan termination date; and any contingent rights to ancillary benefits if all contingencies (other than the passage of time) have been satisfied. Includes vested benefits acquired both before and after enactment. (sec. 403).	No provision.
	Limitations on Amount of Insured Benefit	
The monthly benefits guaranteed to any beneficiary could not exceed the lesser of 50 percent of the participant's average monthly earnings during the participant's highest-paid five years, or $750. The $750 is to be adjusted by changes in Social Security Administration wage base and contribution.	Insures only minimum required vested benefits which may not exceed the actuarial value of a monthly benefit in the form of a single life annuity commencing at age 65 equal to $20 a month per year of credited service. This maximum would be raised annually in accordance with changes in the average taxable wage of all employees, as reported to H.E.W. The Corporation is directed to undertake a study to determine under what conditions it can insure losses of plan benefits over and above those provided in the Act. To the extent that the Corporation determines that losses of the plan, or additional benefits are insurable, the Corporation shall prescribe the terms and conditions of insurance and the premiums to be charged.	No provision.
	Other Limitations	
No benefits would be guaranteed for a plan in effect less than three years, nor would benefits resulting from any plan amendment be guaranteed until the amendment had been in effect for three years. If plan loses its tax-qualified status, no benefits accrued after disqualification shall be guaranteed. (sec. 422).	No benefits would be insured unless the plan had been a member of the Corporation more than five years, although the board of directors may authorize payments for plans terminated with less than five years' membership although in such cases the maximum benefit for plans in existence less than five years would be reduced in accordance with a sliding scale based on years of existence. No benefits resulting from a plan amendment would be insured until the amendment had been in effect for five years. If plan loses its tax-qualified status, no benefits accrued after disqualification shall be guaranteed. (sec. 409).	No provision.
	Alternate Insurance	
No provision.	The Corporation may establish a Single Employer Optional Trust Fund. Each single employer plan is required to choose whether insurance of its benefits is to be covered by this fund or the Single Employer Primary Trust Fund. Premiums to the Optional Fund will be set by the Corporation and based on the individual plan's insured benefits and any excess of insured benefits over plan assets; premiums shall be based on actual and projected experience. Employers electing coverage under the Single Employer Optional Trust Fund are not subject to any employer liability. (sec. 404, 405, 414).	No provision.
	Employer Liability	
Employers would have limited liability for any loss of covered benefits resulting from their plan's termination. This liability would also extend to successor employers as a result of reorganizations liquidations, mergers, and consolidations; and would be limited to 30 percent of net worth. However, employers (except those remaining in business) would be able to avoid any liability by paying a higher premium to be set by the Corp. In lieu of such a surcharge, employers could elect to gain protection against such liability through a private insurance carrier. The amount of any unpaid liability owed by an employer shall constitute a lien in favor of the government, but junior to any lien for unpaid taxes owed to the government. (sec. 461, 462).	Where employers in terminated plans are not so insolvent, they or their successors-in-interest may be liable for reimbursement of a portion of insurance benefits paid. The liability of employers is to pay 100% of the present value of employer underfunding of the terminated plan (defined to take into account any expected employer contributions) but not more than 50% of the employer's net worth. The Secretary shall make arrangements with employers on equitable terms for the reimbursement of insurance paid. The amount of any unpaid liability owed by an employer shall constitute a lien in favor of the government, but junior to any lien for unpaid taxes owed to the government. (sec. 405). Employers covered by the Single Employer Optional Trust Fund are not subject to liability. (sec. 414). No employer shall be liable by reason of his contributions to or sponsorship of a multiemployer plan. (sec. 414).	No provision.

SENATE | HOUSE: TITLE I | HOUSE: TITLE II

Premium Rates

Senate: The Corp. would be authorized to prescribe insurance premium rates sufficient to fund any guaranteed payments. Separate rate schedules would be maintained for single employer and multi-employer plans. Initially, the premiums (to be collected as a "head tax") would be $1 a year for each individual covered by the plan. For plan years ending after 1976, however, the premium rate would be set by the Corporation according to the cost experience of the program. Congress would have to approve any revised rate schedule. Special provisions are included for multi-employer plans. (sec. 403, 463).

