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FIRST PANEL DISCUSSION ON
PRIVATE PENSION PLAN REFORM
WHICH FEDERAL ENFORCEMENT AGENCY: SELF-EMPLOYED AND VOLUNTARY EMPLOYEE PLANS

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

TESTIMONY TO BE RECEIVED MAY 31, 1973
BY THE
SUBCOMMITTEE ON PRIVATE PENSION PLANS
GAYLORD NELSON, *Chairman*

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Daniel Halperin

Summary of Principal Points

1. The purpose of the tax benefits to qualified plans is to foster retirements savings for the low paid who would not be able to provide for themselves.

2. The tax benefits to qualified plans are distributed in an inequitable manner - 50% of the work force get no advantage; the highly paid are aided in accumulations of $1 million or more.

3. The discrepancy must be reduced both by increasing the number of participants and by limiting benefit for the higher paid.

4. A tax deduction for individual retirement plans will be of primary advantage to the high paid and is unwise.

5. Restrictions on benefits should apply to all participants in qualified plans. However, if this seems unacceptable it is reasonable to apply the limits to those plans which do not provide sufficiently for the lower paid.

6. The special averaging for lump sum distributions and the estate tax exclusion for benefits under qualified plans should be eliminated.

STATEMENT TO THE COMMITTEE ON FINANCE

May 31, 1973

Daniel I. Halperin

This statement is principally concerned with the question of dollar limitations on benefits from qualified pension and profit sharing plans. Other matters will be mentioned very briefly in the second section of this paper.

The Need for Benefit Limits

The tax expenditure budget, prepared by the Treasury and Congressional staffs, shows nearly $4 billion per year as the cost of the special tax benefits to qualified plans. This outlay helps finance retirement benefits for only about 30% of the work force. Thus, while many, including a heavily disproportionate share of the lower paid, get no aid from the tax system in providing for their retirement, some people take advantage of the available tax benefits to build-up a retirement nest egg of well in excess of $1 million. It is my belief that the fairness of the tax law is severely compromised by this situation and in particular by the lack of limits on the benefits that can be received under qualified plans. I hope to demonstrate why I take this position.

Tax Benefits to Qualified Plans

Compensation paid to employees is generally deductible only if the employee will include the payment in income at approximately the same time. Thus under section 404 of the Internal Revenue Code if compensation is paid or accrued, on account of an employee under a plan deferring the receipt of compensation, the ordinary rules governing deductions do not apply and special rules are applicable. These rules essentially require that the deduction be taken in the year in which the amount is included in the income of the employee.

It may not be particularly difficult to arrange to defer the taxation of compensation to a later period, perhaps until after retirement, but in order to do so the employer must forego the tax deduction until the income is reported by the employee.* In other words if an employee earns $100,000 in 1972 and the employer insists on deducting the entire $100,000 currently the employee will have to include $100,000 in his income within a short time. If the employee insists on deferring tax on part of this compensation, to say 1980, then the deduction for this part will be delayed until 1980.

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* The employee must also either be willing to take a forfeitable interest (such that his rights will be dependent on the performance of substantial future services) or to rely upon the credit of the employer. If he gets security for vested rights (for example, the employer makes deposits to a trust fund) then the employee will be immediately taxable even though distribution is delayed.

The one exception to this rule is for pension and profit-sharing plans that "qualify" under section 401 of the Internal Revenue Code. Contributions to such plans are deductible while taxation to the employee is delayed until actual distribution from the plan, most often after retirement.

Deferral of taxation until after retirement can of course have the effect of reducing the tax which will have to be paid in those cases where the worker will be in a lower tax bracket in his post-retirement years. This is a possibility wherever compensation is deferred. Under a qualified plan, however, there is an additional advantage which operates even when the tax bracket is not changed.

The mismatching of the employer deduction and the reporting of income enables the parties to increase the amount of money in private hands. For example, if a corporation which normally pays tax at the 48% rate earns $10,000, it can retain $5200 after tax. If instead of keeping the $10,000, the corporation paid it to Mr. Jones as compensation, Jones will be able to keep whatever portion is left after payment of taxes. If he is also in the 48% bracket, he retains $5200. The amount of money in private hands is unchanged by the corporation's decision to pay Jones an extra $10,000 in compensation.

On the other hand if the $10,000 were contributed to a qualified pension plan, the plan gets to keep the full $10,000, thus increasing the amount of money in private hands by $4800. The Treasury does not get this money until the plan distributes $10,000 to Jones (assuming Jones remains in the 48% bracket at the time of distribution).

Value of Tax Benefit Depends upon Tax Bracket

In essence the deferral of tax amounts to an interest free loan from the Treasury to the corporation or Jones. The amount of the loan depends on the tax brackets of the parties and if these differ upon whether one considers the special benefit to be allowance of the deduction or the deferral of the income.

At least in the case of vested benefits, it seems logical to look to the tax bracket of the employee in measuring the benefit from deferral, namely, the size of the interest free loan.

It is clear that for each dollar of retirement benefit purchased the higher the tax bracket, the greater the "loan." For example, assume at a given age it will take a set aside of $1000 per year, each year until retirement, to finance a life annuity of $5000. If the employee is in the 25% bracket, the Treasury's interest free loan is $250 per year; for the employee in the 50% bracket, the loan is twice as much or $500 per year.

Moreover, it is not "discriminatory" in favor of higher paid employees to provide a larger pension for such employees than for the lower paid as long as the ratio of pension to pay is not greater for the higher paid than it is for the lower paid. Thus, a plan providing all employees with a pension of 50% of pay would qualify for the special tax treatment. This would seem to magnify the favoritism to higher paid employees.

There is no limit on the size of the "loan" that would be made as long as the ratio of pension benefit to pay is maintained. For example, if an employee earning $250,000 were entitled to a 50% pension ($125,000) which cost $25,000 annually, he in effect gets a $12,500 annual loan if his marginal tax bracket was 50% or $17,500 annually if the maximum tax did not apply and he reached the 70% bracket.

Justification for Tax Benefits

What is the justification for the existence of these tax rules? Why should the tax system provide encouragement for saving for retirement, by not taxing such amounts until they are spent or are available for spending rather than when earned? It will be noted that this is inconsistent with the general assumption that the tax is on income not expenditures and with the lack of similar tax benefits for savings for other presumably worthwhile purposes.

A possible explanation is the extreme difficulty of planning adequately for retirement. People just can't think that far ahead and judge their needs; they are uncertain about how long they can work, how long they will live after retirement and what the cost of living will be at that stage. Moreover, we are disturbed when we see a substantial number, according to one estimate as much as one-quarter, of the elderly, including those who have worked hard all their lives, living in poverty and many more not able to maintain their previous standard of living.

These considerations have led, of course, to the adoption and constant efforts to improve our Social Security system which provides a basic level of benefits for most Americans.

However, Social Security alone will not replace pre-retirement income. For many people, it would seem unlikely that the gap will be closed out of personal savings (even if a tax-incentive to encourage savings were made available). The only hope in the absence of substantial Social Security increases is a private pension.

As mentioned above, the favorable treatment of pension plans under the Internal Revenue Code is limited to so-called qualified plans -- plans that do not discriminate in favor of stockholders, officers, supervisors or other highly compensated employees. This seems an implicit recognition that the purpose of the tax subsidy is to encourage plans for lower paid individuals who are the ones unlikely to save on their own.

The higher paid who may be expected to provide for their retirement, in any event, are encouraged to do so under tax-favored arrangements which benefit employees in general so that we will gain additional coverage of the low paid group. Unfortunately, we have failed to keep this goal sufficiently in mind in judging the success and failures of the private pension system.

The private pension system is not universal and the poor are more likely to be left out than the rich.

As the Treasury stated in its explanation of H.R. 12272 introduced in the last Congress:

"recent surveys indicate that, in spite of the incentives provided by existing law, approximately one-half of the non-agricultural labor force does not now participate in private retirement plans and that coverage is not likely to expand significantly under existing conditions."

This is true for two reasons -- First many companies do not have retirement programs. Second, not all employees of companies who do have programs are covered by these programs.

An analysis of who is and who is not covered prepared by the Burea of Labor statistics in 1968 leads to one obvious conclusion. The uncovered one-half is heavily drawn from employees of small companies who tend to be at the lower end of the wage scale. For example, the survey shows that for companies where the average earnings of all employees in the company is less than $5000, the percentage of workers covered is 30%, while if the average earnings are over $10,000 the percentage rises to 78%. (See Bankers Trust, The Private Pension Controversy 30 (1973))

Method of Increasing Coverage

This Committee is considering restrictions on age and service requirements for membership in a plan and mandatory vesting after a specified period of service as means of increasing the coverage of the private pension system. Other possibilities may also be suggested.

Many plans exclude employees because they are paid on an hourly basis as opposed to a weekly salary. This should be prohibited for all companies, big or small. The Administration has recommended that employees in a bargaining unit be disregarded, in determining whether a plan discriminates in favor of the higher paid. It is claimed that unions often prefer other benefits to pensions and if this free choice is made there is no reason to limit the pension of employees outside the bargaining unit to the level desired by the union. This may cause particular difficulty when industry-wide bargaining is involved. It seems to me we have to know more about the effect this rule would have on the collective bargaining process before it can be adopted. In any event, it should be noted that under such a rule, there may be cases where the union voluntarily or otherwise, chooses to forego pensions and a plan is adopted covering only a few highly paid executives. Therefore, the operation of such a rule should be limited to those cases where a significant number of lower paid people will be in the plan.

Some plans exclude employees by requiring the employees to make contributions as a pre-condition to coverage or denying employer financed benefits if the employee chooses to withdraw his own contribution on termination of employment (the Civil Service Retirement System is guilty of the latter practice). Offering an employee the carrot of immediate recovery of his accumulated contributions upon pre-retirement separation from service, if he agrees to forego employer financed benefits is contrary to the whole purpose of the private pension program--encouraging savings for retirement and should be prohibited. Contributory plans have a long history and one hesitates to cavalierly advocate their prohibition but I would suggest that the burden of proof be put on those who advocate their retention. There may be something to the position that in certain instances employer financed benefits would be inadequate and the employee needs to be encouraged to save for his own retirement. Before buying this, however, one wants some assurance that employees at all income levels tend to participate and the result is not to leave a large number of lower paid without even an inadequate pension.

Another means by which the lower paid got relatively less benefits from a qualified plan is the practice of integrating such plans with Social Security. In general, this permits the employer to treat a portion of Social Security benefits as part of his plan and to reduce the benefits he pays accordingly.

For example, the benefit formula may be 50% of pay reduced by 83% of the primary Social Security benefit. For low income people this will mean little or no benefit from the private plan. For high income individuals the Social Security offset will have relatively little effect.

Integration would seem to play a proper role in insuring that the total retirement benefit (from Social Security and the private plan) does not exceed full replacement of pre-retirement earnings. On the other side of the coin it seems impossible to justify any special tax benefits for a plan which covers only those employees earning in excess of the Social Security wage base. It seems therefore, that integration should not be allowed unless the total benefit after application of the integration formula will adequately replace pre-retirement earnings (say 70-80% of pay at lower levels).

Of course, even the adoption of these proposals will not give us anything close to 100% coverage. In particular, there will be no effect on employees who work for companies which do not have retirement programs. This has led the Administration to recommend that "employees who wish to save independently for their retirement or to supplement employer-financed pensions should be allowed to deduct on their income tax returns amounts set aside for these purposes."

The primary effect of this proposal will be tax reductions for employees, including all Federal employees earning less than about $21,000, who now contribute to employer sponsored programs. To this degree, it will result in no additional retirement coverage -- but produce considerable revenue loss to the Treasury.*/

Moreover, the large percentage of any new plans will undoubtedly be created by high income individuals and will merely involve the transfer of existing savings from one account to another. Canada has a similar program. The figures show then even 12 years after adoption of the program in 1969, only about 1.2% of all returns filed by persons earning less than $10,000 a year showed contributions while over 35% of those persons earning in excess of $25,000 were participating.

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*/ It may be justifiable on equitable grounds to allow a tax deduction to those, such as federal employees, who are required to contribute to retirement programs as a condition of employment, but such proposals should not masquerade as a means of increasing coverage.

A tax credit in lieu of a deduction, as proposed by S.1179, will probably result in a less unequal distribution of benefits. Nevertheless, it seems unreasonable to expect many people who now cannot afford to put aside money, for retirement to save, for example, $500 per year merely because this would reduce their current tax bill by $125.

Most important provision of a tax incentive for individual savings would seem to lose sight of the theory behind qualified plans -- to encourage savings for retirement in a form which provides security for the low paid who would otherwise not be able to achieve it. When an individual establishes his own-retirement account, he provides only for himself. If there is to be a tax incentive for such savings, it should be limited to those who have need for government aid. It should not be available to the higher paid. Similar objections should be raised to the present exclusion for individual savings, available under section 403(b), to employees of tax exempt organizations and public schools and to qualified plans which permit an election on the part of the employee to participate or take cash currently.

Bringing vast numbers of low paid workers into the mainstream of private retirement programs is difficult if not impossible to accomplish. Thus, the Labor movement generally concentrates on Social Security urging that benefits be raised to the level where Social Security alone will assure the average wage earner that he could continue to live in his present manner after retirement. The private pension system would then function primarily for those with above average earnings.

If this is not to be done and a private pension is to be considered as a partner with Social Security in securing income maintenance, then it seems necessary to explore the feasibility and desirability of a compulsory private system. Tax incentives alone will not lure everyone into a voluntary system.

This is a long-term project but there are things which can be done in the meantime to increase the fairness of the private pension system and to get greater equity in the distribution of its tax benefits.

First, we should remove or lower the barriers to eligibility, discussed above, such as job classification, age, length of service, willingness to contribute and integration with Social Security.

Second, we should take steps (Vesting, Funding, insurance) to insure that those actually covered by private plans will get the benefits they expect and will not be disappointed.

Third, we should limit the presently available tax benefits to the higher paid.

Restrictions on Benefits

As stated above, there are no limitations to the benefits that can be accorded under a qualified retirement plan. For example, if the president of a large corporation earns $250,000 and the company provides a pension equal to 70% of pay, it can pay its president $175,000 a year from its qualified plan. Such a pension would require an accumulation in excess of $2 million. It is hard to see, particularly in light of severe restraints imposed on federal expenditures generally how we can justify a "tax expenditure" to help finance a pension of that size to one individual, particularly one who should be well able to provide for his own retirement.

Some might say that if you can provide a 70% pension to someone earning $10,000 a year, through a qualified retirement plan, equality of treatment requires that a man earning $250,000 also be allowed a pension equal to 70% of earnings. Even if I were to be tempted by this assertion in a situation where all workers are participating, I see no merit to it where 50% of the working population is excluded. Why should their tax burden be increased because of the extreme tax savings for those who receive such large pensions when the excluded 50% get nothing at all themselves. Moreover, it must be remembered that because the higher the tax bracket, the greater the interest free loan, a high paid individual is given more of a break than the low paid even when his pension is the same percentage of pay. Thus, he may still get as much help in relation to pay even when his pension is limited to a lower percentage of earnings.* This would seem to maintain enough of a carrot to encourage the establishment of private pension plans.

Others might suggest a tax deferred set-aside for retirement is necessary because otherwise the inordinately high tax rates make it impossible to build an adequate nest egg. I am not swayed very far by this argument but in any event I think it is precluded by the adoption of the 50% maximum tax on earned income.

Finally, it is essential to make very clear what is <u>not</u> being proposed. There is no suggestion that the amount of retirement benefits payable to an employee cannot be as high as an employer wants. If he wants to reward "excellence" by paying a pension of $175,000 or more a year, he can do so and such payment, as long as it represents reasonable compensation will be deductible when paid.

The issue is whether there should be a limit on the amount of benefits the Treasury should help finance through the special tax benefits to qualified plans.

No one would propose a direct expenditure towards the payment of such a pension and a tax expenditure is not any more justifiable.

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* For example compare the following cases assuming a qualified pension can be based on only the first $50,000 of earnings and the plan calls for a 50% benefit.

Earnings	Benefit	Assumed Tax Bracket	Assumed Contribution	Interest Free Loan	Loan as % of Compensation
$ 20,000	$10,000	25%	$2000	$ 500	2-1/2%
$ 50,000	$25,000	50%	$5000	$2500	5%
$100,000	$25,000	50%	$5000	$2500	2-1/2%

To its credit, the Administration is clearly troubled by the tendency of the tax subsidy to private pension plans to unduly favor highly compensated individuals. Thus, the President suggests increasing the annual limit for deductible contributions on behalf of self-employed individuals to $7500 or 15% of income whichever is less because the "distinction in treatment [between self-employed persons and employees] is not based on any difference in reality." While the administration proposal narrows the distinction, a substantial difference remains. Why, if as the President acknowledges the difference is not based on reality, did the administration not propose either scrapping the limitations or applying them across the board? The answer seems obvious. They were unwilling to further open up the unwarranted tax advantage of an unlimited set-aside for retirement by making it available to the self-employed. Yet they were not brave enough to face the complaints of those whose tax benefits would be reduced if similar limits were placed on corporate plans. I believe it is essential to face these complaints.

The amount of the limits on benefits is essentially a value judgment but the limit should not be so small so as to eliminate the incentive to establish qualified plans. It may be noted that $50,000 is the maximum amount of earnings which can be taken into account under the administration's proposal relating to self-employed individuals. Limiting a pension payable from a qualified plan to 70 or 80% of this amount would seem reasonable, although the Committee may want to consider further restrictions.

The limitation is most easily and equitably stated in terms of a restriction on the amount that could be set aside on a tax deferred basis to provide a pension for any one individual. Once the vested amount set aside for any employee equalled this amount, any future vesting of contributions or earnings on the account would be currently taxable.

I recognize that there will be many people who will object to such an across the board limitation. Therefore, I would like to address myself to the question of whether there is any justification at all for a less universal limit.

As indicated above, the purpose of the special tax benefits to qualified plans is to secure coverage for low paid individuals. Therefore, it is reasonable to examine individual plans to see what proportion of the persons covered are low paid or what portion of the total dollar value of the benefits is allocated to the low paid. Low paid for this purpose might be defined as those earning less than the taxable wage base under Social Security.

If the benefits under the plan are predominantly for higher paid individuals there is little reason to encourage the plan as it then exists. It could be brought into line by limiting the benefits to the high paid to a specified dollar limit or more logically to that amount necessary to produce the required percentage benefit for the lower paid.

If neither of these proposals seem acceptable, it is not entirely unreasonable to impose limitations only on persons who are substantial owners of a business, although it should not depend upon the form of business organization. These persons are in essence saving their own money which would otherwise come to them as owners of the business. If individual savings for retirement are not deductible (or are deductible subject to severe limitations), it may seem illogical to permit deductions for essentially individual savings just because the individual works for himself as an employee. The difference, of course, is that when the plan is established as an employer it may be necessary to provide coverage for employees but it may be noted that closely held businesses are the ones most likely to have pension plans which benefit only a few highly paid people.

Imposing limitations solely on professional corporations is illogical. It can only be justified if the HR 10 limits are to be kept and it is desired to remove the artificial stimulation to professional corporations because one feels such corporations are undesirable on public policy grounds.

Additional Considerations

Other Special Tax Benefits

This paper would not be complete without brief mention of the totally unwarranted special tax benefits for qualified plans - capital gain treatment and special averaging for lump sum distributions, estate tax exclusion and postponement of tax on appreciation of securities of the employer distributed by the plan.

The special treatment for lump sum distributions is a classic case of putting the cart before the horse. Special averaging is supposedly necessary to avoid the harsh results from bunching in one year income which was accumulated over many years. In actual fact, however, most lump sum distributions I know of are the result of a desire to take advantage of the special tax treatment.

It is senseless to encourage retired persons to take the entire amount accumulated for their retirement security in one year and risk its possible dissipation instead of spreading the receipt of the pension over their lifetime.

Bunching need not occur. Under the Code if an annuity contract is distributed, taxation is deferred until the annuity becomes payable. Similar rules can be adopted with respect to special types of government bonds or bank accounts. No special averaging procedure is necessary or desirable.

The Profit Sharing Council of America has argued that most lump sum distributions are relatively small. Moreover, since profit sharing is not necessarily intended to provide retirement income there is no reason to discourage lump-sum distributions. This testimony raises several questions. Since most of the justification for qualified plans is stated in terms of the need for retirement security does Congress intend to confer special tax benefits on profit sharing plans to the extent they are not for retirement purposes? Does the Council's argument extend to lump sum distributions from pension plans or to profit sharing plans without a fixed contribution formula, as is common in closely held businesses? Does the general ratio of lump sum distributions apply to benefits at retirement? Does it exist with respect, to intermediate benefits as opposed to the very small or very large?