House: Title I: Separate rates to be set by the Corporation for single employer plans and multi-employer plans. Initially, the premium would consist of two parts: 1) a rate of not more than 0.1 percent for single employer (0.025 percent for multi-employer plans) on the excess of insured benefits over plan assets and 2) an additional rate levied (separately for single and multi-employer plans) on all insured benefits to yield an amount equal to the revenue raised by (1).

Plans in effect less than six years not required to pay full premium, but in accordance with following schedule:

No. of Years Plan in Effect	*Percent of Premium To Be Paid*
1	50
2	60
3	70
4	80
5	90
6 or more	100

Corporation may issue revised premium rate schedule but such schedule can only be effective thirty days after Congressional aprpoval. (sec. 405, 406).

House: Title II: No provision.

Portability

Senate: The Pension Benefit Guaranty Corporation is directed to administer a program designed to facilitate the voluntary transfer of vested pension benefits between participating plans when an individual changes jobs. A Pension Benefit Portability Fund is established. The program will be entirely voluntary requiring the consent of both the employers who have established the plans to or from which pension monies are to be transferred and the employees who have to request such transfers. Workers who change jobs may have their vested retirement credits transferred to the Portability Fund. The worker may maintain these credits in the Fund or alternatively have the amount in his account transferred to a retirement plan of a new employer. (secs. 301–305.)

House: Title I: No provision (other than to study the existing degree of reciprocity and portability among plans).

House: Title II: No special provision. (However, bill contains a provision which is designed to achieve certain advantages of portability. Under a so-called "rollover" provision, individuals will have the right to roll over into individual retirement accounts—without the payment of current tax—complete distributions of amounts contributed under the plan by his employer.)

Reporting and disclosure

Coverage

Senate: The reporting and disclosure requirements apply to all employee benefit plans (regardless of size) although the Secretary of Labor may grant an exemption or provide a variance in the form or manner of reporting or disclosure. However, exempt plans of tax-exempt religious organizations described in section 501(c) of the Internal Revenue Code and plans outside the U.S. for the benefit of non-citizens. Continues the present Welfare and Pension Plan Disclosure Act exemptions of all governmental plans, and plans required under Workmen's Compensation and unemployment compensation disability insurance laws. (sec. 502, 503).

House: Title I: The reporting and disclosure requirements cover all employee benefit plans except governmental plans; church plans (unless they have elected to be covered), plans required under workmen's compensation and unemployment compensation disability insurance laws; plans outside the U.S. for the benefit of non-citizens. Secretary of Labor may grant an exemption from all or part of reporting, disclosure and publication requirements. (sec. 101, 105).

House: Title II: No provision.

Disclosure to Plan Participants

Senate: The plan administrator shall furnish (or make available) to every participant upon his enrollment in the plan (and after each major amendment), a summary of the plan's important provisions written in a manner calculated to be understood by the average participant; a description of the benefits, and the circumstances which may result in disqualification or ineligibility. A revised up-to-date summary is to be furnished the participants every three years. The plan administrator is also required to furnish each participant or beneficiary requesting in writing, a complete copy of the plan description or a complete copy of the latest annual report, or both. (sec. 503).

House: Title I: The plan administrator shall make copies of the latest annual report available for examination in the principal office of the administrator. Once each year the plan administrator shall furnish each participant and beneficiary with a description of the plan and a statement of assets and liabilities, receipts and disbursements, the ratio of·a assets to liabilities, and such other material as is necessary to summarize annual report. Upon written request, the plan administrator must furnish participants with a complete copy of the latest annual report. (sec. 102, 105, 106).

House: Title II: No provision.