It is also unwise, as well as being an unfair tax advantage, to have special incentives for distributions in the form of employer stock. It seems to me to be more logical to prohibit, or at least discourage, investments in employer stock under either a profit sharing or a pension plan. It may be noted that the special tax benefits are available only in the case of funded plans which provide more security for the employee than just the employer's promise. When the plan assets consist to a large extent of the stock of the employer, in many cases this does not appreciably increase the security the employee would have under an unfunded arrangement.

Vesting

I think the important point to emphasize in comparing S.4 and S.1631 is the similarity rather than the differences. For employees hired at age 31 or 32, 50% (11 years) and full vesting (16 years) are achieved at the same point under both proposals. S.4 achieves faster vesting than S.1631 for those who begin work at age 30 or younger, and takes longer for 50% vesting for those hired at 33 or older. It should also be noted that S.4 recognizes the possibility of alternative approaches to vesting. If a compromise is to be sought between the two proposals, I would suggest that 50% vesting be required at whichever of the following occurs first: 10 years of participation or 5 years of participation and age 45.

Administration

It seems to me to be most important to distinguish between the sanctions to be applied and the agency which will apply them. For example, loss of tax exemption is not a very good deterrent to so-called prohibited transactions. The kind of penalties proposed in S.1631 seem much better but as that bill recommends there is no reason why such penalties cannot be applied by the Internal Revenue Service. It would seem to me that it is even possible for more flexible penalties to be applied by the Service.

Vesting standards are best imposed as conditions for qualification. S.4 purports to apply vesting (and funding) requirements to non-qualified plans but I doubt if this will be very meaningful, at least in part due to the 25 employee requirement.

On the other hand, the suggested sanction for failure to fund suggested by S.1631, full vesting of accrued benefits, would not seem appropriate in all cases. A requirement that the employer assume liability at least up to the required funding may be better.

CM:5/29/73

STATEMENT OF
CONVERSE MURDOCH OF WILMINGTON, DELAWARE
BEFORE THE PENSION SUBCOMMITTEE OF THE
SENATE FINANCE COMMITTEE IN CONNECTION
WITH HEARINGS ON PRIVATE PENSION LEGISLATION

Should Provisions Regarding Vesting, Funding, Etc. Be Enforced By the Department of Labor or by the Treasury Department?

SUMMARY

May 31, 1973

Reform of the private pension plan system can be better achieved through labor laws than through tax laws. To attempt such reform by amending the tax laws will further complicate our overly complex tax laws.

S. 4 provides sanctions directly aimed at securing promised benefits for pensioners. S. 1179 and S. 1631 attempt to achieve reform by imposing tax penalties which move money into the Treasury rather than into the hands of the persons meant to be the beneficiaries of the legislation.

The sanctions imposed under S. 1179 and S. 1631 may turn out to be illusory in many cases and will not directly benefit workers or pensioners in most cases.

The problems resulting from dual administration by the Labor Department and the Treasury can be minimized by sensible administration. In any event, the presence of such problems is a small price to pay to achieve meaningful reform.

S. 1179 and S. 1631 furnish no protection for workers covered by unfunded plans. S. 4 covers plans which are now unfunded.

The unavoidable delays associated with administration of the tax laws are peculiarly inappropriate in a system designed to protect the interests of workers and pensioners. The compromises which occur in connection with tax audits may further erode the reform effects intended by Congress.

CM:5/25/73

GENERAL COMMENTS

There seems to be general agreement on the proposition that the federal tax laws have become much too complex. Just as it is a rare person who can seriously argue that there is no need for tax reform, so it is a rare person who can argue against tax simplification. All discussions in these areas relate to how to achieve tax reform and simplification, not whether to.

Some talk about tax simplification is based on the assumption that simplification means devising simpler forms which taxpayers can use to comply with existing law. To confine moves toward simplification to the area of simplification of tax reporting forms is to deal with illusions. There can be no meaningful tax simplification until there is a simplification of the laws involved.

It has been my observation that much of the complexity in our tax laws can be traced to the tendency to use our federal tax laws, not for the purpose of raising revenue to support the government but rather for the purpose of achieving various economic, social and criminal law purposes. The present Internal Revenue Code is replete with provisions which had their genesis in the thinking that morality, economic progress and enforcement of the criminal laws can be handled by amending the Internal Revenue Code. This thinking is to the effect that if something is bad, immoral, undesirable or just plain criminal, an effective way to obliterate it is to impose a tax on it. On the other hand, if something is moral, economically desirable or helpful to a group which someone wants to favor, there should be an exclusion from tax or a deduction from the tax base with respect to that item.

The pursuit of this philosophy has brought us to the point of having a tax law which for years has been the frustration of ordinary citizens and which is rapidly becoming the frustration of even the most sophisticated "experts". Accordingly, if we are to make a meaningful move in the direction of simplifying our tax laws, we must at some point stop trying to use the tax laws to achieve reform which can be better achieved through more direct legislation.

In my opinion, reform of the private pension system is a good place to stop complicating our tax laws and start achieving desired results by direct, non-tax legislation.

CM:5/22/73

To the extent rules regarding deferred compensation plans have an effect on the revenue needed by the government - obviously the tax laws are the proper vehicle through which to handle that problem. Most of what has been recently said in the area of private pension reform has little, if anything, to do with the government's need for revenue. The basic complaint about the present private pension system is that too often it results in working individuals being deprived of retirement benefits which they have been promised throughout their working lives. The Senate Labor Committee has held extensive hearings on this matter and, as a result of those hearings, has reported out S.4 which in essence would charge the Labor Department with a responsibility for seeing to it that retirement benefits which have been promised to workers become a reality.

I might take exception to some of the rules proposed in S.4 and in S. 1179 and S. 1631 (the latter two bills being those designed to achieve pension reforms through amendments to the tax laws) but I wholeheartedly approve of the basic approach of S.4, i.e., to accomplish pension reform through our labor laws.

THE LABOR LAWS FURNISH BETTER TOOLS FOR PENSION REFORM THAN DO THE TAX LAWS

Assuming that the basic purpose of pension reform is to make promises of retirement benefits meaningful, it seems obvious that the way to do so is to enact laws which will first set standards for covered private pension plans and will then provide sanctions and remedies which will protect the beneficiaries of those plans. This is peculiarly the function of our labor laws and not of our tax laws. Laws having to do with minimum wages, maximum hours, conditions of employment and rights to organize and bargain collectively have traditionally been part of our labor laws and not a part of our tax laws. Assuring a worker that his promised pension benefit will be a reality seems to be akin to the just-mentioned labor laws rather than to our tax laws. The sanctions connected with our tax laws all have to do with bringing money into the Treasury. They do not have to do with getting promised benefits into the hands of retired workers.

If a pension plan administrator is in the process of looting a pension fund or if he is discovered years later to have done so, it is no consolation to the disappointed pensioner to tell him that the Internal Revenue Service has levied a punitive tax on the administrator who deprived him of his benefits. The fact that the administrator, the pension fund itself, or the employer is forced to pay additional taxes into the U. S. Treasury does absolutely nothing for the worker who is suddenly told that there is no fund to pay the pension which he has been promised during his years of active employment. He may get a short-lived satisfaction out of knowing that the persons who deprived him of his pension have been forced to pay money into the U. S. Treasury. However, he gets no relief from his plight because the person responsible for the loss of his pension has been forced to pay additional taxes to the U. S. government.

While no law can be devised which will absolutely assure that persons will not deprive workers of promised retirement benefits, it is obvious to me that a law designed to achieve that result directly is superior to one which attempts to do so indirectly through the tax laws. A worker who sees his anticipated pension benefits being frittered away through misconduct on the part of a plan administrator is better served by a law which gives the Secretary of Labor the power to seek an immediate court injunction against misuse of funds than he is by a law which says when the long drawn out process of assessing and collecting taxes has run its course, a plan administrator may or may not be subjected to a punitive tax.

THE PUNITIVE EXCISE TAX PROVISIONS OF S. 1631

The Tax Reform Act of 1969, in dealing with problems of charitable organizations, imposed a series of new excise taxes which were very thinly disguised fines which the Internal Revenue Service is authorized to impose on charitable organizations and their management where certain proscribed conduct is found. S. 1631 proposes to impose like excise taxes on pension plan administrators who fail to meet fiduciary standards.

As indicated above, the collection of these *in terrorem* excise taxes give no direct benefit to a worker who has been deprived of his pension by virtue of an action calling for the imposition of the excise tax. At best, the threat of imposition of these taxes may discourage some pension plan administrators from stepping over the line of proper conduct. To the extent that such threat is effective, obviously the worker is protected. However, to the extent the threat is ineffective, the worker gains nothing - the Treasury gains only the prospect of additional revenue. It is the worker who needs protection and not the U. S. Treasury.

An employer which "helps itself" to funds earmarked for workers' pensions usually does so as a last resort when it is in an extremely tight financial situation. The manager of the business, who has his back to the wall, is probably not going to be discouraged from "borrowing" the pension fund to stave off collapse of the business merely because of the remote possibility that if, in the course of a tax audit years later, his borrowing is discovered by a revenue agent, he may have to pay an excise tax. This represents a small contingent cost of borrowing to the business man who faces ruin if he doesn't do the borrowing. If the borrowing from

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the pension fund saves the business and the pension plan is repaid, there is a good possibility that the borrowing will never be noticed by the auditing revenue agents. On the other hand, if the borrowing does not save the business and it and its owners are wiped out financially, the assessment of staggering and punitive excise taxes is not going to help the defrauded worker and in all likelihood will not even result in the collection of a tax by the Internal Revenue Service. Perhaps in the situation just posed, not even sanctions under the labor laws can protect the worker. However, the sanctions of S.4 involving collection of claims against the employer and the administrator for the benefit of the worker (as opposed to the collection of an excise tax for the benefit of the Treasury) are bound to come closer to achieving desired reparations.

THE DUAL ADMINISTRATION PROBLEM

An argument which has been advanced in favor of achieving pension reform through the tax laws is that for years the Internal Revenue Service has administered the tax law provisions with respect to deferred compensation plans and is therefore equipped to administer new rules in this area, whereas if jurisdiction over reform measures is vested in the Labor Department, there will be a necessity for establishing a new agency which will duplicate much of the work presently being done by the Internal Revenue Service. If everything else were equal, this argument would have weight. Thus, if I was convinced that reform through the tax laws to be administered by the Treasury Department would furnish just as effective a set of tools as reform through the labor laws, I would accept the proposition that duplication of regulation is undesirable and should be avoided. However, I do not believe that reform through the tax laws will be meaningful and therefore I am resigned to the establishment of dual regulation if that is the price which must be paid for effective pension plan reform.

I believe much can be accomplished at the administrative level to avoid the expense to the government and to employers of dual reporting and dual regulation. Certainly, much can be accomplished even under existing law to see to it that citizens are not harassed by being forced to give reports to various levels of government in forms which vary needlessly and which could be made just as effective in a commonly issued form. I would hope that in the event S.4 is enacted, the Labor Department and the Treasury Department will mesh their enforcement efforts so as to achieve better regulation without unnecessary expense and harassment for taxpayers and employers.

The Internal Revenue Service has for many years been enforcing the tax laws through a decentralized administrative apparatus. The Service takes an almost fierce pride in permitting each of the District offices to handle audits on a basis independent

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of the National office. While decentralization obviously has good aspects about it, it also creates problems. These problems are especially troublesome in connection with the administration of the present tax law provisions regarding deferred compensation plans. Each of the 58 Internal Revenue Service District offices maintains its own staff of pension plan reviewers. Each is very much a law unto itself in interpreting the Internal Revenue Code provisions with respect to funding, vesting and termination. It is true that the National office issues regulations and published rulings in these areas but in day to day administration of the law, each of the 58 Districts establishes its own particular rules. The vesting provisions of a pension or profit sharing plan which are acceptable in one district may be totally unacceptable in a neighboring district.

I fear that if the administration of new pension reform legislation is vested in the Internal Revenue Service alone, the resulting decentralization to 58 District offices will result in chaos.

THE PROBLEM OF UNFUNDED PENSION PLANS

Practically all of the detailed rules under existing tax law having to do with deferred compensation plans apply only to plans which are funded through trusts or with insurance or annuity contracts. The tax law with respect to unfunded plans is very rudimentary when compared with the rules applicable to funded plans. It appears that S. 1179 and S. 1631 would have little or no effect on unfunded plans. S. 4 on the other hand would impose restrictions on both funded and unfunded plans by in effect requiring unfunded plans covered by the act to become funded. The other two mentioned bills would not apparently have this effect. The result would be that if S. 4 is not enacted but if S. 1179 or S. 1631 is enacted, there would be no meaningful pension reform for the workers now covered under unfunded pension plans. Assume the case of worker A who works for 40 years for an employer with an unfunded pension plan. Worker A has worked those years partially in consideration of his employer's promise that when he retires, the employer will see to it that he receives pension payments. Assume worker B works under the same conditions except that his employer creates a trust or purchases insurance contracts to insure that the worker will receive his promised pension. Surely worker A is entitled to as much protection of his promised pension benefits as worker B. S. 4 would, by and large, give both workers comparable protection. On the other hand, S. 1631 and S. 1179 would furnish no protection to worker A (whose employer had an unfunded plan) and would give only indirect protection to worker B by threatening to impose a tax on the perpetrators of certain acts which might interfere with his rights.

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ENFORCEMENT OF THE TAX LAWS INVOLVES LONG DELAYS

With very limited exceptions (e.g., the jeopardy assessment provisions of §§ 6861-6864 of the Internal Revenue Code of 1954) the tax laws do not give the Internal Revenue Service the power to move quickly to collect taxes. In the ordinary income tax situation, there is a lag of at least 2-1/2 months between the end of the taxable period and the filing of a return - that being the first theoretical notice to the Internal Revenue Service of what the taxpayer has been doing during the preceding period. Following the filing of returns, there is a delay for the computer processing of data on the returns, assignment of the returns to District offices and the further assignment to auditing agents. Once the return has been given to an auditing agent, there are further delays while the agent disposes of other, more pressing work. The audit process itself involv es unavoidable delays in scheduling meetings with taxpayers and their representatives and preparation of agents' reports. Once the agent's report has been submitted to the taxpayer, there are further delays occasioned by taxpayer's use of administrative appeals and often litigation.

Attached to this statement is a schedule showing by taxable year (in the case of income tax cases) and date of death (in the case of estate tax cases) the time lapse between the taxable year or date of death and a court decision with respect to the issues raised in the course of audit. This table probably does not tell the whole story since after a court decision has been rendered (even in the U. S. Supreme Court), there may be further delays while the court's decision is implemented. In the case of courts, other than the Supreme Court, there is that delay plus the possibility of further delay while further appeals are taken to other courts.

Surely a system which involves such long delays between the triggering event and final disposition is not one which recommends itself as the correct vehicle to assure a retired worker that he will promptly receive a promised pension.

Assume a worker who, after his retirement party at age 65, discovers to his horror that his promised pension will not be forthcoming because the employer's pension fund is depleted or nonexistent. Assume further that this worker immediately goes to the Internal Revenue Service and reports what appears to him to be a violation of an Internal Revenue law by his employer or the pension plan administrator. How is such a retired worker helped by the presence of a tax law which can only offer him the prospect that possibly by the time the retired worker is 75 years old, a court will decide that his employer or the plan administrator owes a substantial tax to the U. S. Treasury? How much better it would be to permit such a retired worker to go to an office within the Department of Labor, file his complaint, and let the Secretary of Labor move promptly in the courts to attempt to secure the promised benefits for the worker.

TAX AUDITS OFTEN RESULT IN COMPROMISES

It is not unusual that tax audits result in compromises. In many situations, genuine doubts as to tax liabilities or the collectibility of asserted taxes result in taxpayers and Internal Revenue Service personnel compromising during the course of an audit. There is nothing insidious about such a situation. The work of the Internal Revenue Service would not get done unless certain issues raised in the course of audits were settled by compromise. These compromises some times involve settlement at less than 100% of the asserted tax relating to a particular issue. In many other cases, the compromise takes the form of the government conceding one issue and the taxpayer conceding another issue. Such a process is ill-suited for a system designed to assure a retired worker that he will get his promised benefits. The possibility of settlement and compromise may largely eliminate the deterrent effect of tax provisions designed to force employers and plan administrators to act in certain ways.

On the other hand, under the enforcement process contemplated by S. 4, any compromise or settlement of substantial issues can be done solely in the context of doing the right thing for the pensioner. Enforcement of pension plan reform in part through use of injunction actions enables the parties and the court to fashion decrees which will best take care of each particular case. It is salutary when compromise and settlement can take forms designed to protect the pensioner through enforcement of labor laws. However, compromise in the enforcement of the tax laws is inappropriate in terms of protecting the rights of workers.

CONCLUSION

The use of the labor laws to achieve pension reform will avoid one more set of complexities in the tax laws, will more likely lead to effective relief for the persons who are the subject of Congressional concern and will permit needed flexibility in administration which can be achieved without compromising the essential interests of pensioners and active workers.

TIME LAPSE BETWEEN TAXABLE YEAR(S) OR DATE OF DEATH AND COURT DECISION IN RECENT INCOME AND ESTATE TAX CASES

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Years
UNITED STATES SUPREME COURT			
U.S. v. Basye, No. 71-1022, February 27, 1973	1960 - 1963	1973	10 - 13
Chandler, Exec., v. U.S., No. 72-438, January 22, 1973	Died --, 1962	1973	10
U.S. v. Cartwright, Exec., No. 71-1665, May 7, 1973	Died --, 1964	1973	9
Commissioner v. First Security Bank of Utah, No. 70-305, March 21, 1972	1955 - 1959	1972	13 - 17
U.S. v. Mississippi Chemical Corp. No. 70-52, March 6, 1972	1958 - 1963	1972	9 - 14
U.S. v. Generes, No. 70-28, February 23, 1972	1962	1972	10
U.S. v. Byrum, Exec., No. 71-308, June 6, 1972	Died --, 1964	1972	8

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Years
UNITED STATES SUPREME COURT (Cont.)			
Commissioner v. Lincoln Savings and Loan Association, No. 544, June 14, 1971	1963	1971	8
U.S. v. Mitchell, No. 798, June 7, 1971	1955 -1959	1971	12 - 16
Nash v. U.S., No. 678, May 18, 1970	1960	1970	10
UNITED STATES COURTS OF APPEALS			
Harris, Incompetent, v. Commissioner, Fourth Circuit, No. 72-1343, May 4, 1973	1964	1973	9
Transport Manufacturing and Equipment Company v. Commissioner, Eighth Circuit, Nos. 72-1321, 72-1493, May 20, 1973	1957	1973	16
Seaman v. Commissioner, Ninth Circuit, No. 26,736, May 20, 1973	1967	1973	6
Mid-America Industries, Inc., v. U.S., Eighth Circuit, No. 72-1515, May 20, 1973	1964 - 1967	1973	6 - 9
Hines v. U.S., Fifth Circuit, No. 72-2731, May 2, 1973	1966 - 1967	1973	6 - 7

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Years
UNITED STATES COURTS OF APPEAL (Cont.)			
Bevan v. Commissioner, Sixth Circuit, No. 72-1748, February 15, 1973	1962 - 1964	1973	9 - 11
West v. U.S., Fifth Circuit, No. 72-1168, April 27, 1973	1961 - 1964	1973	9 - 12
Greene Est. v. U.S., Seventh Circuit, No. 72-1155, April 5, 1973	Died February 25, 1967	1973	6
Park Est. v. Commissioner, No. 72-1710, March 21, 1973	Died March 1, 1968	1973	5
Lumpkin Est. v. Commissioner, Fifth Circuit, No. 72-1298, February 14, 1973	Died March 15, 1964	1973	9
UNITED STATES DISTRICT COURTS UNITED STATES COURT OF CLAIMS			
Crosby v. U.S., So. Dist. Miss., So. Div., Civil Action No. 72 S-39 (N), April 23, 1973	1965 - 1966	1973	7 - [illegible]
First Railroad & Banking Company of Georgia v. U.S., So. Dist. Ga., Augusta Div., Civil Action No. 1738, April 9, 1973	1961 - 1964	1973	9 - 12

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Years
UNITED STATES DISTRICT COURTS UNITED STATES COURT OF CLAIMS (Cont.)			
Sechrest v. U.S., Midd. Dist., N.C., Greensboro Div., No. C-56-G-72, November 29, 1972	1967	1972	5
Fancy Foods of Virginia Inc. v. U.S., East. Dist. Va., Norfolk Div., No. 288-72-N, February 15, 1973	1966 - 1967	1973	6 - 7
Gasche v. U.S., No. Dist. Calif., Civil No. 71-1451, GBH, April 4, 1973	1968	1973	5
Old Dominion Box Company v. U.S., West Dist. Va., Lynchburg Div., Civil Action No. 70-C-47-L, August 31, 1972	1959	1972	13
Conversion Chemical Corp. v. U.S., Dist. Conn., Civil 14,202, April 27, 1972	1966 - 1967	1972	5 - 6
AMF Incorporated v. U.S., U.S. Court of Claims, No. 217-72, April 13, 1973	1961 - 1963	1973	10 - 12

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Years
UNITED STATES DISTRICT COURTS UNITED STATES COURT OF CLAIMS (Cont.)			
Bank of Palm Beach Trust Company, Exec., v. U.S., U.S. Court of Claims, No. 308-69, April 13, 1973	1960	1973	13
Morgan Est. v. U.S., So. Dist. Iowa, Civil No. 4-976-D, 11-331-C-1, March 30, 1973	Died September 27, 1964	1973	9
UNITED STATES TAX COURT			
Hammerstrom v. Commissioner, Docket No. 5736-71, May 7, 1973	1967	1973	6
H. and G. Industries, Inc. v. Commissioner, Docket No. 6952-71, April 30, 1973	1968 - 1969	1973	4 - 5
Hi-Plains Enterprises, Inc. v. Commissioner, Docket No. 7923-70, April 30, 1973	1966 - 1968	1973	5 - 7
Cleary v. Commissioner, Docket No. 8353-71, April 25, 1973	1967 - 1969	1973	4 - 6

UNITED STATES TAX COURT
(Cont.)

Name of Case	Taxable Year(s) or Date of Death	Year of Decision	Elapsed Time
Helena Cotton Oil Company, Inc. v. Commissioner, Docket No. 3519-17, April 25, 1973	1965 - 1967	1973	6 - 8
Abely Est. v. Commissioner, Docket No. 7765-71, April 25, 1973	Died March 29, 1969	1973	4
Bieberdorf v. Commissioner, Docket No. 7053-71, April 24, 1973	1968 - 1969	1973	4 - 5
Black v. Commissioner, Docket No. 3475-71, April 24, 1973	1968	1973	5
Carroll v. Commissioner, Docket Nos. 3127-71, 336-72, April 23, 1973	1965 - 1967	1973	6 - 8
Cummings v. Commissioner, Docket No. 2653-71, April 23, 1973	1962	1973	11

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STATEMENT OF CONVERSE MURDOCH
OF WILMINGTON, DELAWARE
BEFORE THE PENSION SUBCOMMITTEE OF THE SENATE
FINANCE COMMITTEE IN CONNECTION WITH HEARINGS
ON PRIVATE PENSION LEGISLATION

Pensions, Profit Sharing and Deferred Compensation

Need For A Fair System

May 31, 1973

Tax reform is the subject of much discussion at all levels - from neighborhood bars to the highest councils of government. Throughout these discussions, there is one recurring theme - there is a crying need to have a system which is fair - or just as important, appears to most of the citizens as fair.

Some persons in government honestly believe that tax cheating by rank and file taxpayers and preparation of false returns by some alleged tax experts are matters which can be traced to nothing more than a corrupt and criminal motive. They believe these "antisocial" tendencies can be stopped by threats of fines and imprisonment and by flattering speeches about the glory of our "voluntary" self-assessment system.

I believe the spread of tax "cheating" by the rank and file citizens must be recognized as due in large part to two things. First, the tax laws applicable to the ordinary taxpayer have become so complicated that he feels frustrated by them and is ready to fight back by doing what he can to avoid them. Second, the more the average taxpayer hears about tax reform, the more he is convinced that the system is unfair. He believes that people of wealth can afford the help of experts to do tax planning and he sees nothing immoral in engaging in a little do-it-yourself planning by claiming an extra dependent. The worker who files a tax return and omits a few hundred dollars his wife earned as a babysitter is not doing so because he is a dangerous criminal type. He's more apt to be an otherwise solid citizen who was recently outraged to hear about some wealthy person, all of whose income completely escaped tax because he could enjoy the luxury of investing his wealth in municipal bonds. I'm not condoning this sort of tax cheating. I'm merely saying that much of this sort of thing is not done by the persons we ordinarily think of as criminal types, and, accordingly, it's

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not going to be stopped by imposing more and more criminal penalties. Much of the petty tax cheating represents in the mind of the perpetrator nothing more than his protest against an unfair system.

. Unless something is done soon to make our income tax system both simpler and more fair, we are going to see more, not less, petty tax cheating. Accordingly, I believe any move in the field of tax legislation must be tested against a basic criteria, i.e., does the change lead to a fairer system. No longer can the sole test be: "Can we afford the loss of revenue which will follow from a particular legislative move?" Now the question must be, "Can we afford to risk the erosion of respect for our tax system which can be traced to the continuation of what many citizens believe (rightly or wrongly) to be unfair discriminations in our tax laws?"

The Tax Burdens on Earned Income

Throughout most of the history of our present federal income tax system, the recipients of earned (as opposed to unearned) income have been the least favored group of taxpayers. Not even the recently enacted 50% maximum federal income tax rate on earned income has done much to change that situation. The 50% maximum rate only applies to a tiny percentage of the millions of taxpayers who are dependent on earned income and who regularly give up a substantial part of their earned income through federal, state and local income, wage and social security taxes.

A person who starts with no inherited wealth and must depend on earned income faces a staggering burden of taxes, living expenses, life insurance premiums, education costs, etc. It is a very serious problem for him to lay aside from after-tax income sufficient savings to see him through periods when his earned income may suddenly be cut off by illness, death or retirement. If he also happens to be self-employed, the present tax laws put an additional hurdle in the way of his achieving even a modest level of financial security. The law severely limits his ability to establish a tax qualified deferred compensation plan. The maximum deductions under so-called Keogh plans are 10% of earned income but in no event more than $2,500 per year. There is no provision for a carry-over of unused deductions and there is no provision permitting a person with the prospect of only ten more earning years a greater deduction limit than the person who can look forward to forty more earning

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years. The law gives no recognition to the fact that for many persons dependent on earned income a meaningful plan of saving for retirement must be postponed until the relatively short period between completion of paying staggeringly high costs for education of children and the time of retirement.

The present law gives no recognition to the fact that retirement and consequent loss of earnings may not occur at a time planned for over many years. It may occur suddenly and prematurely through death or disability.

The Tax Burdens on Unearned Income

The taxpayer who can live on the income from inherited wealth faces few of the financial problems faced by the worker dependent on earned income. That much most people are willing to accept stoically - that's life. However, more and more people are becoming resentful about the fact that the tax laws seem designed to widen the financial gap between recipients of earned and unearned income. With even the most rudimentary tax and financial planning, a man receiving fifty thousand dollars a year of income from investments can minimize or entirely eliminate his income taxes. However, for the person receiving a like income from work as a sole proprietor, the prospects of meaningful reduction of taxes and the resulting increased ability to save for planned or unplanned retirement are remote.

The recipient of unearned income can create trusts for family members, he can purchase real estate producing high tax-free cash flow, he can shift his investments into municipal bonds - the list goes on and on. Not so with his neighbor who works to produce his income. Assuming after paying for maintenance of a home, education of children and insurance against an early death or disability that the worker has anything left to save, he is told that the maximum he can lay aside (and pay tax on later) is $2,500 per year.

The answer is not in taking away the tax "goodies" available to the person living on inherited wealth. Even if that were feasible, it would not make the system fair to the worker unless it enabled the latter to establish a meaningful retirement plan.

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Tax Reform and the Deferred Income Rules

Unlike most of the items usually included in the catalogue of tax preferences requiring review as part of tax reform, the advantages of tax qualified deferred compensation plans are pure and simple matters of timing income taxation. I'm not suggesting that timing of taxation is unimportant. However, it involves far different problems than those associated with most of the other areas under study. A dollar of municipal bond interest which escapes the income tax today, escapes it forever. Not so with a dollar of income deducted because it is saved for spending and taxation later.

A person living on unearned income has myriad opportunities to determine for himself the timing of the income taxation (if any) on his receipts. The only comparable and significant opportunity with respect to earned income is found in the qualified deferred compensation area.

Unlike many of the items now being reviewed as part of the tax reform studies, the deferred compensation items involve limited tax breaks for savings as opposed to expenditures. At a time when inflation and outflow of U. S. capital are looked on as serious problems, one would assume that a tax rule which encourages savings within this country would be viewed with favor.

Special Problems of the Self-Employed and Employees of Closely Held Businesses

All persons dependent on earned income are at a financial and tax disadvantage compared to those living on invested wealth. Within the group dependent on earned income, those who are self-employed or who work for small or closely held businesses are subjected to even further tax discrimination.

The self-employed person or the individual working for a small or closely held business faces special financial problems. His income is likely to stop if he or a principal owner of the business becomes disabled or dies. Usually any program of savings for planned or unplanned retirement involves an immediate and direct reduction of his spendable income - this is so whether or not the plan involves an income tax break.

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In a large organization, it is feasible for the employer to establish non-qualified, unfunded, deferred compensation plans which provide meaningful financial security for the employees and owners. Such is not possible in a small organization. For example, in a law firm with a hundred partners, it is possible to establish an unfunded retirement plan. This is because each of one hundred partners now active can afford a small decrease in current compensation to provide retirement payments for from ten to twenty retired partners. Also, such a firm is in the nature of a continuing institution and thus can give good assurances that when the active partners reach retirement status, there will be money available to "pay them back" for their earlier contributions to the retirement pay of their predecessors.

Such a plan is unworkable in a two-lawyer firm. It's not fair or feasible for the older of two partners to ask the younger to sign a contract guaranteeing that when the older man retires, the younger one will bear the burden of meaningful retirement benefits.

Within the group consisting of the self-employed and those employed by small or closely held business, there is a further tax discrimination against the self-employed. Not only do they miss out on such tax goodies as stock options and king-size group life insurance coverage, but they are put under an unreasonably low ceiling when it comes to deductible contributions to retirement plans. Under existing law the limit is 10% of earnings, but in no event more than $2,500 per year. There is no consideration given to the plight of the person who for one reason or another can't save for retirement until comparatively late in his working life. There is no carry over of unused deductions. A sixty year old has the same limits imposed on him as does a thirty year old person. Likewise, a thirty year old person with nothing but earned income and no savings ability has the same limits as a thirty year old who has both earned and unearned income and who, accordingly, can start saving earlier.

Under existing law, the only clearly defined tax discrimination against closely held businesses (as contrasted with large or publicly-owned businesses) is found in Code § 1379. That is the section which in effect places Keogh limits on the pension and profit sharing plans of Sub-Chapter S corporations. In my view, this provision has discouraged small businesses from electing Sub-Chapter S status. It also involves an unwarranted further discrimination against closely held businesses with respect to which there is a special need to encourage meaningful pension and profit sharing plans. I urge the Subcommittee to recommend the repeal of the discriminatory features of § 1379.

Professional Corporations

In every jurisdiction in the United States (including the District of Columbia by virtue of action by Congress) licensed professional persons may now practice in a corporate form. This means that now professional persons have the opportunity to achieve the same tax and non-tax advantages which non-professionals have enjoyed for at least sixty years.

At one time the idea of practicing a profession in a corporate form seemed a shocking break with tradition. Now, however, the fact of professional incorporation has gained wide acceptance and is no longer looked on as an aberration.

I don't remember hearing anyone who ever expressed disgust with the idea of professional incorporation who pointed out even a single concrete case in which a patient or client was harmed by the fact that his lawyer or doctor incorporated. A competent and honest lawyer does not become incompetent or crooked by virtue of incorporating his practice. The converse is also true - an incompetent or crooked lawyer does not become less so by virtue of practicing as a sole proprietor or as a member of a partnership.

There are those who urge that the tax laws should be changed so as to put persons employed by professional corporations at a tax disadvantage compared with those employed by other corporations. They tend to overlook the fact that the adoption of professional incorporation statutes did not give away anything to professionals. The only effect of such laws was to give professionals in private practice an <u>opportunity</u> to use their own earned income in an attempt to provide for themselves the security which for years had been enjoyed by non-professionals and professionals employed by government, educational institutions, banks, exempt organizations, manufacturing corporations or any of a host of other corporate entities.

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Deductions for Employee Contributions Under Deferred Compensation Plans

The administration proposals for reform in the deferred compensation area (as embodied in S. 1 6 31) include a provision for limited deductions for voluntary contributions under retirement plans. I believe this is a move in the right direction, if for no other reason than to give a signal to the taxpayers that their government is interested in giving them a greater opportunity to save for their retirement years.

I assume that whatever dollar limits are imposed in this area will be based on revenue considerations. I hope that those who prepare estimates of revenue costs in connection with such proposals will not proceed on the assumption that all (or even a sizeable number) of taxpayers will rush to save and deduct up to the maximum limitations. Most taxpayers have a limited ability to increase their rate of savings, with or without a tax incentive. It is worth a substantial temporary loss of revenue to convince the average taxpayer that we are moving towards a fairer system.

It is a very rare person who sees an empty parking space and rushes out to buy a car to put in it. Likewise, most individual taxpayers are not inclined to rush out and spend or save a dollar just because they are told "it's deductible". If the ordinary taxpayer is inclined to spend or save a dollar for non-tax reasons, he may do it more readily if the move is coupled with a tax break. However, the presence or absence of a tax advantage is rarely the critical factor in the ordinary person's decision on a financial matter.

Conclusion

If for no other reason than moving towards fair tax treatment for persons dependent on earned income, there should be a considerable relaxing of the tax rules applicable in the deferred compensation area - and particularly for plans of the self-employed and those associated with small and closely held businesses.

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PAPER ACCOMPANYING STATEMENT OF
CONVERSE MURDOCH OF WILMINGTON, DELAWARE
BEFORE THE PENSION SUBCOMMITTEE OF THE SENATE
FINANCE COMMITTEE IN CONNECTION WITH HEARINGS
ON PRIVATE PENSION LEGISLATION

Pensions, Profit Sharing and Deferred Compensation

SUMMARY

May 31, 1973

Much of the creeping disrespect for our present tax system can be traced to the fact that many persons believe that the present system is unfair. Any proposal in connection with tax reform should be first tested in terms of (1) will it tend towards a fairer system and (2) will it appear to most persons to be a move towards a fairer system.

For years recipients of earned income have been the least favored group of income tax payers. A person dependent on earned income is at an obvious financial disadvantage versus a person with a like amount of unearned income. Unlike a person living on the income from wealth, a person dependent on earned income must make all of his plans on the assumption that his source of income is bound to disappear - certainly by virtue of death and, likely, by virtue of planned or unplanned retirement. These obvious disadvantages of earned income are further aggravated by our present income tax system.

The recipient of unearned income has available many ways to reduce or eliminate his income tax liabilities. The person dependent on earned income has no effective way to escape income tax liability. One of the very few tax "breaks" available to the recipient of earned income is in the area of qualified deferred compensation plans. Even this break involves nothing more than a forward averaging. Many of the tax breaks available to persons living on income from property involve complete and permanent escape from the income tax. This is not so in the case of qualified pension and profit sharing plans.

Within the group consisting of persons dependent on earned income, general financial problems and the income tax burden are particularly onerous for those who are self-employed or employed in small or closely held businesses. Persons employed by large organizations have a measure of financial security which comes from the sheer size of their employer - a person who is self-employed or who works in a small business

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does not have even that measure of security. He must build his own security by savings out of income. This makes particularly unfair the provision of Code § 1379, which in effect imposes "Keogh limits" on deferred compensation plans of closely held corporations which elect Sub-Chapter S treatment.

All American jurisdictions have enacted laws permitting professionals in private practice to try for tax equality with all other taxpayers who depend on earned income and who are employed by corporations. Professional corporations are real. They have now spread to the point where they can no longer be considered revolutionary breaks with tradition or aberrations.

The adoption of a provision, such as that in S. 1631, permitting all recipients of earned income larger tax deductions for amounts saved for retirement would at least be a move in the right direction. If it accomplished nothing else, it would be a signal to the rank and file taxpayer that Congress is interested in moving towards an income tax system which is fair to the person living on earned income.

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REFORM OF THE PRESENT SYSTEM OF TAXING DEFERRED COMPENSATION

Most statements on tax reform seem to proceed from the basic premise that there is a crying need for a tax system which is fair - or, probably just as important, appears to most citizens to be fair. Once a sizeable bloc of taxpayers become convinced that a tax system is unfair, no amount of threats of imprisonment or flattering speeches about the grandeur of our so-called "voluntary" self-assessment system are going to keep the system free of evasion and save it from eventual disintegration. There has recently been a great deal of publicity about the growing problems caused by inept or crooked preparers of tax returns. I'm not prepared to make a brief for professional or amateur preparers of false tax returns. However, I do think legislators and administrators should start looking for the root causes of this situation.

During the recent Presidential election campaign, one of the candidates, in talking about tax reform, pointed out that the rank and file worker in his audience couldn't deduct the cost of the bologna sandwich in his lunch pail while the corporate executive could deduct the cost of his three-martini business lunch. I don't believe that a rank and file worker hearing that comment is going to attempt to deduct the cost of his bologna sandwich in his next tax return. However, he is likely to think about what he perceives to be an obvious unfairness in the system when he has to decide whether to report the baby-sitting fees his wife receives.

I believe Congress and the Administration should first test every proposal for tax reform in terms of: Will the adoption of the proposal lead to a fairer system and will it appear to the bulk of the taxpayers as being a move towards fairness?

More and more persons are suggesting that we achieve greater fairness in our system of taxing earned income by permitting more recipients of earned income to defer taxation of that part of their earned income which is saved for future expenditure. President Nixon's proposal, as embodied in H.R. 12272, is but one of these proposals. Others have gone even

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farther in their proposals. Regardless of which proposal is being considered, a frequent response from those who urge rejection of (or delay in considering) the proposal is: "We can't afford the resulting loss of revenue."

No responsible advocate of tax reform can ignore the revenue effects of any proposal. However, we are now reaching the point where one can ask in all seriousness: "Can we any longer afford the unfairness and complexities which are a part of our present system?"

In considering the need for reform in the deferred compensation area, we should consider the effects of the present system on recipients of earned income and secondly on various types of earned income.

The Present Burden on Recipients of Earned Income

For over fifty years persons dependent on earned income have been the least favored group. The exceptions to that generalization are few and far between.[1] Yet, I can't recall any person in or out of government who ever said with a straight face that earned income is dirty while unearned income is clean; that earned income is bad for the economy while unearned income is good; or that persons dependent on earned income are contributing less to the nation than those who enjoy unearned income. Very few tax technicians seem outraged by the ever-increasing income taxation of earned income while they observe the simultaneous introduction of more and more relief provisions

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1 E.g., there was a limited earned income credit available under the Revenue Acts of 1924, 1926 and 1928, it was eliminated in the 1932 Act, it was reenacted as part of the 1934 Act but was finally repealed by the 1943 Act when the high individual income tax rates necessitated by World War II began to take hold. The Tax Reform Act of 1969 introduced what is now a 50% maximum tax on earned income. However, that provision has no significance to the great bulk of recipients of earned income since it has an effect only after taxable income passes a level of $52,000 in the case of a married taxpayer filing jointly. For the year 1969, less than 1% of individual returns showing taxable income involved adjusted gross income from all sources of over $50,000.

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for recipients of unearned income. To appreciate the unfairness of the system, one has only to compare the income tax and economic plight and prospects of two hypothetical individuals, aged thirty, whom we can identify as W (for worker) and H (for heir). Both are married and have children ages six and four.