[S 4755] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
The plan administrator is further required to furnish any participant or beneficiary requesting in writing a statement indicating (1) whether or not he has a nonforfeitable right to a pension benefit, (2) the nonforfeitable benefits which have accrued, or the earliest date they will become nonforfeitable, and (3) the total pension benefits accrued. (sec. 503).	The Secretary may by regulation require that the plan administrator furnish each participant or his surviving beneficiary a statement of the rights of participants and beneficiaries under Title I. (sec. 102).	
	Plan Description	
The description of a plan shall be comprehensive and written in a manner calculated to be understood by the average participant. Also calls for plan description to include a description of the provisions providing for vested benefits. (sec. 502).	Same as Senate-passed bill. (sec. 103).	No provision.
	Annual Report to the Department of Labor	
Annual report must include: Statement of assets and liabilities; The aggregate cost and value of each security, by issuer; The aggregate cost and value of all other investments separately identifying each investment which exceeds 3 percent of the value of the fund; and each investment in securities or property of any party in interest; The aggregate amount by type of security, of all purchases, sales, redemptions, and exchanges of securities made during the reporting period including a list showing separately for each security the issuer, type and class of security, quantity, and information on price, gain, or loss (similar information also required for investment assets other than securities); A detailed list of and information on each transaction with any party in interest; A list and specific information on each lease with any party in interest or with an individual in default; The ratio of market value of the reserves and assets to the present value of all liabilities for nonforfeitable benefits; and A copy of the most recent actuarial report together with the assumptions used. (sec. 502, 503).	Annual report must include: Statement of assets and liabilities; A schedule containing specific information on assets held for investment aggregated and identified by issuer, borrower, or lessor; Detailed list and information on each transaction with a party in interest; A list of all leases which are in default or are uncollectible; The ratio of the current value of assets to liabilities allocated to each termination priority category; A statement of the amount, if any, by which the assets exceed or fall below the funding requirement; A copy of the applicable actuarial report together with the assumptions used. (sec. 104).	No provision.
	Annual Audit	
Annual report would include the opinion of an independent certified or licensed public accountant based upon an annual audit. (sec. 502).		No provision.
	Fiduciary standards Coverage	
Fiduciary requirements apply to all employee benefit plans (regardless of size). However, exempts plans of tax-exempt religious organizations described in section 501 (c) of the Internal Revenue Code and plans outside the U.S. for the benefit of noncitizens. Continues the present Welfare and Pension Plans Disclosure Act exemptions of all governmental plans, and plans required under workmen's compensation and unemployment compensation disability insurance laws. (sec. 501, 511).	Fiduciary requirements cover all private plans except governmental plans; church plans (unless they have elected to be covered), plans required under workmen's compensation and unemployment compensation disability insurance laws; plans outside the U.S. for the benefit of noncitizens. (sec. 101).	No provision.
	Standards of Conduct of Fiduciaries	
A fiduciary shall discharge his duties solely in the interest of the plan participants, and for the exclusive purpose of providing benefits and defraying reasonable administrative expenses. (sec. 511).	Same as Senate-passed bill. (sec. 111).	No provision.
	Liability	
Any fiduciary who breaches any of the responsibilities, obligations, or duties imposed by this act is personally liable to the fund for any losses resulting from such breach. (sec. 511).	Same as Senate-passed bill (Trustees and plan administrators not liable for acts of investment advisers). (sec. 111).	No provision.