The Tax Outlook For The Recipient of Earned Income

W has no hope of receiving any inherited wealth from any source. He has completed his education (paid for at top rates with no discounts or tax deductions) and has been licensed to practice aeronautical engineering. He has worked five years in the U. S. space program with his salary subjected to federal, state and local income and wage taxes.[2] W has decided to become an independent consultant and to operate as a sole proprietor. He anticipates that with any breaks, he will net $20,000 during his first year as a consultant and that his net income will increase on an average of $2,500 per year until his age 42, when he expects to peak out at $50,000 per year. W realizes that out of his fully taxed compensation, he must pay all of the costs of running a household. He also realizes that if he should die before his children are educated and self-supporting, his widow and children will be faced with a staggering financial problem which can only be met (and then only in part) through life insurance, the premiums on which must be paid for out of after-tax dollars. It suddenly comes to W that there is an even graver possibility facing him - suppose his income stops, not because he dies, but because he is disabled by a disease which requires expensive treatment. W finds that insurance against loss of income furnishes only limited benefits, is expensive and the costs of it are by and large not deductible in computing his taxable income.

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[2] In considering the effects of taxation on recipients of earned income, it is often forgotten that recipients of earned income not only bear high federal income taxes but they must also pay ever-increasing federal social security taxes and state and local income and wage taxes. Persons dependent on earned income are also likely to be those who have a high percentage of their savings invested in their own residences with the result that local real estate taxes are to them a substantial burden. Attached is a schedule showing the combined federal, state and local income tax burden in certain localities selected at random.

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Since in the eyes of those who administer scholarship aid programs W has a "good" income, W must plan for the four to eight year period when he must spend from five to ten thousand dollars per year per child to pay for the ever-spiraling costs of higher education. Those costs are not going to be deductible for tax purposes.

For the same reasons, W can anticipate that any charges to him for medical expenses (insurance, doctors, hospitals, drugs, etc.) will be billed to him at top rates because he has a good income. Yet unless these expenses are abnormally bunched in such a way as to permit limited deductions under the medical expense deduction rules, he must pay for these expenses out of after-tax dollars.

W's formal education, which put him in a position to earn his so-called "good" income, in all likelihood cost W or his father anywhere from forty to fifty thousand dollars - possibly much more. Despite the fact that as every second ticks by, W's working life is shortened, W is not given any deductions for depreciation or depletion in connection with the costs of getting the training necessary to earn his "good" income.

If we assume the present level of personal exemptions and tax rates and that W will claim the maximum standard deduction, W can look forward to the following adjusted gross income, federal income taxes, social security taxes and after-federal tax income:

Age	Adj. Gross Income	Fed. Inc. and S.S. Taxes	After Federal Tax Income
30	$20,000	$3,874	$16,126
35	32,500	7,784	24,716
40	45,000	13,004	31,996
45	50,000	15,424	34,576
50	50,000	15,424	34,576

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Between ages 30 and 50, W's adjusted gross income has increased by 150%. During the same interval, the costs for educating his children have undoubtedly risen even more dramatically, but his income after federal income taxes has risen by only 133%. Ever-spiraling inflation has further eroded his after-tax income. While H's adjusted gross income at age 45 is two and one-half times his income at age 30, his federal taxes have risen nearly four fold.

It is from his after-tax income that W must feed and house his family, pay for education of his children, pay life insurance premiums, pay health insurance premiums and start laying aside funds to give him some hope of living on other than social security or welfare payments when he voluntarily or involuntarily quits working. W is losing ground on the treadmill of economic life.

Under present law so long as he remains self-employed, the only income tax break available to him in meeting the problem of laying aside funds for his planned or unplanned retirement is found in the almost parsimonious provisions relating to so-called "Keogh plans". In essence, these provisions permit a deduction of 10% of gross income but with a maximum of $2,500 per year. The fact that these provisions are in the Internal Revenue Code does not mean that government has arranged things so that W will be able to save $2,500 per year starting at age 30. The presence of these provisions means only that if W is able to save ten percent of his income every year after taking care of all of the other financial demands associated with raising a family, he can deduct up to a maximum of $2,500 per year.

The stark reality of life is that most persons in W's situation are not able to "save" even the limited amounts contemplated under Keogh plans until they approach their few peak earning years and then usually only after their children have completed their formal education. Yet, the tax law permits no "catch up" in the form of deductions in excess of $2,500 in recognition of the fact that for years W could not, or did not, save the maximum amounts. The tax law makes no allowance for the fact that when he first became able to start saving for retirement, his effective tax rates were peaking while his remaining years for saving were rapidly diminishing .

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The Tax Outlook For The Recipient of Inherited Wealth

Let's look at the tax and financial prospects of H, the thirty year old person who has just received an after-tax bequest of one million dollars. It should be noted that in all likelihood H's million dollar bequest is the net of a larger bequest which has been reduced as it passed through the death tax mill. Nonetheless, the death taxes were paid with money not produced by H. He can still count himself fortunate to have been "born right" despite his protestations about the confiscatory death tax system.

If H does nothing more than invest his entire million dollar inheritance in fully taxable bank certificates of deposit yielding 5%, he and his family can look forward to a very comfortable existence with an after federal tax spendable income of approximately $35,440 per year as long as H lives.[3] H is not troubled by the spectre of a disabling illness - his income will continue whether or not he works. Accordingly, H feels no compulsion to save from his taxable income to provide for the day when he can't work.

W must have a tax domicile where he works. Often this means being required to help feed the seemingly insatiable appetite of state and local taxing authorities, who are in turn faced with the ever-spiraling costs of supplying public services in urban and suburban areas. H, on the other hand, can pick his tax domicile which can be one with a minimum of state or local taxes. In this regard, H need only worry about telling someone where to mail the checks.

Even the prospect of death does not pose a serious income tax problem for H. With only the bare minimum of pre-death estate planning (viz., creating a marital deduction trust for Mrs. H), H can assure that his widow and children will have an investment base of approximately $873,500 during Mrs. H's widowhood. After the deaths of both Mr. and Mrs. H, their children will each receive inheritances of $353,500. With just slightly more pre-death estate planning, the after-tax inheritances of Mrs. H and their children can be raised dramatically. With such an assured future for his family, H can forgo the payment of large life insurance premiums out of after-tax earnings.

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[3] The same as W's after federal taxes income starting at age 45 but adjusted <u>upward</u> to reflect the fact that H pays no federal social security taxes.

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With an inheritance of one million dollars, H can easily afford to secure the help of advisers who can further brighten his tax and financial picture.

H can put $100,000 into each of two trusts for the benefit of his children. Immediately, H removes $10,000 per year of income taxed at his marginal rates of roughly 46% and puts it into the hands of his children where it bears an effective federal income tax of 9% - an annual tax savings of roughly $3,700.[4] More to the point - H can go to sleep each night knowing that no matter what happens to him, his children are assured of an education and probably a secure start in a business or professional career.

Next H can sell $200,000 of the certificates of deposit and purchase tax free municipal bonds yielding 5% or more. This produces a further annual tax savings of $3,900.

H can take another $100,000 and purchase an equity in an apartment house producing a tax free annual cash flow of $5,000 - with an additional annual tax savings of $1,640.

With very little effort and no loss of income to the family unit, H has reduced the family's annual federal income tax bill by $9,240.

One could go on and on with further refinements in H's financial planning, each producing further tax savings. The point is that none of those mentioned are available to W who is dependent on his own personal efforts to support himself and his family.

Even if it were politically feasible to eliminate each of the recited tax advantages enjoyed by H, we would still not have gotten appreciably closer to a fair tax system unless somehow the extra revenue secured from H and his family could all be earmarked to give immediate tax relief to W. That seems most unlikely.

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[4] This move will involve a federal gift tax of approximately $5,580. However, this gift tax "cost" is more than recovered by two years of income tax savings. More to the point, by paying $5,580 of gift tax, he has eliminated $65,786 of eventual federal estate taxes otherwise payable on the gift and the gift tax.

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Accordingly, we are faced with the question, should tax reform aimed at producing fairness as between those working for earned income and those enjoying unearned income include some income tax relief for persons dependent on earned income. I respectfully submit that the answer to that question should be affirmative.

The Qualified Deferred Compensation Rules and Their Relation to Reform in Taxing Earned Income

The so-called tax breaks enjoyed by persons participating in qualified pension and profit sharing plans are vastly different from most of the other items which are usually mentioned as loopholes or tax subsidies.

Any income which is not currently subjected to income taxation because it is saved as part of a qualified deferred compensation plan is destined to eventually be picked up as gross income by the recipient at the time the savings are drawn down. By virtue of a provision enacted as a part of the Tax Reform Act of 1969, even the limited slippage in taxation caused by treating lump sum distributions as long term capital gains has been largely eliminated. It is true that one of the selling points for establishment of a deferred compensation plan is that it enables the participant to move marginal income from high rates applicable during active working years to lower income tax rates likely to be applicable during post-retirement periods. However, no one seems shocked that for many years and for the foreseeable future the same effect has been (and will be) achieved by persons living on unearned income. An investor can decide to realize capital gains in years of low income or losses; he can sell on the installment basis and spread his gain into low rate years; he can invest in stocks paying little or no dividends and select the years to "cash in" by selling his appreciated securities; he can bunch deductions into years when he chooses to realize gains - the list goes on and on. Yet, even a severely limited spreading of income by a person dependent on earned income is looked on with disfavor by some.

A dollar of tax free municipal bond interest escapes the federal income tax forever. A dollar of the excluded half of long term capital gain is not taxed when realized or at any future time. Every dollar that goes into a qualified deferred compensation plan is destined to someday be a part of some person's gross income. True, personal exemptions and deductions may provide a tax umbrella for some part of the pay out. However, the same exemptions and deductions are available with respect to all other gross income (earned and unearned) of the same magnitude.

The deductions and exemptions associated with qualified deferred compensation plans are unique in another important respect. They are practically the only ones associated with taxpayer savings rather than with expenditures. At a time when many persons in and out of government seem concerned with the need to slow down inflation and to encourage capital accumulation in the United States, it seems anomalous to talk about discouraging the spread of plans designed to encourage saving while giving tax breaks to plans involving spending.

The Special Problems of The Self-Employed and Employees of Closely Held Businesses

At the present time self-employed persons are singled out for particularly restrictive rules in connection with their rights to establish qualified deferred compensation plans. Probably the most unfair of these restrictive rules is that which limits the individuals deductible contribution to $2,500 or 10% of income, whichever is the lesser. This imposes a particularly unfair hardship on the self-employed individual who for much of his working life was unable to contribute to a retirement plan and who is placed under this unreasonably low ceiling during the relatively few years when he has completed paying for his children's education and is experiencing peak earnings.

The individual who is employed by a small closely held business corporation is also faced with special problems in establishing and continuing a qualified deferred compensation plan. Generally, the tax law does not discriminate against deferred compensation plans established by small businesses. The one glaring exception to that generalization is found in Code § 1379 which in effect places Keogh limitations on the pension and profit sharing plans of Sub-Chapter S corporations I respectfully urge that this Subcommittee propose the repeal of § 1379.

It has been suggested that the rules in the deferred compensation area should be made more stringent for small and closely held businesses than for large or publicly held corporations. Various reasons are advanced in support of this proposal. I believe that a fair analysis of the situation will show that the employees of small and closely held businesses do not deserve worse tax treatment than their fellow taxpayers who work for big corporations, governments or exempt organizations. To the contrary, those who are employed in small businesses have a greater need for favorable tax treatment for their deferred compensation plans.

In the case of an employee of a closely held business who also is the owner, any increase in amounts going into a deferred compensation plan represents a direct reduction of funds otherwise available for current payment to the owner in the form of cash compensation or dividends. Hence, there is a practical limitation on amounts which the owner can afford to put into his retirement savings plan. He must still hold out of the plan amounts needed to support him and his family and to take care of the capital needs of the business. On the other hand, an increase in the deferred compensation benefits to executives of large, publicly-held corporations, to government employees or to college professors is not usually coupled with a direct reduction of what would otherwise be current cash income.

Some people believe that in closely held businesses the only limit on the owner's ability to salt away money in a deferred compensation plan is the limit of his own greed, whereas in a corporation with non-management, public shareholders, it is the latter who put limits on deferred compensation plan contributions. It has been my observation that neither of those assumptions is valid. I have yet to see any minority stockholder proposals to limit deferred compensation plans for publicly owned companies which have gotten off the ground. I am not suggesting that deferred compensation plans of the large, publicly-held corporations which I have seen are too generous. I'm only stating that I have seen nothing to indicate that there is more need for tax law imposed limitations for plans of small employers than there is for plans of large employers.

Another stated reason for suggesting tougher rules for small businesses is that their owners are more inclined to

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"do in" the rank and file employees in matters of eligibility, vesting and funding. My observations do not support that charge. To the contrary, my experience has been that deferred compensation plans for small business are likely to have more generous eligibility, vesting and funding provisions than those of large businesses, governments and exempt organizations. This may be due in part to the fact that IRS agents seem to take a harder line in qualifying plans of small businesses. Regardless of the reason, the fact is that small business plans I have seen tend towards the generous side in matters of eligibility, vesting and funding for the rank and file employees.

If there are to be any distinctions between small and large businesses, it would seem that fairness dictates more lenient rules for the small and closely held business.

In a closely held business, the death or disability of a principal employee (particularly in a personal service business) often marks the end of the business. Accordingly, there is a greater need for a plan which is funded quickly. In a large organization, the death or disability of even a top executive may temporarily slow down the operation but it seldom kills it.

In a large organization, payments of compensation after the retirement (due to disability or age) or death of an employee can be handled in whole or in part under a non-qualified, unfunded deferred compensation plan. That is not a workable alternative in a small organization. For example, in a law firm with one hundred partners, it is possible to provide in the partnership agreement that the younger, active partners will continue to pay something to the retired older partners. This sort of unfunded self-insured pension plan can work because at any one time one hundred active partners will each be taking a small drop in take home pay to support ten to twenty retired partners. However, in a two-lawyer firm, it is not fair or feasible for the older partner to ask the younger partner to enter into an agreement obligating the younger person to make meaningful retirement payments to the older man. In such a situation, there is only one form of tax deferred compensation plan which will work,viz., one that permits each partner during his working life to lay aside funds which he will spend (and on which he will pay income taxes) during his retirement period.

The employee of a closely held business without publicly traded stock has no real opportunity to receive meaningful compensation under stock option or restricted stock plans. His coverage under group insurance programs is usually miniscule compared with that which can be acquired under an insurance program adopted by the large publicly-held corporations.

Professional Corporations

At the present time all fifty states (and Congress for the District of Columbia) have enacted statutes permitting persons engaged in the practice of a profession to conduct such practices through professional corporations. There is no question about the fact that one of the main reasons for the enactment of such laws was a desire on the part of legislators to afford professional persons an opportunity to achieve some measure of tax equity for themselves. It is important to note that such laws do not give public funds to professionals. They merely give a professional person the opportunity to use some of his own income in a way which lets him approach tax parity with his fellow professionals who work for public corporations, the government or exempt organizations. The fact that one of the reasons for forming a professional corporation can be traced to an unfairness in the tax law does not mean that a professional corporation is any less real than any other corporation.

Aside from the fact that professional employees of professional corporations are generally made personally liable for professional acts, professional corporations have all of the attributes of any other corporation. Even the mentioned difference is more theoretical than real. If a plumber who practices his skills through a controlled corporation botches a job, he can be held personally liable for 's negligence just as is true of a surgeon who practices through a professional corporation.

When it first occurred, the practice of one of the so-called "learned" professions through a corporation represented a break with long tradition. However, today the concept of professional incorporation has spread to such an extent that a professional corporation is no longer an oddity. More important, I have yet to hear of a single instance in which a client or patient received bad advice or treatment which could be traced to the fact that his lawyer or doctor was incorporated.

A competent and honest lawyer does not become incompetent or crooked by virtue of incorporation.

Despite all of this, there are some persons who still agonize about the trend towards incorporation of professionals. I don't recall hearing any person who opposed the idea of professional incorporation who could point to a single concrete instance in which the fact of incorporation led to a bad result for the professional or his clients.

The gist of the complaints against the spread of professional incorporation seems to run like this: 1. A professional who incorporates his practice gets a better tax break than one who doesn't. 2. One who doesn't incorporate has little chance of gaining tax equality with corporate employees. 3. Ergo, all professionals who incorporate should be thrown back into the tax situation of the self-employed. This is an almost classic example of a dog in the manger attitude.

No one has ever satisfactorily explained to me why as an attorney in private practice I am entitled to less tax equity than my fellow attorneys who work for manufacturing corporations, governments or universities.

With every United States jurisdiction now permitting professional incorporation, there is no professional person in the country who is <u>by law</u> suffering tax discrimination in relation to his fellow professionals. Any remaining discrimination in this area is the result of the voluntary act of the affected professional and not a result of any prohibitions imposed by Congress or the state legislatures.

This argument often brings the response from the unincorporated professional: "Why should I be forced to incorporate to get tax equity?" That response furnishes an excellent argument for the proposition that the tax benefits for the deferred compensation plans of the self-employed should be <u>raised</u> to the level of those available for corporate employees. However, that response does not support the argument that incorporated professionals' benefit plans should be <u>dragged</u> <u>down</u> to the level of present discriminatory rules applicable to the self-employed.

It's surprising to me that it is usually lawyers (not other professionals) who ask the question as to why one should be forced to incorporate to gain equity. Because of their training, one would assume lawyers, of all people, would be less inclined to think of incorporation as an abhorrent act.

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They are usually in a position to do much of the work of incorporation for themselves so they can't even complain about the legal fees involved.

If we assume that one of the aims of any tax reform program is to approach tax equity, it seems to me to be wrong to seriously consider imposing special discriminatory rules on professional corporations - or on any small business.

Deduction For Employee Contributions Under Deferred Compensation Plans

From time to time commentators have suggested that the present tax rules in the deferred compensation area are unfair to taxpayers who voluntarily or involuntarily contribute under retirement plans. A good example of such a situation is the U. S. Civil Service Retirement System. I seriously question whether under modern concepts, the civil servant's so-called "contribution" is in legal or practical contemplation a true employee contribution. I don't believe it is possible for any one covered under the system to elect not to make the contribution. I believe it would be more realistic to treat this contribution as what it really is, i.e., a reduction in pay to finance a retirement system. I believe that the taxation of this particular form of employee contribution could be handled in either of two ways, by changing the law regarding civil service pay and treating what is now called an employee contribution as a reduction in pay or by amending the tax laws to permit a deduction for such "contributions". Either way, the result will be much the same for the employee. However, if the relief comes through the amendment to the tax laws, members of Congress may be hard pressed for an explanation if they fail to give like relief to persons who are not employees of the federal government.

The administration proposals for tax reform in the deferred compensation area (as embodied in S. 1631) include provision for limited deduction for taxpayer contributions under retirement plans. I think this proposal has much to recommend it. I have doubts that many taxpayers will have the savings abilities or inclination to use the provisions, but despite that reservation, I think the idea of giving more and more taxpayers the <u>opportunity</u> to achieve tax equality with their neighbors is all to the good.

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I realize that revenue considerations are uppermost in the minds of the tax technicians who propose various limits on deductions for contributions under retirement plans. I don't know how those responsible come up with revenue loss estimates based on various assumed levels of limitations on deductions under qualified retirement systems. I hope it isn't done by assuming that all (or even a large percentage) of taxpayers will contribute the maximum deductible amount. Most taxpayers have trouble saving money whether or not there is a tax incentive associated with the savings.

Much will have been accomplished in terms of convincing the public of the fairness of the system if Congress offers more people an opportunity to increase their savings for retirement. If for no other reason than that, I urge a deduction for contributions under retirement plans for all recipients of earned income who are not adequately provided for under employer sponsored retirement plans.

Conclusion

I do not urge that there be legislation aimed at further limiting deferred compensation plans for large employers. I do urge that in considering the tax rules in this area every effort should be made to raise the benefits available to employees of closely held businesses towards those now available for employees of large employers (taxable, governmental or tax exempt). To do otherwise would be contrary to what I see as one of the principal aims of tax reform - to strive towards a fair and equitable tax system.

For years the person dependent on earned income - and particularly the self-employed and those employed by closely held businesses - have been the least favored of all taxpayers. For Congress to legislate further discrimination against them would be a step backward, not a step in the direction of tax reform.

Combined Federal Income (Including Self-Employment) Tax and State and Local Income Taxes at Various Assumed Levels of Adjusted Gross Income in Randomly Selected Locales.

(Note: For ease of calculation, it is assumed that other income is offset by deductions and exemptions other than the deductible state and local income taxes. Accordingly, the latter are federal tax effected. It is also assumed that the taxpayer is filing a joint return).

Adj. Gross Income (in thousands)	Atlanta, Ga.	Cleveland, Ohio	Chicago, Ill.	Minneapolis, Minn.	Montgomery Co., Md.	Portland, Oregon	Richmond, Va.	San Francisco, Calif.	Wilmington, Del.
10	2885	2753	2815	3271	3135	3158	2909	2768	3139
20	4645	4740	4740	5968	5395	5597	5050	4884	5543
30	10049	9293	9202	11004	10062	10385	9662	9677	10354
50	19594	18799	18549	21277	19754	20269	19252	19784	20544
75	32844	31862	31362	35652	33192	34019	32471	33659	34982
100	46094	44924	44174	50027	46629	47769	45689	47534	49494

SUMMARY OF

STATEMENT OF JOHN S. NOLAN
MILLER & CHEVALIER, WASHINGTON, D.C.
BEFORE THE SUBCOMMITTEE ON PRIVATE PENSION PLANS
COMMITTEE ON FINANCE, UNITED STATES SENATE

The extraordinary tax benefits granted to qualified pension and profit-sharing plans have been an effective incentive to widespread adoption of plans and extension of benefits under existing plans. This rapid growth has demonstrated, however, that additional statutory standards are necessary for employee benefit plans. Minimum coverage, vesting, and funding requirements are needed, as well as improved, uniform fiduciary responsibility and disclosure and reporting requirements for the operation of such plans.

I

By reason of its long experience in enforcing coverage, vesting, funding and similar requirements under broad but insufficient pre-existing standards in the Internal Revenue Code, the Internal Revenue Service is best qualified to administer these new provisions. The Service has a proven record of effective administration of employee benefit plans, based on even-handed but vigorous and aggressive enforcement of a network of regulations and rulings which it has developed. These rules were developed to insure that plans are organized and operated for the exclusive benefit of the employees.

The Service has expert, experienced personnel; extensive data files on nearly all plans in the United States; an effective audit system for review of plan operations; and the most proven system of sanctions through denial of tax benefits.

Dual administration of overlapping requirements by both the Internal Revenue Service and the Labor Department would be inefficient -- detrimental to the Government, employers, and employees. Major conflicts would inevitably develop. The administration by the Labor Department of the Welfare and Pension Plans Disclosure Act, as it may be strengthened and extended by the pending legislation, may be integrated to a much greater degree with operations of the Internal Revenue Service to eliminate duplication in reporting and supervision in the future.

II

An additional matter of major importance requiring legislative action is equality in treatment of self-employed persons and shareholder-employees of Subchapter S corporations. The existing limitations on contributions on behalf of such persons should be greatly liberalized -- to a somewhat greater degree even than the Administration recommends. These limitations, however, should be extended to participants of all qualified plans, including all corporate plans.

Uniform limitations on all participants are appropriate in light of the essential public policy underlying the granting of the extraordinary tax benefits accorded to qualified plans. These tax benefits are granted to encourage personal saving for retirement out of earned income under employer-sponsored plans which are "non-discriminatory" (that is, provide proportionate benefits to high-paid and low-paid employees). Employer sponsorship induces wide coverage and assures efficient operation of such savings plans. The provisions are designed to encourage personal saving to build on the Social Security System base so that the individual may fund a post-retirement income to maintain his existing general standard of living after he ceases work. The qualified plan system is not designed to provide tax advantages for wealth accumulation beyond this post-retirement income need.

Under these circumstances, by today's standards, a maximum level of post-retirement income of \$50,000 - \$60,000 for high bracket individuals is all that need be encouraged by these provisions. I recommend specific limitations on contributions or benefits under the qualified plan provisions in this general range, subject to automatic upward adjustment if significant further increases in the cost of living occurs.

STATEMENT OF JOHN S. NOLAN
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BEFORE THE SUBCOMMITTEE ON PRIVATE PENSION PLANS
COMMITTEE ON FINANCE, UNITED STATES SENATE
May 31, 1973

ADMINISTRATION OF NEW PENSION PLAN REQUIREMENTS LIMITATIONS ON CONTRIBUTIONS OR BENEFITS

The Internal Revenue Code provides special tax benefits for "qualified" pension, profit-sharing, and stock bonus plans -- plans which in general benefit employees of the particular employer on a broad basis, without discrimination in coverage or benefits in favor of higher-paid employees. The employer is entitled to an immediate deduction for amounts set aside ("funded") for employees under such a plan. The earnings on the amounts set aside for the employee, including earnings on additional amounts which he voluntarily sets aside as "employee contributions" out of his earnings, are not currently taxable to him. The employee does not incur tax on the amounts set aside for him by his employer, on his share of the earnings on such amounts, and on earnings on amounts which he himself voluntarily sets aside, until the time such amounts are subsequently made available to him individually in cash or other property. Appreciation in the value of employer securities which the employee receives is not taxable to him even then; he is not taxed until he sells such securities. Amounts received as a lump sum distribution on termination of employment or death are taxable as long-term capital gains to the extent they consist of earnings on the amounts set aside, or appreciation in value of securities in the employee's account. Transfers of an employee's interest in such a plan by gift or at death are not subject to Federal gift or estate tax except to the extent attributable to voluntary "employee contributions".

These substantial tax benefits are granted to induce private savings, particularly for retirement, and they are an essential element in our system of providing post-retirement security for our citizens. They permit the development of private plans tailored to the needs of particular groups of workers -- that is, they permit necessary flexibility through private rather than public action. They provide investment discretion to such groups, and also the greater efficiency of decentralized administration of savings plans by the interested parties themselves. They build on the income floor provided by the Social Security System. They give the individual the independence and dignity that proceeds from the provision by him for his own future out of his own earnings during his lifetime.

These substantial tax benefits have been an effective inducement to the adoption of qualified plans -- some 30 million persons are now covered by such plans. This rapid growth has highlighted some major problems in the development of employee benefit plans -- coverage of employees, vesting, funding, the treatment of self-employed persons, and other matters. The major legislative proposals now under study by this Subcommittee (S.4; S.1179; S.1631 and S.1557) deal in varying degrees with these problems; all, however, provide minimum coverage, vesting, and funding requirements, as well as improved, uniform fiduciary responsibility and disclosure and reporting provisions. They differ completely on the matter of responsibility for the administration of these new provisions -- S.4 provides that they shall be administered by the Department of Labor, and S.1179 and S.1631 provide generally that they shall be administered by the Treasury Department. This is a most important issue which deserves the Subcommittee's closest attention.

Administration of New Requirements

The development of our existing, extensive private system over the past 30 years has been under the supervision, almost solely, of the Internal Revenue Service. Working with the barest and broadest form of statutory standards -- such as requirements that the amounts set aside be used "for the exclusive benefit of employees", and that contributions or benefits not discriminate in favor of persons who are officers, shareholders, or highly compensated employees -- the Service has been an effective overseer of a system that now covers, as previously stated, some 30 million persons in the United States. The Service has steadfastly developed and enforced

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such rules as requirements that plans be fully vested on termination, that vesting requirements be included in plans of smaller employers to insure that the prohibited non-discrimination in favor of highly-paid employees does not occur, and that at the minimum the employer fund each year current service liabilities plus the interest due on unfunded past service liabilities.

These are merely examples of literally hundreds of other detailed rules and requirements built by the Service only on the bare, broad statutory standards previously described. These rules have generally been accepted by employers and employees alike, and by the courts, as fair and reasonable, and as having contributed immensely to the development of the highly effective private pension system which exists in the United States today.

During the past 30 years, the Internal Revenue Service has intensively reviewed the organization or adoption of substantially every qualified plan in the U.S., and has monitored the subsequent operation of a high percentage of such plans. The Service has developed and applied extensive rules as to the necessary coverage of the plan to insure non-discriminatory coverage of the employee group; the Service has required inclusion of various provisions to protect the rights and benefits of lower-paid employees; and the Service has required inclusion of provisions to prevent diversion of the fund to any purpose other than the exclusive benefit of the employee group (so-called "prohibited transactions"). The practical necessity of an employer obtaining a "determination letter" from the Service approving the plan, so as to assure the favorable tax benefits, has given the Service the opportunity to enforce effectively its extensive network of regulations and rulings.

To accomplish these objectives, the Service over such 30-year period has developed a cadre of personnel highly skilled in the operation of private pension plans. These personnel are to a large extent decentralized into district offices. They are complemented by a group of experts, including qualified actuaries, in the National Office of the Service who deal with the most complex of the problems presented. These personnel are not only involved in the approval of plans when first created but also in the regular monitoring of plan operations under the Service's extensive audit and compliance programs.

The Service has collected extensive files and data on the operation of particular plans, and through its computer system Master File has developed a special Employees Plan Master File system which produces invaluable information in the tax audit of employee benefit plans.

The problems which exist in the existing private pension system -- lack of adequate vesting and funding, absence of uniform fiduciary standards, and insufficient reporting and disclosure -- are attributable to the absence of sufficiently comprehensive statutory requirements for the development of the system, not to inadequate supervision by the Service. Tax men would generally agree that the treatment of employee benefit plans by the Service reflects a history of administration over the years in which the Service has been most aggressive in insuring that plans are operated for the exclusive benefit of employees, without discrimination in favor of higher-paid personnel. The Service has thereby guided the development and operation of employee benefit plans to an extraordinary degree. Now that legislative proposals are being considered to provide the necessary statutory requirements, it seems highly inadvisable to commit their administration to any agency other than that department -- the Internal Revenue Service -- which has the proven background, experience, personnel, and demonstrated fortitude to enforce them effectively.

I recommend strongly, based on my own experience, for the reasons just outlined, that administration of new requirements governing coverage, vesting and funding be committed solely to the Treasury Department. These particular requirements are matters with which the Internal Revenue Service has had extensive experience in the past and which are best enforced in the existing framework of grant or denial of the favorable tax treatment. (Improvement in the existing system of tax sanctions is necessary to insure that the burden of denial of these favorable benefits does not fall unduly on innocent employee-participants who are not responsible for the failure to satisfy statutory requirements, but this is a widely recognized and separate problem which can and should also be solved in connection with the new legislative action in this area.)

Otherwise, we will have an overlapping and duplicating system of administration which will be highly inefficient with unnecessary cost to both the Government and industry. It will still be essential for the Internal Revenue Service to pass on the qualification of plans and audit their operations to insure that the favorable tax benefits are justified. This discretion cannot be committed to another department of government; with one minor exception, it never has been so delegated in the history of the administration of our tax system, and division of responsibility in such administration would be extremely unwise.

Thus, the Service would necessarily continue to concern itself with coverage, vesting, and funding to insure the organization and operation of plans on a basis that does not discriminate in favor of higher-paid employees, and that is for the exclusive benefit of employees. The Labor Department would attempt to enforce coverage, vesting, and funding requirements under different statutory provisions. Conflicts would surely develop. An employer satisfying Labor Department requirements would not readily accept Internal Revenue Service refusal to approve his plan, and he would not readily conform it to Service requirements, as is generally the practice today. The Labor Department, required to obtain a court order to enforce its administration on S.4, would urge the Service to extend the tax requirements without adequate statutory foundation to take advantage of the self-enforcing feature of the tax system. Two separate investigative staffs would be necessary, and employers and plan trustees would be subject to two sets of audits. The extent of potential duplication is already well documented in Summary of Proposals For Private Pension Plan Reform, prepared for this Subcommittee by the Staff of the Joint Committee on Internal Revenue Taxation (see pp. 12-14), and it need not be repeated here.

With respect to uniform fiduciary standards and improved reporting and disclosure requirements, I would recommend continuation of the dual administration that presently exists but with much closer integration of requirements and sanctions than any of the pending bills provide. The Labor Department has been administering the Welfare and Pension Plans Disclosure Act, which would be greatly strengthened by all of the pending bills, and some duplication in reporting and disclosure already exists as between Internal Revenue Service and Labor Department requirements. This seems wholly unnecessary and in all events should not be intensified.

The purpose of the prohibited transaction rules of the Internal Revenue Code and the fiduciary standards rules of the above-referenced Disclosure Act, as it would be amended, are essentially the same. They should be integrated into a single set of requirements, with lessons learned from the self-dealing and investment restriction provisions of the Tax Reform Act of 1969. These latter provisions serve essentially the same purposes for charitable organizations. Enforcement should be by penalty excise taxes similar to those provided under the Tax Reform Act provisions, improved with the benefit of hindsight as to the operation of those provisions over the last three years. The effectiveness of this system is now proven. Provisions in S.4 contemplating enforcement by class actions on behalf of employees should in all events be abandoned as highly inefficient and an unnecessary burden on our judicial system. See, for example, Eisen v. Carlisle and Jacquelin, ___F.2d___ (2d Cir. 1973), 41 Law Week 2586, in which the United States Court of Appeals for the Second Circuit is highly critical of class actions.

Similarly, the Internal Revenue Service requires extensive reporting, and disclosure to plan participants, for many of the same purposes that these are required, or to be required, under the Disclosure Act. The agencies could be required to develop a single set of reports, serving both their purposes, and to integrate their enforcement activities.

There simply is no merit in two separate systems for achieving essentially the same objectives in the development and operation of private pension plans. The existing Internal Revenue Service system must be continued. Private pension plans are adopted by employees, and benefits under existing plans are extended, in large measure because of the favorable tax advantages, and the Service must carefully monitor the plans to insure that the objectives of such benefits are being served. Efficiency of government would seem to require that additional statutory requirements, of the same nature as requirements already being imposed by the Internal Revenue Service and designed to serve the same general objectives, also be administered principally by the Service.

Limitations on Contributions or Benefits

The major tax advantages of qualified plans have already been described (pp. 1-2). The heart of these benefits is that a plan participant may defer tax on employer contributions which are funded for his benefit, and on the earnings on such contributions and on additional voluntary contributions which the employee may make under the plan, until he draws them down in cash or other property individually at a later time. This tax deferral is a substantial tax benefit, and the question arises whether the benefits to any individual participant under the qualified plan system should be subject to some over-all limit.

In the case of corporate employees, the only limitations on contributions or benefits for employees are -- (1) contributions or benefits must not discriminate in favor of higher paid employees, that is, in general, they must bear a uniform relationship to total compensation; (2) the employer may not deduct, in general, contributions in excess of certain limits (25% of current compensation of plan beneficiaries where both a pension and profit-sharing plan exist); and (3) in the case of Subchapter S "small business" corporations, shareholder-employees (owning more than 5% of the stock) must include in income amounts contributed on their behalf in excess of $2500 (or 10% of compensation, if less). Except for Subchapter S corporations, these rules do not in practice serve to limit contributions or benefits on behalf of individual highly paid employees to any substantial extent, and accordingly retirement annuities on behalf of corporate executives exceeding $100,000 per year are not uncommon.

In the case of self-employed persons, deductible contributions are presently limited to $2,500 per year (or 10% of earned income, if less)(which is also effectively the result for shareholder-employees of Subchapter S corporations, as set forth above). As a consequence of this limitation, self-employed persons have increasingly organized themselves into so-called "professional corporations" pursuant to special provisions of state laws permitting professional persons to incorporate under conditions whereby the professional responsibility of the lawyer, doctor, accountant or other member of a profession to the client or patient is preserved. This development has served to circumvent the limitations on contributions on behalf of self-employed persons which are contained in the tax law. See Summary of Proposals For Private Pension Plan Reform, supra, at p. 30.

The special limitations applicable to self-employed persons and shareholder-employees of Subchapter S corporations reflect the fact that the non-discrimination standard is not adequate to prevent excessive tax benefits to owner-employees under the qualified plan provisions. As previously indicated, the result of such limitations, however, is to deny to such persons the same benefits as may be realized by corporate employees, and accordingly the professional corporations have been organized. In recognition of this difference in treatment, the Administration bill proposes to increase the limit on deductible contributions for self-employed persons and shareholder-employees of Subchapter S corporations to $7,500 (or 15% of earned income, if less). It is apparent, however, that this will not eliminate the difference in treatment -- it will simply reduce its scope. The incentive for operation through professional corporations will continue to exist to obtain the greater tax benefits available to corporate employees.

The Administration pension bill (S.1631) also proposes that contributions to a money purchase pension plan in excess of 20% of current compensation of an employee for whom such contributions are made be includible currently in the employee's income. This is presumably designed to reach the case in which owners of small closely-held corporations, including professional corporations, seek to set aside a substantial portion of their compensation under a vested plan under conditions whereby there is not sufficient assurance that the plan will be non-discriminatory in its actual operation. Benefits under a defined benefit aggregate funded plan would not be affected by this limitation.

There is no basis for difference in treatment of corporate employees and self-employed persons under the qualified plan provisions. In each case, the plan must be non-discriminatory as to contributions or benefits as between high-paid and low-paid employees. Differences should not arise by reference to the form of business organization utilized, or the existence of ethical considerations which make operation in corporate form less appropriate. There should be complete equality of treatment in the application of the qualified plan provisions with respect to all earned income.

Equality of treatment may be achieved by removing all special limitations on the treatment of self-employed persons and shareholder-employees of Subchapter S corporations. It may also be achieved by extending the same limitations to all corporate plans. It may be partially achieved by extending such limitations to closely-held corporations, including professional corporations, but this merely moves the point of difference in treatment, or discrimination, to high-paid employees of closely-held corporations versus high-paid employees of publicly-held corporations, an equally unsatisfactory result.

The analysis points up the question whether limitations are appropriate to any extent, and if so, for what reason.

The essential public policy underlying the qualified plan provisions is to encourage personal saving, particularly for retirement, out of earned income under employer-sponsored plans which are not discriminatory. Employer-sponsorship of non-discriminatory plans assures reasonably wide coverage and efficient operation. It is not necessary to achieve these objectives, however, to permit tax deferral benefits to individual participants which are unduly large or permit the funding of post-retirement income beyond what is reasonably needed for maintaining the individual's standard of living after he ceases work. The qualified plan provisions are not designed to sponsor wealth accumulation beyond what is appropriate to maintain such a standard. The realization by some individuals of excessively large tax benefits through the qualified plan system undermines public confidence in the integrity and fairness of our income tax system.

Accordingly, while I recommend strongly that the Congress increase the limitations for self-employed persons and shareholder-employees of Subchapter S corporations, I recommend that a uniform limitation be applied to all qualified plans, including those of all corporations. In the case of defined benefit plans, the limitation should be in terms of benefits under the plan. In the case of money purchase pension plans or profit-sharing plans, the limitation should be somewhat higher than the Administration has recommended for self-employed plans and should contain provisions for automatic increase as inflation occurs.

As an example, benefits under a defined benefit pension plan might be limited to 2% for each year of service based on final average compensation, except that the amount

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of final average compensation to be taken into account for this purpose would not exceed $100,000. Thus, the annual retirement benefit for a participant with 25 years of service whose final average compensation was $100,000 or more would be limited to $50,000 (in terms of a single life annuity at normal retirement age). If the participant had 30 years service, the maximum would be $60,000. Additional benefits attributable to employee contributions would be permitted.

In the case of a money purchase pension plan, the maximum annual deductible employer contribution would be at the rate of 10% of compensation taking into account a maximum amount of compensation for this purpose of $100,000. In the case of a profit-sharing or stock bonus plan, such maximum would be at the rate of 10% on compensation up to $100,000 per year, or at higher rates up to 15% on lower maximum compensation amounts ($66,667 for 15% rate), so as to permit a maximum annual deductible employer contribution for any participant of $10,000 per year. Using a 6-1/2% earnings assumption, this would produce a single life annuity for a male retiring at age 65 for whom maximum contributions of $10,000 per year had been made for 25 years of about $50,000.

The $100,000 amount or other maximum compensation base should be automatically adjusted upward in steps of $10,000 each time the cost of living index rises an additional 10% over its base at the time such new limitations are adopted.

Those limits are reasonable enough to assure that sufficient incentive remains for voluntary adoption of qualified plans by employers. My experience tells me that officers of publicly-held corporations, owner-employees of closely-held corporations, and self-employed persons will be persuaded sufficiently even under these limits to adopt non-discriminatory qualified pension and profit-sharing plans for themselves and their employees -- as much as they would do so under present law.

If such persons wish to defer a larger portion of their current compensation to post-retirement years, they will remain entirely free to do so under non-qualified plans, which do not provide the same substantial tax advantages and which may be adopted for individual employees, or higher-paid groups, without regard to any non-discrimination requirement. Deferred compensation contracts, phantom stock plans, restricted property arrangements, and non-qualified stock option plans provide a variety of means for the higher paid executive to defer receipt of his compensation, but without the extraordinary tax benefits which are granted to qualified plans.