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Prohibited Transactions	
Under the amendments to the Internal Revenue Code and the Welfare and Pension Plans Disclosure Act, a fiduciary would be prohibited from dealing in his own interest, or engaging in a transaction with a party in interest which constitutes a (1) sale or exchange, or leasing, of any property, (2) lending of money or other extension of credit, (3) furnishing of goods, services, or facilities, or (4) transfer to or use of any assets of the trust. (sec. 511). The prohibitions would not apply to any loan to parties in interest who are participants or beneficiaries of the plan if such loans (1) are available to all participants on a nondiscriminatory basis, (2) are not made available to highly compensated employees in an amount greater than that made available to other employees, (3) bear a reasonable rate of interest, and (4) are adequately secured. Similarly, a fiduciary would not be prohibited from receiving any reasonable compensation for services rendered. Several other exemptions would be provided from the list of prohibited transactions. For instance, loans and the leasing of property to a party-in-interest under a binding contract in effect on August 21, 1973 would be permitted for ten years if it remains at least as favorable to the trust as an arms-length transaction. The sale disposition, or acquisition of this property during the ten year period must be for fair market value. Secretaries of Labor and Treasury given joint rule-making authority regarding exemptions and administration of certain prohibited transaction provisions, sec. 511, 521, 522).	A fiduciary would be prohibited from dealing with the assets for his own account, acting in the adverse interests of the plan participants, or receiving any consideration for his own personal account. The transfer or use of any property by a party in interest (except for no less than adequate consideration) would be prohibited. The acquisition of any property from a party in interest for no more than adequate consideration also would be prohibited. (sec. 111). The prohibitions would not apply to (1) receiving any benefit to which he may be entitled as a participant or beneficiary, (2) receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly incurred, or (3) serving as a fiduciary in addition to being an officer, employee, or other representative of a party in interest. (sec. 111).	No provision.
	Prudent Man Rule	
Fiduciaries must act as a prudent man would in a like capacity and familiar with such matters. (sec. 511).	Fiduciary must use the same care, skill and prudence as a prudent man acting in a like capacity and familiar with such matters. (sec. 111).	No provision.
	Limitation on Investments in Employer Securities	
No more than 7 percent of a pension fund could be invested in employer securities. Plans would have to divest themselves of any excess within ten years. This limitation, however generally would not apply to profit-sharing and stock bonus plans. (sec. 511).	Fiduciaries must diversify the investments so as to minimize the risk of large losses, unless under the circumstances it is prudent not to do so. This generally does not apply to profit-sharing, stock bonus, or thrift and savings plans. In order to provide for an orderly disposition of investments, a fiduciary may in his discretion effect the disposition of such investments within three years of enactment. (sec. 111 and 115).	No provision.
	Enforcement	
The Secretary of Labor would have primary responsibility for enforcing rules with respect to fiduciaries. Where fiduciaries breach these standards of conduct, the Secretary of Labor (and participants and beneficiaries of the plan) may bring civil actions to impose liability on the fiduciaries for losses incurred by the plan or profits which they have gained as a result of the breach. Civil actions would also be available to enjoin fiduciaries or otherwise remedy a breach of conduct. (sec. 692).	Civil actions to enforce the fiduciary responsibility provisions may be brought by the Secretary of Labor, or by a participant, beneficiary, or fiduciary for appropriate relief. (sec. 503).	No provision.
	Excise Tax	
The Internal Revenue Service would have primary responsibility for enforcing prohibited transactions with respect to parties-in-interest through an excise tax. The excise tax is at two levels. Initially, parties in interest who participate in a prohibited transaction would be subject to a tax of 5 percent of the amount involved in the transaction per year. A second tax of 100 percent would be imposed if the transaction was not corrected after notice from the Internal Revenue Service that the 5 percent tax was due. (sec. 522).	No provision.	No provision.

PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	Prohibition Against Certain Individuals Holding Office	
Persons convicted of certain crimes could not serve as an administrator, trustee, or officer of the plan. (sec. 511).	Same as Senate-passed bill. (sec. 113).	No provision.
	Effective Date	
All rules governing fiduciary standards except prohibited transactions would be effective on January 1, 1974. The prohibited transaction rules would be effective one year later on January 1, 1975 (sec. 521).	Six months after enactment. (sec. 115).	No provision.
	b. Subchapter S, Corporation Plans	
Repeals present tax treatment of qualified pension plans for shareholder-employees of subchapter S corporations. Shareholder-employees of subchapter S corporations are subject to the same limitations as corporate employees. (sec. 702.)	No provision.	Limitations on contributions or benefits applicable to self-employed individuals also apply to a shareholder employee (an employee who owns more than 5 percent of the outstanding stock of the corporation) of a Subchapter S corporation. (sec. 2001.)
	c. Corporate Plans	
Imposes limitations on contributions which may be made or the benefits which may be paid under qualified corporate plans for all employees.	No provision.	Imposes limitations on contributions or benefits for all employees. Permits annual adjustments for cost-of-living increases.
	(1) Defined Benefit Plans	
No deduction is allowable for contributions in excess of those necessary to fund a basic benefit in the form of a straight life annuity commincing at age 65 in excess of 75 percent of the participant's average high-three year compensation from the employer, not in excess of the first $100,000 a year. (sec. 702, 706.)	No provision.	The annual benefit under defined benefit plans cannot exceed 100 percent of the participant's average compensation for his highest 3 years of earnings (regardless of the age at which the benefits start) or $75,000 beginning at age 55 or later, whichever is less. The limitation does not apply to retirement benefits which do not exceed $10,000 for the plan year or for any prior plan year (if the employer has not maintained a defined contribution plan in which the participant was covered.)
	Retirement Savings, Limits on Contributions and Benefits, and Other Tax Provisions	
	Individual retirement savings plans	
Employees who are not covered under a qualified plan (including an H.R. 10 plan), a government plan, or a tax exempt organization annuity plan are allowed to establish their own qualified retirement accounts and take an annual income tax deduction for contributions for an amount up to the greater of $1,000 (not in excess of earned income), or 15 percent of earned income, up to $1,500 (sec. 701).	No provision.	Employees who are not covered under a qualified plan (including an H.R. 10 plan), a government plan, or a tax exempt organization annuity plan are allowed to establish their own qualified retirement accounts and take an annual income tax deduction for contributions up to $1,500 or 20 percent of earned income, whichever is the lesser. (sec. 2002).
	Limits on contributions and benefits	
	a. Self-employed plans	
Allows a self-employed individual to take an annual income tax deduction on his own behalf for contributions to a qualified retirement plan (H.R. 10 plan) equal to an amount which is the greater of $750 (but not in excess of earned income) or 15 percent of earned income up to $7,500. A $100,000 limitation is provided for the portion of earned income which may be taken into account in determining contributions or benefits. Also, a formula is provided which would allow the self-employed, in effect, to translate the 15 percent—$7,500 limitation on contributions into limitations on benefits which they could receive under a defined benefit plan. (sec. 704).	No provision.	Same as Senate—passed bill (sec. 2001).
	(2) Defined contribution plan	
The corporation is permitted to make deductible contributions sufficient to fund a pension for the employee on this same 75 percent of average high-three year compensation basis. Procedures to be followed in this situation take into account contributions accumulated in prior years, and provide that contributions made in current and subsequent years can provide any additional amounts necessary (together with earnings on those amounts at a standard 6 percent interest rate) to bring the pension benefits up to the level referred to above. (sec. 702, 706).	No provision.	The sum of the employer's contributions for the employee, a specified portion of the employee's own contributions, and any forfeiture allocated to the employee cannot exceed 25 percent of the employee's compensation or $25,000 annually, whichever is less. (sec. 2003).