Such an over-all limitation is more appropriate in light of the 50% maximum tax rate on earned income which became fully effective in 1972. High-bracket earners no longer require the same protection from high marginal rates under the progressive rate structure to achieve a reasonable degree of lifetime averaging of their compensation.

I would couple these limitations with a restriction generally applicable to all qualified plans preventing withdrawal of alienation of interests attributable to employer contributions until age 59-1/2. I would also require withdrawals to begin by age 70-1/2 on the same basis as is presently required for self-employed plans. These requirements are consistent with the public policy underlying the qualified plan provisions of encouraging retirement savings and help prevent undue tax advantage.

Conclusion

The development of a comprehensive statutory pattern of minimum requirements for tax-sponsored employee benefit plans is urgently needed. The administration of such provisions falls more appropriately within the expertise of the Internal Revenue Service because of its long experience in the area and because of the self-enforcing effects of a tax sanction system. In addition to the key issues of coverage, vesting, and funding, the Congress should liberalize the treatment of self-employed persons, but Congress should apply the same higher uniform limits to contributions or benefits for all qualified plan participants, including participants in all corporate plans.

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STATEMENT OF
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Washington, D. C.
Before the Subcommittee on Private Pension Plans
of the Committee on Finance
United States Senate
May 31, 1973

I. Administration and Enforcement of Retirement Plan Legislation

Speaking from the standpoint of a private practitioner representing employers, employees, and plan administrators in all aspects of the establishment and operation of private pension plans, including compliance with the various applicable regulatory statutes, it seems to me that certain assumptions may be generally agreed upon in approaching the question of administration and enforcement of any new legislative rules applicable to this area.

Historically, the institution of the private pension plan has grown in a remarkably short time to staggeringly large proportions with relatively little regulation.[1/] Even among those most insistent on new legislation to assure greater protection of employees through vesting, funding, termination insurance and fiduciary standards, most agree that a large proportion of the plans in existence today operate in a manner which would be substantially unaffected by many of the major legislative proposals now under consideration. Accordingly, a sound approach to new rules will be one which deals effectively with the deficiencies which have been identified without unnecessarily regulating those plans which do not exhibit those deficiencies.

Most advocates of legislation agree that those persons who are not covered by any retirement plan at all or are covered only by a plan providing low benefits present a problem at least as pressing as that of the adequately covered worker who may lose expected benefits. Since approximately one-half of the labor force is still not covered by private retirement plans, regulation of the design and behavior of plans which today fall short of acceptable standards must be carried out in a way which does not have a tendency to discourage the continued improvement and expansion of private plan coverage.

Much has been written in the last few years on the history of the private pension movement and need not be repeated here. Until this time, the basic federal statutory rules bearing on the substantive content of pension plans have been found in section 401(a) of the Internal Revenue Code of 1954, and predecessor provisions, and have been administered by the Internal Revenue Service. Since 1958, the Department of Labor has been charged with administration of the Welfare and Pension Plans Disclosure Act, which deals principally with disclosure but also contains some limited provisions regulating the conduct of plan administrators.

The first issue presented here today, and one which I regard as of great importance, is whether any legislation which is enacted concerning eligibility, vesting, and funding in the private pension area should be administered by the Treasury Department through the Internal Revenue Service, which presently administers rules on these subjects, by the Department of Labor, or by both departments simultaneously. In addition, the question is posed as to the proper administering agency in the case of adoption of a termination insurance program or a portability program, neither of which currently exists in any form. Finally, although not directly posed by any conflicting approaches in pending legislation, the mode of enforcement of any new rules relating to fiduciary responsibility is, in my opinion, deserving of attention.

A. Eligibility, Vesting and Funding

The tax rules presently applicable to funded employee trusts which fail to meet the qualifications of section 401(a) of the Internal Revenue Code are so extremely adverse that it is safe to say that virtually all funded retirement arrangements are established to comply with these rules. The result of a failure of a plan to qualify is the taxation of employees on the full value of their accrued benefits as and when they become vested, without regard to whether the benefits are then payable,[2/] and the denial of a deduction to the contributing employer until the employee does become vested.[3/] In other words, if the plan provides for full and immediate vesting, the active employee is immediately taxed in full on his future retirement benefits as they accrue. If the plan contains no vesting, the employer, although making regular contributions, will obtain no tax deduction until the employee retires and receives his benefits. The situation in between, that of graduated deferred vesting as is found in most plans, is equally intolerable. Furthermore, the earnings of a trust under a nonqualified plan are fully taxable.[4/]

Because of these adverse consequences, I am aware of no instances in which funded retirement plans have been established in an intentional effort to circumvent the rules of section 401(a). Accordingly, it is fair to say that these rules have been to a large extent self-enforcing. In my opinion, cooperative compliance would not be likely to continue at as high a level if the statutory requirements were enforced only through court orders without automatic sanctions. In such instances, there is an all too frequent tendency to comply with aspects of the legislation which are considered onerous only to the extent ordered to do so, resulting in an enforcement procedure which is slow and cumbersome. One example of the dramatic contrast in enforcement effectiveness of the two approaches can be found in recent experience with sex discrimination in retirement plans. Title VII of the Civil Rights Act of 1964[5/] prohibits sex discrimination in employment and the Equal Employment Opportunity Commission is given strong enforcement authority through the federal courts.[6/] Regulations under the Act, promulgated in 1968, provided specifically that differences in retirement ages based on sex are prohibited.[7/] But reaction to the statute or regulations among pension plans containing such differences has been slow. The reluctance to change voluntarily in response to these rules is evident from the decided cases appearing in the advance sheets for years thereafter each of which has resulted in a court order to single employers to eliminate age differences in a plan.[8/] By contrast, when the Internal Revenue Service in 1971 changed its rules on plans integrated with Social Security to require for the first time use of the same retirement age for men and women,[9/] it was my experience that every employer affected by these rules voluntarily amended its plan to bring it into compliance before the deadline of April 1, 1972 set by the Internal Revenue Service for such changes. Based on evidence of this type, I strongly submit that the approach of S. 4 to administration and enforcement of proposed rules on eligibility, vesting and funding may be expected to be less effective than the approach taken by S. 1179 and S. 1631 which continue the present system reinforced by more specific requirements in each of these areas.

To say that the present requirements are largely self-enforcing is not intended to imply that no administrative bureaucracy has been required in this area. For corporate plans covering most workers, the present statutory rules are very general, centering basically around the legislative requirement that in order to avoid unfavorable tax treatment a plan must not discriminate in favor of officers, stockholders, or supervisory or highly-paid employees.10/ Around this legislative standard the Internal Revenue Service, through detailed regulations developed over many years and through hundreds of published rulings, has evolved numerous specific criteria with which plans must comply, including administrative rules specifically relating to eligibility, vesting and funding.11/ Furthermore, local District Offices of the Internal Revenue Service, which are staffed with agents who are specialists in this area, are empowered to review specific plans and issue advance determination letters concerning qualification when plans are established and amended,12/ and the vast majority of plans seek such determinations, again because of the risk of adverse tax treatment inherent in failure to qualify. Detailed reporting by employers and trustees is required, which forms a basis for office or field audit by agents who are specialists in this area.13/

It seems evident that the provisions of proposed legislation, if added to the Internal Revenue Code as requirements for tax qualification, would be administered in very much the same way as the present provisions with hardly a ripple in the bureaucratic machinery. Administration and enforcement of such provisions by the Department of Labor, however, would require the creation of a completely new and quite extensive bureaucracy. This seems not only unnecessary but unwise. Some of the proposed provisions, such as those concerning funding, are highly technical and would require considerable expertise to administer properly. The Internal Revenue Service has already accumulated this expertise, particularly in the area of actuarial techniques and actuarial personnel, but also in such matters as report processing and audit procedures, and the handling of rulings. It would inevitably require some time before similar capabilities could be developed in another department.

The most serious problem which would result from the enactment of S. 4 but which would be avoided by the approach taken in S. 1179 and S. 1631 is that of dual administration. Since S. 4 does not repeal the nondiscrimination provisions of the Internal Revenue Code on which are based the present administrative rules concerning eligibility, vesting and funding, we are not dealing simply with the question of which agency should administer private pension plan legislation. Rather, in the present posture of pending proposals we are dealing with the question of whether these rules should be administered by a single agency or by two separate agencies simultaneously. The approach of S. 4 would lead to a need for dual staffs, dual reporting requirements and dual audits which could not be fully avoided by interdepartmental coordination due to the differences in the statutory requirements. This would not only be wasteful and inefficient, but frustrating and burdensome and costly for those being regulated. Accordingly, it seems a compelling conclusion that if the approach of S. 4 should be adopted, the creation of an enforcement authority in the Department of Labor should be accompanied by a repeal of the provisions of the Internal Revenue Code dealing with this subject matter. In such circumstances, it would be sufficient and desirable simply to provide that the present tax consequences will follow from issuance of a registration certificate by the Secretary of Labor, and to specify the limits on the amount of contributions under registered plans which can be deducted by employers in any year. Unfortunately, even this would not be a satisfactory solution to the problem of duplication unless S. 4 were extended both in the aspects of the subject which it regulates and the plans to which it applies. For example, S. 4 does not deal at all with small plans (25 participants and under) and does not contain any rules on such matters as coverage and integration with Social Security benefits.[14/]

Some commentators have taken the position that the Internal Revenue Service should not administer retirement plan legislation because it is concerned not with the protection of the rights of employees but with protection of the revenue. This is merely to assume a conclusion. Internal Revenue Service personnel administering a set of vesting, funding or other rules designed to protect the rights of employees will, based on my experience of dealing with Internal Revenue Service administration of plans under current law, focus on compliance with those rules in the same manner as any other civil servant administering similar rules, without regard to revenue considerations.

Another conclusion which is sometimes stated as though it were foregone is that "pension regulation belongs in the agency established to protect the interests of workers." If pension coverage were made mandatory, perhaps so, but as long as it is not I believe that this proposition is no more warranted then would be the proposition that pension regulation should be centered in the Department of Commerce because pensions are established by private business interests. The fact is that the private pension movement has so many aspects and is typified by so much diversity that it cannot be characterized as the natural charge of any existing agency, but there are practical and historical reasons for continued administration of the program by the Treasury.

In summary, I believe that the approach to administration and enforcement of the eligibility, vesting and funding requirements which is contained in S. 4 is inferior to the approach taken by S. 1179 and S. 1631, because:

(a) it would be less effective;

(b) it would create an unnecessary new bureaucracy;

(c) it would not take full advantage of existing governmental expertise;

(d) it would inevitably result in duplication of governmental functions and dual regulation of retirement plans.

For these reasons I believe the approach of S. 4, given the same substantive content of the proposed new rules, would have a greater tendency than S. 1179 or S. 1631 to place unnecessary burdens on the many plans which to date have exhibited no need for additional government regulation and would also have a greater tendency to discourage the creation of new plans.

B. Portability and Insurance

Since there is nothing comparable to these provisions in present law, much of the above discussion is inapplicable to the issue of which agency should administer such programs if they are enacted. However, there seems no particular reason to place these functions in the Department of Labor if other regulatory functions are not placed there.

With respect to portability, the clearing-house approach of S. 4 creates an additional bureaucracy which, in view of its voluntary nature, could be justified only by citing the very marginal benefit of consolidating the pension checks of some workers who have acquired vested rights under several plans. The Report on S. 4 by the Committee on Labor and Public Welfare suggests that the clearing-house might be dispensable if the tax laws were amended to permit tax-free transfer of credits. This approach of amending the tax laws is adopted by S. 1179 and S. 1631. If portability is deemed desirable, there is much to be said for delaying the creation of any new federal bureaucracy until there has been more experience with a tax law change which might accomplish much of the same objective on a self-administering basis.

With respect to plan termination insurance, S. 1179 takes the approach that this sort of risk pooling among under-funded plans may not be strictly a governmental function, and proposes a nongovernmental, nonprofit membership corporation to perform the same functions proposed by S. 4 to be placed in the Department of Labor. If plan termination insurance is deemed desirable, the use of such a nongovernmental membership corporation seems a sound approach to continuation of the successful self-regulation which has characterized the private pension plan movement to date.

C. Fiduciary Standards and Disclosure

The Welfare and Pension Plans Disclosure Act provides that retirement plans covering more than 25 participants must file plan descriptions with the Secretary of Labor and that plans covering 100 or more participants must file annual reports.[15/] For the last 10 years the Act has provided the Secretary with investigative and enforcement powers.[16/] Although it is clear that the provisions of the Act are not as strong as they should be either with respect to the information required or the investigative and enforcement powers conferred on the Secretary, it is also clear that the Act has not been administered and enforced to nearly its full potential. My experience has been that there are many plan administrators covered by the Act who do not file or who file incomplete information without apparent repercussions. Furthermore, the information which up until this year has been required under the regulations has not been calculated to make the Act useful for its intended purpose.17/ Therefore, to some extent the problem has been not one of inadequate laws but rather of a failure of enforcement.

The Welfare and Pension Plans Disclosure Act now in effect touches on fiduciary responsibility in requiring bonding of plan administrators and imposing criminal penalties for embezzlement and kickbacks.18/ The Internal Revenue Code also deals with this area in its provisions resulting in loss of trust exemption where plan administrators engage in prohibited transactions, including various non-arm's length transactions with the employer.19/

Both S. 4 and the Administration proposals (S. 1557) contain substantially similar provisions on fiduciary responsibility and disclosure and provide for continuation of the administration of these functions by the Department of Labor. In addition, the Administration proposals embodied in S. 1631 would amend the prohibited transaction provisions of the Internal Revenue Code to define fiduciary duties by reference to the amended Welfare and Pension Plans Disclosure Act and to impose an excise tax on plan administrators who run afoul of these provisions, substantially similar to the excise taxes imposed on foundation managers by Chapter 42 of the Internal Revenue Code added by the Tax Reform Act of 1969.20/

While there has been little disagreement on the fact that new rules are desirable relating to fiduciary responsibility, it seems to me that in this instance the Administration proposals are guilty of the same duplication that it sought to avoid in the handling of eligibility, vesting and funding proposals. We are faced with two agencies being simultaneously granted investigatory and enforcement powers over identical offenses. One agency is told to proceed by action in the federal district courts while the Tax Court is granted jurisdiction to handle the more automatic penalties imposed by the other.[21/] I am concerned that there may be a bit of overkill in this which is not present to the same degree in the private foundation area where, although state authorities may have concurrent rules, there is no duplication of federal enforcement agencies.

There are good reasons to continue the disclosure functions in the Department of Labor under a new statute expanding these functions. I believe it also acceptable to follow the approach of S. 4 and S. 1557 of placing responsibility for enforcing the new fiduciary responsibility rules in that department. However, I am intrigued with the excise tax approach taken by S. 1631. This approach cures the criticism which has been leveled in the past at IRS enforcement of prohibited transaction rules, i.e., that the loss of exemption of the trust was so great a penalty on innocent parties that it would not as a practical matter be invoked. In view of the poor record of endorcement by the Labor Department under the statute now in force and the fairly good enforcement experience of the Internal Revenue Service under the very general rules which it has been charged with administering to date, I would suggest to the Administration and this Committee that they take a careful look at the idea of using the proposed excise tax provisions as the primary enforcement tool in this area, cutting back the overlapping powers of enforcement of fiduciary responsibility rules proposed to be granted to the Secretary of Labor by S. 1557. In any event, I would urge that, if the excise tax rules are adopted, further study be devoted to the question of whether additional provisions are needed to avoid problems of concurrent enforcement.

II. Limitations on Pension Benefits

In discussing the question of whether upper dollar limitations should be placed on the amount of individual retirement benefits which will be given the tax treatment applicable to qualified benefits in general, it is important to put the matter in proper analytical context.

Some who have advocated such limits have done so on the ground that the treatment which the tax laws provide for qualified retirement plans should not be used as a means by which high income individuals may accumulate large estates, stating or implying that the provisions for qualified plans are in the nature of a "tax loophold." Whether it is more accurate to state that qualified plans receive favorable tax treatment under the Code or that nonqualified plans are penalized[22/] is a rather fruitless issue which does not necessarily lead to a correct solution to the inquiry, but there is, in my opinion, sufficient merit in the latter proposition to warrant rejection of the premise that lack of overall limits is a "tax loophole."

The question of whether there ought to be limits, it seems to me, should be addressed on essentially two levels:

(1) As a matter of tax theory; and

(2) As a matter of practicality.

In the first category are questions such as whether larger pensions should in effect be taxed less favorably, and if so whether this objective is not already accomplished more equitably and directly through the progressive rate structure. In the second category are such questions as whether the adoption of provisions relating to qualified plans which are designed to discourage employers from providing pensions for highly compensated employees which are as high in proportion to their cash wages as are provided for other employees would be ineffective because of a willingness to gross up the benefits to compensate for the higher taxes on nonqualified benefits. Another practical consideration is whether the incidental tax revenue resulting from such a practice would be worth the possible loss of incentive to management to adopt and improve pension plans, and whether limits are needed as a practical matter in some situations simply because of the opportunity for disguising business profits as earned income and the difficulty of drawing any clear distinctions between them.

Even though one subscribes fully to the view that larger pensions should be taxed less favorably than smaller ones, I believe there is much to be said for the proposition that the progressive rate structure is the best approach to allocating the tax burden among individuals according to income level and that it is generally poor tax theory to attempt to achieve further progression on the hit and miss basis of rather arbitrarily drawn dollar limits to deductions and exclusions here and there in the Code.[23/] Retirement benefits attributable to employer contributions accruing since 1969 are no longer eligible for capital gain treatment, and a very highly compensated executive will remain in a high bracket even after application of the applicable averaging provisions. The argument that tax deferral is worth more to the high bracket taxpayer than the low bracket taxpayer is incontrovertible, but this is merely an inevitable result of the fact that he would be in a higher bracket if taxed currently, is true of all deductions and exclusions, and does not assist in analyzing the issue.

Furthermore, in my judgment business will provide for its favored employees regardless of tax consequences. While making this more costly would have some revenue raising tendency (difficult to measure), this uncertain fiscal advantage is offset by an also uncertain but potentially more significant disadvantage. My pragmatic experience has often been that there is a great deal of enlightened self-interest on the part of management in its willingness to establish and improve retirement benefits and its inclination to administer them with loving care. As long as we are relying on private forces to maintain and expand the pension system, i.e., unless "private" pensions are in effect made mandatory, it may be dangerous to experiment with rules that might dull the incentives which have operated to date.

Accordingly, I believe that as a general proposition there should be a presumption against limits, and that limits should be applied only where compelling reasons exist. It is arguable that such reasons exist in the case of plans maintained by closely-held businesses where ownership interests are prominently represented among the covered employees. Where such businesses are unincorporated and capital (or goodwill) is a material income producing factor there is an obvious problem. The same problem exists where such businesses are incorporated, limited only by the rather imprecise rules concerning nondeductibility of unreasonable compensation. It is difficult to devise a workable set of rules for limiting covered compensation in such instances to the portion of the income from the business received by the owner employee which actually is derived from his services and indeed this may be a very subjective matter. One approach which I do not believe has been sufficiently investigated, as an alternative to arbitrary dollar limits, would be application of the principles being developed in the "earned income" area under Internal Revenue Code §§ 911 and 1348, including presumptions and limitations applicable where capital is a material income producing factor. Any such approach is inevitably complicated, but because of the maximum tax provisions will have to be faced in any event.

Nevertheless, it may be concluded that complications in alternative approaches or other practical reasons justify a judgment on the part of Congress that somewhat arbitrary limits on tax qualified retirement benefits should be imposed in situations where there is reason to presume that stated compensation or self-employment income is not determined at arm's length subject to the constraints of outside ownership. Such limits might be imposed where, e.g., more than one-half of the benefits accruing under a plan are for the benefit of persons owning directly or indirectly more than a specified portion (e.g., 5%) of the business, as sole proprietor, partner, stockholder, or otherwise. To promote tax neutrality in the question of form of business organization and discourage artificial reasons for incorporation of businesses which otherwise would operate in non-corporate form, any such rules should apply to corporations as well as unincorporated businesses and professional groups. This approach would permit repeal of the present limitations which discriminate against unincorporated businesses and Subchapter S corporations.

If dollar limits are imposed in such limited situations, it would seem desirable to provide a mechanism for adjustment to inflationary changes, such as tying the figure into increases in a recognized wage table or cost of living index. The base limits are obviously a matter of judgment. The limits of present law applicable to unincorporated businesses and Subchapter S corporations are intolerably low, and have a real tendency to discourage adoption and improvement of plans which would be of benefit to rank and file common law employees. The provisions of S. 1631 raising these limits to the lesser of $7,500 or 15% of earned income are a vast improvement and approach the reasonable area, in my view, although an increase in the dollar limit to $10,000 might be more realistic.