[S 4758] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
	(3) Coverage under both plans	
The maximum benefit payable under the defined benefit plan would have to be reduced in proportion to the amount of the benefit which was funded through the defined contribution plan. (sec. 702).	No provision.	Provides an overall limit to coordinate the two limits outlined above for an individual covered by both a defined benefit plan and a defined contribution plan established by his employer. The sum of (1) the percentage utilization of the maximum limit under the defined benefit plan and (2) the percentage utilization of the maximum limit under the defined contribution plan cannot exceed 140 percent. (sec. 2003).
	Lump Sum Distributions	
The portion of a lump-sum distribution representing pre-1974 value is to be taxed as capital gain. The post-1973 portion of a distribution is to be taxed as ordinary income but with 15-year forward averaging. The ordinary income portion will be taxed under a separate tax rate schedule—the schedule applicable ,to single persons. A special minimum distribution allowance is provided under the separate tax rate schedule for lower income individuals. (sec. 703).	No provision.	Same as Senate-passed bill, except that 10 year averaging is provided for the portion of the lump-sum distribution which is taxed as ordinary income under the separate tax rate schedule (sec. 2004).
	Salary Reduction Plans	
Amounts contributed under a salary reduction plan prior to January 1, 1974 are considered to be employer contributions. Thereafter, such contributions will be treated as employee contributions and will be included in the employee's income. (sec. 706)	No provision.	Directs the Secretary of Treasury to withdraw the proposed salary reduction regulations issued December 6, 1972. No other regulations may be issued in proposed form before January 1, 1975, or in final form before March 16, 1976. Until issuance of final regulations, such plans are to be administered as they were before January 1, 1972. (sec. 2005)
	General	
	Joint and Survivor Option	
All plans would be required to offer a joint and survivor option of at least half the amount payable to the participant during the joint lives of the participant and his spouse. The option could not be waived unless the participant affirmatively waived it, after receiving a written explanation concerning the terms of the annuity. (sec. 261)	Essentially the same as Senate-passed bill, but requirement for joint and survivor annuity applies only when participant and spouse have been married throughout the five years prior to annuity starting date. (sec. 204)	Same as Title I.
	Recordkeeping for Vested Benefits	
To assist employees in keeping track of any vested retirement credits, each plan (including Federal, state and local government plans) is required to report annually to the Secretary of Treasury the names of individuals who leave the plan with vested benefits and the amount of such vested benefits. (A statement setting forth this information would also have to be furnished to the individual.) This information would then be transmitted to and maintained by the Social Security Administration. Upon an individual's application for social security retirement benefits, the Social Security Administration is to furnish him with information regarding any vested pension benefits that he may have accumulated over his working career. (sec. 151, 152)	Essentially the same as Senate-passed bill excent that 1) government and church plans are covered only on a voluntary basis, 2) information is to be furnished to Secretary of Labor and then transmitted to the Social Security Administration, and 3) regulations to carry out this provision may be prescribed by the Secretary of Labor with approval of Secretary of Treasury. (sec. 106)	Essentially the same as Senate-passed bill except that 1) government and church plans are covered only on a voluntary basis, and 2) regulations to carry out this provision may be prescribed by the Secretary of Treasury with approval of Secretary of Labor. (sec. 1031, 1032)
	Preemption of State Law	
The provisions of this Act or the WPPDA supersede all state law as they relate to the subject matters covered by these two acts (i.e., vesting, funding, termination insurance, portability, reporting and fiduciary standards). (sec. 699)	The Act supersedes all state and local laws relating to fiduciary standards, reporting, disclosure, vesting, and funding (except for civil action by a participant or beneficiary to recover benefits due or to clarify rights to future benefits). No employee benefit plan subject to Title I (except plans primarily providing death benefits) can be considered an insurance company for purposes of State regulation. (sec. 514)	No provision.
	Enforcement	
Departments of Treasury and Labor both given responsibility for enforcement. Responsibility varies with different titles of the bill. Treasury Department enforcement authority includes the power to compel payment of taxes, already contained in the Tax Code, as well as new authority for an excise tax on any employer failing to fund the plan at minimum required amounts.	Department of Labor given responsibility for enforcement authority. Enforcement authority is exercised through the certification of a registration statement which each plan subject to the vesting and funding provisions must file. If the Secretary determines that a plan is not qualified (or no longer qualified), he is required to notify the administrator of the deficiency. If not correct-	Department of Treasury given responsibility for enforcement. Enforcement authority includes power to compel payment of taxes, already contained in the Tax Code, as well as new authority for an excise tax on any employer failing to fund the plan at minimum required amounts (sec. 1013)

[S 4759] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
Secretary of Labor is given authority to petition appropriate U.S. District Court for an order requiring corrective action whenever he believes an employee benefit fund is being administered in violation of this Act. (sec. 692)	ed, the Secretary of Labor may cancel (or deny) the certificate of registration and may petition the appropriate U.S. District Court for an order requiring the plan to comply. (sec. 503, 512)	
Civil actions for appropriate relief (legal or equitable) may also be brought by a participant or beneficiary to redress or restrain violations of fiduciary duty. (sec. 693)	. Civil actions may be brought by a participant or beneficiary for appropriate relief, to recover benefits, or to clarify rights. (sec. 503)	
	Variances From Requirements Under the Act	
No provision.	For any type of plan, Secretary of Labor may prescribe an alternate method of meeting participation, vesting, funding, or plan termination insurance requirements if compliance with Act would cause substantial risk of plan termination or substantial reduction in benefits. (sec. 501)	For any multi-employer plan, Secretary of Labor may, for a limited period of time, prescribe an alternate method of meeting certain requirements of Title II (vesting of employer contributions, benefit accruals, charges and credits to funding standard account and charges in funding method or in plan year) if compliance with Act would cause substantial risk of plan termination or substantial reduction in benefits. (sec. 1015)
	Investigations	
The Secretary of Labor may make appropriate investigations when he believes it necessary to determine whether any person has violated the provisions of this act or the Welfare and Pension Plans Disclosure Act. He may enter such places, inspect such records and accounts, and question such persons as he may deem necessary to enable him to determine the facts relative to such investigation. (The Secretary of Labor is to make arrangements with the Secretary of Treasury so as to preclude a duplication of effort with regard to investigation of violations relating to fiduciaries.)	The Secretary of Labor is authorized to make an investigation in order to determine if any person has violated any of the provisions of Title I and may, where he has reasonable cause, enter such places, inspect such records and accounts, and question such persons as he may deem necessary to enable him to determine the facts relative to such investigation. (sec. 503)	No provision.
	Interference with Rights	
It shall be unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against any participant or beneficiary for exercising any right under the pension plan. It shall also be unlawful to use fraud, force, intimidation, etc. for the purpose of interfering with the exercise of any right under the plan, this act, or the Welfare and Pension Plans Disclosure Act. (sec. 699)	Same as Senate-passed bill. (sec. 510–511)	A plan will not be considered to meet the vesting requirements if there has been a pattern of abuse under the plan such as a firing of employees before their accrued benefits vest. (sec. 1012)
	Arbitration	
Each plan shall provide a procedure for the fair and just review of any disputes between the administrator of the plan and any participant or beneficiary and an opportunity after such review and a decision by the administrator for the arbitration of such disputes. A participant or beneficiary may bring a civil action in lieu of submitting the dispute to arbitration under the plan. The cost of arbitration shall be paid by the plan unless the arbitrator determines that the allegations are frivolous. The Secretary of Labor shall inform participants of their rights and is authorized to furnish assistance in obtaining such rights. (sec. 691)	No provision.	No provision.
	Studies	
Secretary of Labor given broad authority for studies relating to the effect of new law, the role of private pensions in meeting retirement, security needs of the Nation, alternative methods of providing additional retirement security, and the operation of private pension plans. Secretay also directed to undertake special study of the sufficiency of provisions of the new law for high mobility employees.	The Secretary of Labor is directed to undertake research studies relating to pension plans, including but not limited to (1) the effects of Title I upon the provisions and costs of pension plans (2) the role of private pensions in meeting the economic security needs of the Nation, and (3) the operation of private pension plans including types and levels of benefits, degree of reciprocity or portability, and financial characteristics and practices, and methods of encouraging the growth of the private pension system. (sec. 502)	No provision.

[S 4760] PRIVATE PENSION REFORM LEGISLATION—COMPARISON OF SENATE-PASSED AND HOUSE-PASSED VERSIONS OF H.R. 2—Continued

SENATE	HOUSE: TITLE I	HOUSE: TITLE II
The Secretary of Treasury is directed to study the extent to which Federal and State pension plans are adequately funded, and determine whether it would be appropriate to require such plans to comply with the same minimum standards applicable to private plans. (sec. 281)	The Committee on Education and Labor and the Comimttee on Ways and Means of the House of Representatives shall study retirement plans established by Federal, State, and local governments including the (1) adequacy of existing levels of participation, vesting, and financial arrangements, (2) existing fiduciary standards, (3) the unique circumstances affecting mobility of government employees and individuals employed under Federal procurement, construction, or research contracts or grants, and (4) the necessity for Federal legislation and standards with respect to such plans. (sec. 502)	Same as Title I. (sec. 1023)
	Advisory Council	
A broadly-representative Advisory Council on Employee Welfare and Pension Benefit Plans consisting of 21 members appointed by the Secretary of Labor would be established, and would include 3 persons representing those receiving benefits from a private pension plan. (sec. 506)	A broadly-representative Advisory Council on Employee Welfare and Pension Benefit Plans consisting of 15 members appointed by the Secretary of Labor would be established. (sec. 114)	No provision.

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