Footnotes

1/ For a historical account of the private pension plan movement, see President's Committee on Corporate Pension Funds, Public Policy and Private Pension Programs (1965) at 1-10; Bankers Trust Company, The Private Pension Controversy (1973) at 5-12.

2/ Internal Revenue Code, § 402(b) and § 83.

3/ Internal Revenue Code, § 404(a)(5).

4/ Internal Revenue Code, § 501(a) and § 641(a).

5/ 42 U.S.C. § 2000e-2a.

6/ 42 U.S.C. § 2000e-5 through 2000e-9.

7/ 29 C.F.R. § 1604.31(a).

8/ See, e.g., Fillinger v. East Ohio Gas Company, Civil No. 69-788 (N.D. Ohio, August 17, 1971); Rosen v. Public Service Electric and Gas Co., Civil No. 245-66 (D. N.J., August 25, 1970; reaffirmed, November 24, 1970).

9/ Rev. Rul. 71-446, 1971-2 C.B. 187.

10/ Internal Revenue Code, § 401(a)(3) and (4).

11/ See, e.g., Rev. Rul. 70-75, 1970-1 C.B. 95; Rev. Rul. 71-150, 1971-1 C.B. 123; Treas. Reg. § 1.401-6(c).

12/ See Rev. Proc. 72-6, 1972-1 I.R.B. 20.

13/ Annual returns are required on Forms 4848, 4849, and 990-P. In addition, there are many other notification and reporting requirements applicable to specific situations, such as investment in employer securities, termination of a plan, etc.

14/ All of the same considerations would apply to the creation of a new independent agency to administer proposed retirement plan legislation, such as was proposed in earlier bills considered by the Committee on Labor and Public Welfare.

15/ Welfare and Pension Plans Disclosure Act, as amended, Sec. 4-7, 29 U.S.C. § 301 et seq.

16/ Welfare and Pension Plans Disclosure Act, Sec. 9, 29 U.S.C. § 308.

17/ In 1973 the Department of Labor amended its regulations to provide greatly expanded information concerning plan descriptions and requiring written explanations of plans and amendments to be provided upon request to participants and beneficiaries in language reasonably calculated to be understood by them. 29 CFR Part 460.

18/ Welfare and Pension Plans Disclosure Act, Sec. 13, 29 U.S.C. § 308(d); 18 U.S.C. §§ 664, 1027 and 1954.

19/ Internal Revenue Code, § 503.

20/ Internal Revenue Code, §§ 4940-4948.

21/ A penalty of 5% of the amount involved is imposed upon a finding by the Internal Revenue Service that one of the fiduciary standards has been contravened and a further penalty of 200% of the amount involved is imposed if it is not corrected within a specified period during which the fiduciary, if inclined, may petition the Tax Court for a determination that the administrative finding was erroneous. Internal Revenue Code, § 6213.

22/ For a discussion of this issue see Raymond Goetz, Tax Treatment of Pension Plans--Preferential or Normal?, American Enterprise Institute (1969).

23/ Such dollar limits may be found in the Code today in § 79 dealing with employer-provided group term life insurance and § 217 dealing with employer-paid moving expenses. However, unlike the pension area, these are situations in which the benefit, if not taxed when paid for by the employer, would escape taxation permanently, and are not comparable to a mere deferral situation where progressive rates will ultimately apply.

<u>Statement by Harold T. Swartz</u>
<u>Before the Subcommittee</u>
<u>on Private Pension Plans</u>
<u>of the Committee on Finance</u>
<u>United States Senate</u>

<u>May 31, 1973</u>

My name is Harold T. Swartz. Before my retirement from the Internal Revenue Service a little more than a year ago, I occupied the position of Assistant Commissioner (Technical) of the Internal Revenue Service. One of the functions of that office is to issue rulings and technical advice on the provisions of the Internal Revenue Code relating to pension, profit-sharing, stock bonus, and annuity plans. I have been involved with those provisions since 1942 when the tax laws pertaining to private retirement plans were substantially overhauled.

My comments will be limited generally to the administration and enforcement of the provisions in the Internal Revenue Code relating to employees' pension, annuity, and profit-sharing plans.

Under present law, section 401 of the Code sets forth the requirements for the qualification of these plans and the tax results of many other provisions of the Code depend on whether or not a particular plan meets the requirements of section 401.

For example:

1. Whether the income earned by a pension trust is exempt from taxation under section 501.

2. When the contributions by an employer are deductible under section 404.

3. When the beneficiary of an employee's trust is taxable on the contributions made to the trust on his behalf.

4. Whether the beneficiary of a plan is entitled to capital gain treatment (or the seven year averaging treatment) on total lump-sum distributions from a trust.

5. Whether a life insurance company may treat certain reserves as "pension plan reserves" under section 805(d).

6. Whether for estate tax purposes, the value of certain annuity or other payments are excluded from the gross estate under section 2039(c).

7. Whether, for gift tax purposes, an election by an employee to provide a survivor annuity to his beneficiary is an exempt gift under section 2517.

Thus, whether any agency of the Government other than the Treasury is granted enforcement authority over the vesting, funding, or other similar provisions of private retirement plans, the Commissioner of Internal Revenue will still have to examine into the qualification of all such plans under section 401 of the Internal Revenue Code in order to determine the tax results in all of the foregoing situations.

Prior to the pension trust legislation in the Revenue Act of 1942 there were a limited number of funded pension and profit-sharing plans in existence. While there were some large corporations that maintained pension trusts and group annuity plans for their rank and file employees, there had begun to be established a large number of plans which were designed to cover only the officers, and other highly compensated employees. There were no provisions in the tax laws at that time that prohibited favorable tax treatment to this type of plan.

After the 1942 Act, no longer could an employer maintain a funded deferred compensation plan that could continue to receive favorable tax treatment where it covered only a selected group of employees.

The 1942 Act provided that employee retirement plans, in order to qualify, had to cover a stated percentage of total employees or a classification of employees found by the Commissioner of Internal Revenue not to discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees.

Despite these situations, a large number of employers rushed to establish qualified deferred compensation plans for their employees. One of the reasons for their popularity was that contributions were deductible for excess-profits tax purposes. Another reason was that under the rules governing salary and wage restrictions then in effect, a contribution made to such a plan by an employer on behalf of an employee was not considered to be a prohibited increase in salary or wages.

One of the questions that Congress considered in 1942 was that of "vesting". During the hearings on the Bill many employers testified that a fast vesting requirement would be extremely costly, particularly in pension and annuity plans. They testified that this could very well discourage the establishment of plans and might compel cut-backs in benefits under existing plans. Apparently the Congress was impressed by this testimony because it did not provide in the 1942 Act for any requirement for vesting.

Upon enactment of the 1942 Act, the Commissioner of Internal Revenue was faced with the responsibility of administering and enforcing the deferred compensation provisions. Very few, if any, corporations wanted to establish a plan until the Commissioner had issued a ruling that its particular plan qualified under the new law.

As a result, the Commissioner set up a separate pension trust office within Internal Revenue to issue advance rulings on deferred compensation plans and to administer the provisions of the new law.

At the present time there are approximately 400 specialists in the field offices of the Internal Revenue Service and about 60 specialists in the National Office in Washington who devote their entire time to the administration and enforcement of these provisions of the Code.

<u>Vesting</u>

Under section 401(a)(7) of the Code, a qualified plan must provide that an employee's rights are to become vested upon termination of the plan or upon complete discontinuance of contributions thereunder. In addition the regulations require full vesting of benefits at the time an employee reaches normal retirement age.

While there are no other specific provisions in the Code with respect to vesting of benefits, the Internal Revenue Service has required fast vesting in many plans seeking qualification under section 401. This is particularly true of profit-sharing and stock bonus plans. Such plans usually provide that the nonvested portion of the credits in an employee's account are forfeited when an employee leaves the employer before retirement. These forfeited amounts are allocated among the accounts of the remaining participants. Since the officers and highly compensated employees tend to remain with the employer until retirement these allocations of nonvested forfeitures often result in final benefits discriminating in their favor.

It is the practice of the Internal Revenue Service to insist that in order to qualify, such plans contain vesting provisions adequate enough to prevent this.

With respect to pension and annuity plans, forfeitures may not be used to increase the benefits of remaining employees. These forfeitures, if any, must be used to reduce the employers' contribution or premium cost of the plan in the following years. In addition, the Internal Revenue Service has held that a pension plan, in certain instances, may not qualify under section 401 unless satisfactory vesting provisions are incorporated in the plan to prevent contributions or benefits from discriminating in favor of officers, shareholders, supervisors or highly compensated employees. Revenue Ruling number 71-263, published in the Internal Revenue Cumulative Bulletin for 1971, describes a plan that covered all employees but provided benefits only for employees who retired at age 65 with 15 years of service. The employees, other than officers etc., were workers who stayed on the job only a relative short time so that only the executive employees remained to receive any benefits. The Ruling holds that such a plan does not qualify under section 401. The Ruling indicates, however, that the plan might qualify if satisfactory provisions for vesting are provided.

Funding

With regard to funding, the Code contains no specific provisions relating to the funding of benefits, however, Treasury regulations and rulings require that contributions to a qualified pension or annuity plan must be funded to the extent of the current pension liabilities, plus interest on the unfunded past service cost.

The Service often checks the status of the funding of a plan during the course of an audit. While it is concerned also with a plan that may be overfunded because a contribution to an overfunded plan is not considered to be deductible as an ordinary and necessary expense, it at the same time enforces the rules regarding underfunding.

Termination

While there are no provisions in the Code that require plan termination insurance, there are regulations and rulings that are designed to protect employees in the event of termination of a plan.

Under existing law a plan, in order to qualify, must expressly provide that upon termination of the plan or upon complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to the date of such terminations, to the extent then funded, must become vested.

In the event a plan is terminated, or if contributions are curtailed, the Internal Revenue Service requires that certain information is to be filed so that a determination may be made as to the effect of the termination or curtailment on the prior qualification of the plan.

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The regulations also contain provisions that are designed to benefit the lower paid participants in the event a plan is terminated within ten years after its establishment or where the current costs for the first ten years of the plan have not been fully funded.

Thus, the Internal Revenue Service has had considerable experience in enforcing existing rules pertaining to termination of plans.

Enforcement

While not required by the Code, almost all funded deferred compensation plans are submitted to the Internal Revenue Service for approval before they are put into effect. These plans are thoroughly examined by Internal Revenue pension specialists before a determination is made as to whether the plan qualifies under section 401. In addition, when a substantial amendment is made to the plan it is usually submitted to the Internal Revenue Service for a new determination letter.

After the plan has been established, the Internal Revenue Service, during the audit of the tax return of an employer, examines the continued qualification of the plan in operation.

There is an appeals procedure under which a taxpayer may request that a proposed disqualification of a plan, or a proposed disallowance of a contribution deduction, be submitted to the pension specialists in the National Office of the Internal Revenue Service for review. The taxpayer is entitled to file a brief and is entitled to be heard in conference in the National Office. The same procedures are available where a District Director proposes to revoke the exemption of a trust when he is of the opinion that the trust has entered into a prohibited transactions under section 503 of the Code.

Conclusion

The Internal Revenue Service has more than 400 pension experts in its field offices and more than 50 pension specialists and actuaries in its National Office in Washington. They all have had experience with the problems relating to vesting, funding, termination and qualification of pension, profit-sharing, stock bonus and annuity plans. The Internal Revenue Service has been administering and enforcing the existing provisions of the Internal Revenue Code relating to these plans for more than 30 years and will have to continue to do so.

During the first nine months of the fiscal year 1973, Internal Revenue agents have examined into more than 23,000 returns involving Code section 404 deductions and the employee plans pertaining thereto. In addition, they audited more than 9,000 Forms 990-P filed by trustees of pension and profit-sharing trusts.

A new Employees Plan Master File system has been adopted by the Internal Revenue Service which, starting with the taxable year 1971, will enable it to account for all plans, the employer entities adopting such plans, the trust funds involved, and the fiduciaries of such plans. The system will also provide data for statistical purposes, detection of non-filers and selection for audit examinations.

It would seem logical and preferable, therefore, that any additional vesting, funding, and other similar provisions that may be required of these plans be enforced and administered through the Treasury Department.

STATEMENT OF PAUL S. BERGER

for a Panel Discussion on Private Pension Plan Reform

Before

THE SENATE FINANCE SUBCOMMITTEE ON PRIVATE PENSION PLANS

Honorable Gaylord Nelson, Chairman

2227 Dirksen Senate Office Building May 31, 1973

I appreciate the opportunity to participate in this morning's discussion of a subject so important as the landmark legislation before this Subcommittee. Despite Social Security, and despite the explosive growth of private pension plans, American working people are not yet assured of the basic economic security that should be their birthright. As a practicing tax lawyer, working frequently with health, welfare, and pension plans, particularly those established under collective bargaining agreements, I have become aware of the importance of these plans to the general well-being of the American worker and his family. I have no doubt that the pension reform statute which emerges from this Congress will contribute importantly to securing this goal -- if effective machinery is provided for its administration and enforcement. But, just as surely, without the proper machinery to effectuate its goals, the new law will disappoint the people's high expectations.

As noted by Senator Nelson in his remarks at the opening of these Subcommittee hearings, the subject of the private pension system and its needs have been exhaustively studied by various committees of Congress, as well as by the Executive Branch during several administrations. These studies have produced somewhat of a consensus "that certain legislated minimum standards are necessary to strengthen the private pension system." While there remain differences to be resolved with respect to these standards, my testimony will not deal with these substantive issues. Hopefully, however, an examination of the problems of administration can contribute to a resolution of some of the outstanding differences.

The prospective administration of the various pending bills has received less attention than the issue merits, perhaps because of the unusual complexity of the substantive provisions of the bills. In itself, none of the three bills faces up to the considerable challenge of assuring effective administration. This morning I would like to focus on this question, to outline provisions which seem to me to be necessary to make the regulatory scheme work, and to suggest appropriate modifications in the existing proposals.

The Administration and Senator Bentsen are correct to prescribe a system of tax incentives to encourage compliance with the new federal standards. On the other hand, I do not believe that tax remedies should be the only or principal means of enforcing these new standards and I do not believe that the Internal Revenue Service should be the primary administrative home for the legislation. In this respect I differ with the Administration's bill, S. 1631, and Senator Bentsen's bill, S. 1179. Furthermore, I share the concerns voiced by some critics of S. 4 -- the proposal introduced by Senators Williams and Javits. These critics, who include the Senate Finance Committee in the Report it issued last year on the predecessor of S. 4, have argued: that to house pension reform in the Labor Department as that bill proposes, might without further action require funds to satisfy different and conflicting requirements under different statutes; could fail to take advantage of the priceless expertise built up over the years by IRS in its administration of existing pension requirements; could create two parallel bureaucracies with similarly trained staffs duplicating much of each other's work; and that it would impose on the vast number of private interests affected by the legislation extremely burdensome and expensive requirements of processing and dealing with two regulators, rather than one. I would, however, solve these problems in a different manner than most of these critics, who favor IRS administration of the new law.

My specific recommendations to the Subcommittee are these:

First, Congress should with this legislation establish one set of minimum federal standards that covered pension plans must meet, which standards must determine both whether a plan is entitled to approval by Labor, and whether it merits favorable tax treatment by IRS;

Second, the legislation should provide for both the traditional tax sanctions in S. 1179 and S. 1631, and regulatory sanctions and remedies similar to those established by S. 4;

Third, primary administrative responsibility should be located outside the Internal Revenue Service, in the Department of Labor as proposed by S. 4;

Fourth, consideration should be given to the transfer of IRS pension experts to the Department of Labor;

Fifth, coordination should be assured and duplication minimized by instituting a certification procedure whereby Labor would certify to IRS that particular plans were in compliance with federal standards and therefore entitled to favorable tax treatment.

The Mission of The Internal Revenue Service

These conclusions are based on a sense of the prerequisites necessary to make the new pension reform law work. They are also based on a concern that the Internal Revenue Service continue its generally superior administration of the revenue laws. Administering this new legislation will be a classic regulatory task. But the mission of the Internal Revenue Service is, has been, and should remain, not the conduct of regulation, but raising revenue for the government. Its devotion to this mission should not be diluted by the imposition of regulatory activities such as will be necessary to make this legislation work.[1/]

The complexity of the tax law is well known by this Committee as it has become also well known to the American public.[2/] It is generally accepted that, in our time, simplification (together with other tax reforms) of the tax system is a major legislative target. In the context of the pending pension reform legislation, it is essential to keep in mind that much of the complexity of the tax law derives from its use "to achieve goals entirely unrelated to the raising of the revenue."[3/] Congress should not use this opportunity to add to this complexity, especially when to do so will reduce the opportunity for achievement of the goals of the legislation. The pending legislation has as its principal object the development of a legislative framework to provide increased assurances

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1/ Cf. Joseph H. Guttentag, Letters to the Editor, New York Times, Thursday, November 11, 1971.

2/ See, e.g., A Report on Complexity and the Income Tax, Committee on Tax Policy, New York State Bar Association, Tax Section, 27 Tax L. Rev. 325 (1972).

3/ Id. at 345. See also, Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 Law & Contemp. Prob. 673, 684 (1969).

that a desired social goal will be attained. Aware of the object of the legislation, the major conclusion should easily follow.[1/] Congress should invest the primary responsibility for the laws' administration in the Department of Labor, an agency whose mission is totally consistent with the objects and needs of the legislation.

Of course, regulatory purposes are often achieved in whole or in part through the use of incentives written into the Internal Revenue Code, and that in particular, the regulatory purposes of pension legislation have been and should continue to make use of the tax incentive strategy. Professor Surrey has recently criticized the use of tax incentives to promote various non-revenue social objectives; he has shown that in many cases tax subsidies are inefficient.[2/] Whether or not that particular criticism applies here, as a practical matter tax incentives seem to me to be the price that must be paid

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1/ The remaining inquiries should deal with the questions of how the administration might be accomplished effectively, efficiently, and with a minimum of duplication and other undesirable burdens. Those subsidiary questions will be dealt with at some length hereafter.

2/ Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures," 83 Harv. L. Rev. 705 (1970).

for the continuity and growth of a private pension plan system. This price, I believe, is justified for a system which benefits those who could not or would not otherwise save enough to provide for their welfare after retirement.[1/] However, although the use of the Internal Revenue Code for this non-tax objective may be justified, it does not follow that the Internal Revenue Code should be the repository of the entire law or that the Service need be or should be used to perform regulatory functions or operations incident to the proper administration of the law.

To make this particular regulatory scheme work will require administrative tasks ranging beyond ordinary tax administration. Normally in tax administration the sole aim is to determine whether or not the taxpayer is in compliance with particular legal standards. Where, as here, such determinations are not in themselves sufficient to promote the regulatory aims of a given statutory scheme, primary regulatory responsibility should not rest with the IRS.

1/ Whether the instant subsidy is wholly directed to this valid end is a central issue vis-a-vis the second question this panel has been asked to consider -- concerning the appropriate limitations on deductions on contributions to pension plans. This issue is briefly discussed below at p. 38.

IRS officials approach their job with a mandate very different from that which guides officials in agencies created to promote social or regulatory goals. The revenue official's task is to maximize the revenue of the United States Government. He is directed by law to give priority to that objective and to construe narrowly exemptions, exclusions, and deductions from citizens' tax obligations. Quite the reverse is the attitude with which a regulatory official must view his role. For example, the Social Security Act, whose mission is kindred to the legislation before this Committee, is, as the courts have repeatedly emphasized:

> "to be construed, wherever possible, to the benefit of the plaintiff who seeks its aid. Instead of a strict interpretation, it must receive a liberal construction if the beneficial results for the people are to be obtained." Cancel v. Gardner, 268 F. Supp. 206, 208 (D. Puerto Rico 1967). See also Social Security Board v. Nierotko, 327 U.S. 358, 364 (1946); Celebrezze v. Kilbarn, 322 F.2d 166, 168 (5th Cir. 1963); Pearson v. Gardner, 267 F. Supp. 498, 503 (W.D. Ark. 1967); Blankenship v. Celebrezze, 232 F. Supp. 229, 232 (S.D. W.Va. 1964).

This is the type of mandate which must guide administration of pension reform. It is not the type of approach to which IRS procedures, practices, and traditions are hospitable.

As tax practitioners well know, the Internal Revenue is under-staffed as it is and hard put to manage the massive job of revenue collection and administration. Indeed, the Service's burgeoning work load has recently obliged it to adopt greatly more formalized procedures restricting "oral advice to tax payers." Rev. Proc. 72-3, 1972-1 Cum. Bull. 698, 705. Within the last several months, the technical staff of the IRS, including its Pension Branch, have been urged to strictly follow the published restriction against oral advice. To impose such a procedural straitjacket on relations between the agency administering the new pension legislation and the individuals and organizations subject to its jurisdiction would be impossible; to attempt to do so would stultify the humane purposes of the law. [1/]

Indeed, strains on the agency's resources have dangerously confined its capacity to administer existing pension standards embodied in Sections 401-407 of

1/ Section 306 of S.4 directs that "technical assistance shall be provided to all parties concerned in the efforts "to provide greater retirement protection for individuals . . . ."

the Internal Revenue Code. As recounted by the recent study made by the General Accounting Office for the Senate Labor Subcommittee concerning the activities of all federal agencies dealing with private pension plans.

> "IRS has conducted little investigative or audit activity to ensure that private pension plans are operated in compliance with the tax laws or IRS regulations. This has been due, in part, to the large number of requests for IRS to make advance determinations of the tax status of proposed pension plans. According to an IRS official, these determinations have taken so much time that they have prevented IRS from establishing an effective audit program. In 1969 a total of 156,779 determinations were made." 1/

The Administrative Prerequisites of Pension Reform

Bearing in mind the appropriate institutional limits of the IRS, we can turn to the other side of the coin -- the administrative prerequisites necessary to realize the promise of pension reform. To make this analysis on a systematic basis, we should again begin at the beginning -- by looking to the purposes of the substantive standards Congress is in the process of establishing.

1/ Senate Subcommittee on Labor, Interim Report of Activities of the Private Welfare and Pension Plan Study, 1971 S. Rep. No. 92-634, 92d Cong., 1st Sess. 97 (Feb. 22 1972).

Only then is it possible to design a proper home for their administration. Second, we have to distinguish three questions which have often been confused in the discussion of whether Labor or the Treasury should administer the new pension law. The first question is, what should be the regulatory standards applicable to pension plans generally. The second question is, what kinds of sanctions and remedies should be provided in the statute to make the regulatory scheme work. The final question then would be, how should administrative responsibility be allocated among various agencies. Though plainly related, these issues are in principle quite distinct. Just because tax benefits or sanctions are included in the package passed by Congress, it need not necessarily follow that the IRS must be the primary administrator of the law. We need not, and indeed must not, be restricted in our choice of regulatory tools by our choice of an agency to house the law -- or vice versa.

The Overall Regulating Standards

In large measure, the pending bills have been drafted in a "tail wagging the dog" manner and the proposed revisions would be made in the labor law or in the tax law depending upon the view of whether the provisions should be administered by the Labor Department or by the Treasury. In the case of S. 4, this approach would result in two sets of standards, administrators and rules without any apparent justification in substance. There is no reason why this problem cannot be easily corrected.

Congress must, in the legislation which emerges from the present session to govern the administration of private pension plans, establish a single set of legislative standards. These standards must specify the minimum requirements needed for a pension plan to comply with national policy for the retirement needs of our work force. These standards should determine both whether a given plan is entitled to favorable tax treatment and whether it is to receive the approval of the Department of Labor.

From this starting point, the legislation could move more easily into sanctions, remedies, and incentives in light of the universal standards adopted. From there, a division of responsibilities among or between agencies of government should be made in light of their respective missions and ability to carry out legislative purpose.

Implementing the Heart of the Legislation -- Vesting and Funding

The heart of the new legislation, as it is the heart of all three of the proposals before the Subcommittee, will be minimum requirements for "vesting" and "funding" which, under S. 4, all pension plans will have to meet in order to be "registered" with the Secretary of Labor, and, under S. 1179 and S. 1631, plans will have to meet in order to qualify for the three tax benefits now accorded qualifying plans under the Internal Revenue Code.[1/] The broad purpose of these provisions is not simply to set out the circumstances under which taxpayers may defer, deduct or exclude from their tax-returns, sums which would otherwise be owed to the United States. The provisions are aimed at ensuring that sums of money will reach the American working man, when the

1/ These benefits are: the right on the part of an employer to deduct contributions made to the plan; the right on the part of the employee to defer taxation for the contribution until his pension is distributed; and the right of the plan itself to be exempt from taxation on its income.

time comes for his retirement, so that he can continue to live in self-reliant dignity.

This is the aim which must infuse administration of the law. Though its achievement can and should be enforced in part through the use of traditional tax incentives, this social objective requires much broader supervision than the IRS has been able to provide in its administration of existing pension standards in the Internal Revenue Code. It requires more varied enforcement tools and a more active regulatory posture than the IRS can or should reasonably be expected ever to employ.

The first task imposed on the administrator of the law, whatever version eventually clears the Congress and the White House, will be the analysis of plans to see whether, on their face, they comply with the dictates of the law. In the first instance at least, this demanding and highly technical task will be substantially identical to that performed by IRS officials in their administration of the less stringent and somewhat less (but still) complex provisions of existing law.[1/]

It is obvious that the perspective from which this task is performed will be a most important determinant of whether pension reform will succeed. This means not only that skill and diligence must be shown by officials in examining those plans presented to them, but these officials in their examinations and consultations, should have in mind the overriding purposes of the statutory standards. If virtually all pension plans conform on their face to the dictates and the purposes of the law, then it is clear that we will be a long way toward securing the objectives of the law. If many plans do not conform, then the law will be a failure.

Because of the importance of this facet of the administration of the law, it seems a terrible mistake to discard, as S. 4 appears to have done with respect

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1/ Present law does not require advance IRS approval of plans, but as a practical matter all proposed plans or amendments seek such approval. Examining plan documents pursuant to such requests constitutes the overwhelming bulk of the Service's activities in administering §§ 401-07. See Senate Committee on Labor and Public Welfare, Interim Report of Activities of the Private Welfare and Pension Plan Study, 1971, S. Rep. No. 92-637, 92d Cong., 2d Sess. 97 (Feb. 22, 1972).

to its new standards, the potent spur to initial compliance inherent in the traditional use of a tax incentive. As a practical matter, few plans will be adopted if contributions are not deductible to the employer and deferrable by the employee. Considerable expense and care will be invested in the preparation of plans to prevent any risk of incurring a massive tax liability sometime down the road. The same results may not obtain -- for certainly the same potent incentive to comply will be absent -- if exclusive reliance is placed on judicial remedies such as those provided by S. 4.

However, the administrative tasks incident to implementation of the new legislation will not end with the kind of documentary review which the IRS has traditionally performed in the pension area, and performed with distinction. The second task that will have to be performed in carrying out the basic vesting and funding provisions goes beyond the experience of the IRS under existing law. This task will be the preparation of new regulations to effectuate legislative intent. To be sure, regulation-writing is hardly unknown to the IRS, under the pension or other provisions of the Code. But the regulations required under the new law, especially if its vesting and funding provisions resemble those of S. 4 and S. 1179, should be of an altogether different character than those promulgated in conventional tax administration. The most important regulations promulgated under these bills will be purely legislative. They will require, in addition to expertise of the sort developed by the Service in its administration of existing pension standards, substantial sensitivity to labor-management relations and industry conditions. Many of these plans are the product of collective bargaining conducted by labor and management with the aid of labor lawyers, and in light of labor law principles. Moreover, the proposed legislation will have a substantial impact on collective bargaining itself. For example, under Part C of Title II of S. 4, the administering agency will acquire virtually unlimited legislative power to define the scope of the law. Section 216(a) of Part C authorizes the Secretary to "defer, in whole or in part, applicability" of the vesting requirements of the Act, for a period not to exceed five years; the standard for the exercise of this discretion involves a showing that compliance with the vesting requirements:

> would result in increasing the costs of the employer or employers contributing to the plan to such an extent that substantial economic injury would be caused to such employer or employers and to the interests of the participants or beneficiaries in the plan.

Although Section 216(b) offers some guidelines as to the meaning of "substantial economic injury," the Secretary's determinations will not be significantly dissimilar to those made by Congress in originally framing the statute. These determinations should be made by the Labor Department which is familiar with the collective bargaining process, its requirements and the needs of the parties, as well as the dictates of the legislation.

Under Section 217, which prescribes the terms on which variances may be granted from the Act's funding provisions, the Secretary's discretion is in some respects broader than under Section 216. He may grant up to five consecutive waivers from the funding requirements if he "has reason to believe that such required payments . . . cannot be made. . .," as long as a waiver of such payment will not "adversely affect the interests of participants or beneficiaries of such plan . . . [or] impair the capability of the Pension Benefit Insurance Fund [established by Title IV of the bill]." Section 217(a)(1), (2). Under Section 217(d), the Secretary is instructed, notwithstanding the provisions of the legislation, to:

> prescribe alternative funding requirements for multiemployer plans which will give reasonable assurances that the plan's benefit commitments will be met.

No doubt such broad grants of discretionary -- in effect, legislative -- power are inherent in a regulatory scheme as ambitious as the one we have here under consideration. Similar grants of essentially unlimited power to prescribe the meaning of the law appear elsewhere in S. 4,[1/] and throughout S. 1179 and S. 1631 as well.[2/]

1/ See, e.g., § 210(b)(2)(B), providing that if an amendment after the effective date of the new law "results in a substantial increase to any unfunded liability of the plan, as determined by the Secretary, such increase shall be regarded as a new plan for purposes of the funding schedule . . . ."

2/ See, e.g., S. 1179, § 322(a), amending Internal Revenue Code § 401(a)(12)(B); § 323, amending Internal Revenue Code § 401 with the addition of subsection (j)(6) and subsection (k); S. 1631, § 2(a)(1)(B): "In lieu of the minimum funding standard otherwise provided under this paragraph, the Secretary or his delegate may authorize the use of another minimum funding standard which results in a satisfactory rate of funding."

Such determinations will often involve potentially drastic consequences for the health of large segments of the economy. Necessarily they will depend on judgments about the conditions in an industry, the needs of workers and employers, or the appropriate standards of fairness, which are not at all the kind of determinations which the Internal Revenue Service has customarily been charged with undertaking. It would be unfortunate if this tradition were now breached, at least if there is some other way efficiently to carry out the legislation.

This disadvantage associated with handing over administrative responsibility to the Treasury appears magnified when one considers the third task which will be imposed on the administrator of pension reform. This third task is enforcement -- discovering violations of the provisions and policies of the statute, and reacting to them. As we discussed briefly above, some -- indeed, much -- of this task will be discharged "automatically" in the initial process of reviewing plan documents for compliance with the statute. As we noted above, this critically important aspect of the enforcement function will be most efficiently discharged if compliance is prerequisite to the acquisition of favorable tax treatment. However, enforcement cannot stop with examination of the substantive provisions of plan documents.

Some observers have contended, or assumed, that reliance on a tax strategy for enforcement is sufficient; they have characterized the tax as "self-enforcing." But this, it is clear, is a radical overstatement. The aims of this legislation go beyond securing initial compliance on the face of the document. Indeed, the principal reason why Congress has these bills under consideration is precisely because the promises undertaken by some pension plans have turned out to be hollow in practice, for one reason or another. Basic objectives of the new law will be to assure that paper promises are kept by plan administrators and employers, and, most important, to provide relief for beneficiaries when the promises are not kept.

To attain these ends, it is apparent that the traditional tax sanctions of existing law, and of S. 1179 and S. 1631, are not sufficient. For example, S. 1179 provides that to enforce its funding requirements (Section 324), Section 408 of the Internal Revenue Code shall be added to enable the Secretary, upon a determination that an employer has failed to make the required contributions, (1) to order the plan terminated, or (2) retroactively to include all deductions attributable to the plan in the income of the employer for the five previous taxable years, or (3) to take "such other action as he deems consistent with the purposes of such section." This limited array of remedies -- which are in any event broader than those offered to cope with similar situations by S. 1631 -- would constitute a blunt and often useless instrument. Wherever the employer would prefer to ignore the needs of beneficiaries and accept the loss of favored tax status, the administrator will be without means to promote the basic aim of the statute to assure relief to employees threatened with the loss of their pensions. The administrator will be helpless -- if disqualification from favored tax status is his only resort -- even where the employer has sufficient assets within his control to meet the terms of the statute or of the plan and make required payments to the beneficiaries.

Apart from such catastrophes -- which, it should not be forgotten, it is a central aim of this law to prevent and redress -- the proper implementation of this law will necessarily involve the administering agency deeply in the routine operations of unions, companies, and plans. The administrator will have to play a role of continuous oversight -- investigating, counseling, and pressuring -- to secure compliance or to provide relief. It is no insult to the capability of the Service to state the obvious -- that tax sanctions are often not at all a helpful aid in this type of regulatory work. Indeed, the Senate Finance Committee has made precisely the same observation in criticizing the use of loss of deductions and tax exemptions as a sanction for engaging in prohibited acts of self-dealing by administrators of private foundations:

> On occasion [such] sanctions are ineffective and tend to discourage the expenditure of enforcement effort. On the other hand, in many cases the sanctions are so great, in comparison to the offense involved, that they cause reluctance in enforcement . . . . Where the Internal Revenue Service does seek to apply sanctions in such circumstances the same factors encourage extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.

Senate Finance Committee, Report on the Tax Reform Act of 1969, S. Rep. No. 91-552, 91st Cong., 1st Sess. 28 (Nov. 21, 1969). The Committee's critique of disqualification from favorable tax treatment as a device for regulating private foundations applies with greater force to the pension plan regulation under the new law.

One partial response to this need for graduated and flexible sanctions would follow the solution adopted in 1969 to deal with abuses in private foundations. This would be to empower the Service to assess an array of penalty taxes covering specified categories of abuses for which disqualification would not be an appropriate response.[1/] Such taxes could, for example, be authorized when an employer or plan administrator failed to comply with a lawful order to make required contributions or benefit payments; they could be increased if the delinquency persisted. They would not, of course, have to be assessed against the plan (which would ultimately

1/ The Tax Reform Act of 1969 authorized graduated penal taxes on various types of violations of the Code's prohibitions on self-dealing, and against speculative investments, and restrictions on the use of funds. I.R.C. §§ 4941, 4944, 4945.

harm its beneficiaries) but against the parties responsible for the violation. Indeed, the Administration has included in its bill just such a penalty tax to be imposed on interested persons engaging in self-dealing transactions with pension funds in contravention of the statute. See S. 1631, Section 6, adding to the Code a new Section 4971, imposing an "excise tax [of five percent of the amount involved] on prohibited transactions."

Provisions similar to those provided for the regulation of private foundations by the 1969 Tax Reform Act could be included in the instant legislation. Alternatively, and preferably, amounts in the nature of punitive damages payable to the fund or the beneficiary wronged, would be a useful complement to the sanctions in S. 4. The exclusive reliance in the present version of S. 4 on judicial remedies sought by the Secretary of Labor or by private civil claimants offers the advantage of flexibility in devising remedies. But it also promises delay and disinclination by recalcitrant offenders. Without a scheme of penalty taxes, or without the right to collect punitive damages or fines (not now provided for by S. 4), the administrator of the law will be without adequate means to compel swift respect for its provisions, when he finds a violation.

Administering Supplementary Provisions: Termination Insurance, Reporting and Disclosure, and Fiduciary Standards

Examination of the supplementary provisions of the legislation before the Committee reinforces the conclusion that active, expert regulation, beyond that to which the IRS is accustomed, will be necessary to make pension reform work. Indeed, while the bills conflict as to whether to include certain types of the programs that have been proposed to supplement vesting and funding requirements, they reflect little or no controversy as to where such programs should be administered, if Congress chooses to enact them.

Plan Termination Insurance

Plan termination insurance is provided for by S. 1179 and S. 4, but not by S. 1631 -- though Secretary Shultz stated in his testimony before the Subcommittee last week that the Administration is continuing to study this concept and is not irreversibly hostile to including it in the final legislation. It would seem incontrovertible that this program, if enacted, could not be administered by the IRS. S. 1179 would house it in a new Pension Guarantee Corporation. S. 4 follows the scheme of its other provisions and puts the program under the supervision of the Secretary of Labor. The latter seems clearly to be the superior option. If enacted, termination insurance should be coordinated with the other aspects of the regulatory scheme, especially with its funding component. There is no reason why this coordination should be complicated by an artificial interagency relationship, and no reason why administration of the insurance program itself should not be informed by the expertise acquired by the Labor Department in its administration of the entire legislative scheme -- if the legislation follows S. 4 in giving primary responsibility to the Department of Labor.

Fiduciary Standards, Reporting and Disclosure

Both S. 4 and the S. 1557, the Administration's companion bill to S. 1631, the only bills which provide for new fiduciary, reporting, and disclosure standards, assign these responsibilities to Labor, as they have been assigned under existing legislation. Despite the fact that the Labor Department has been criticized for some aspects of its treatment of these programs,[1] it remains clearly the proper place to house them. The remedy for the inadequacies found in the administration of these requirements by the Comptroller General is not to fragment administration of federal pension standards, but to strengthen the authority of the Labor Department to effectuate their aims, as the present legislation proposes to do, and as both the Comptroller General and the then-Secretary of Labor urged, when the Report was issued.[2]

1/ By the General Accounting Office, in a Report to Congress filed in 1967. Comptroller General of the United States, Review of Certain Activities Related to Administration and Enforcement of the Reporting and Bonding Provisions of the Welfare and Pension Plans Disclosure Act of 1959, in the Labor-Management Services Administration of the Department of Labor (March 1967).

2/ Id. at 2, 25-27.

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Coordinating Labor and IRS Activities
Under the Legislation

To be effective, the new law needs to be backed up by all three of the types of sanctions we have discussed -- disqualification from favorable tax treatment, standard judicial equitable remedies and damage awards, and either penalty taxes, administrative fines, or punitive damages. In addition, the law requires the active supervisory posture that only a genuine regulatory agency can provide. It requires expertise in industrial conditions and employment relationships. And it requires the priority and prestige within its administering agency that can only come if pension regulation is concentrated primarily in a single agency, and in one which can comfortably regard the law as harmonious with its own general mission, history, and constituency.

All these considerations seem to require that authority over the administration of federal pension standards be concentrated in the Department of Labor. None of the bills before the Subcommittee, not even S. 4, have gone as far in this direction as the new law will require.

The failure of the present proposals to provide the full complement of remedies and regulatory power to promote the aims of pension reform stems, perhaps in part, from the confusion referred to earlier between standards, sanctions, and administration. All the competing proposals apparently share an assumption that tax sanctions would be inappropriate in a bill to be administered primarily by the Labor Department, and, conversely, that judicial remedies would be inappropriate in a bill to be administered by the IRS. But these assumptions seem unjustified. If Administrative responsibility were concentrated in Labor, there is no reason why tax sanctions cannot be retained in the legislation.

As previously discussed, Congress should establish a set of standards applicable generally to private pension plans. Then the only difficulty created by a regulatory scheme based on this comprehensive array of standards, sanctions, remedies, and supervisory capacity on the part of the administering agency, would be the problem of coordination between Labor and IRS. It is not impossible to solve this problem. But it can only be solved if Congress seizes the occasion and dictates the solution itself, rather than passing the buck to the two agencies to attempt to work out through bargaining.

Further, Congress must specify that, since the Labor Department is to be the primary home for pension administration, it shall have the power to certify to the Internal Revenue Service that a particular plan meets federal statutory standards. There is precedent for making tax determinations based upon regulatory determinations of agencies other than the IRS. For example, Sections 851-55 of the Code define the tax status of regulated investment companies. Under Section 851(a)(1) the SEC determinates whether particular companies can qualify as regulated investment companies by determining whether they are to be registered under the Investment Company Act of 1940 as a "management company" or a "unit investment trust." Similarly, Section 1071 provides that the IRS treat as involuntary conversions of property under Section 1033 any sale or exchange of property certified by the FCC to be "necessary or appropriate to effectuate a change in policy by that agency." Section 1081 precludes taxation of transfers of corporate units of registered holding companies made "in obedience to an order of the Securities and Exchange Commission." Section 1101 forbids taxation when a bank holding company transfers property to a shareholder therein, when the Federal Reserve Board has certified that the transfer is "necessary or appropriate to effectuate section 4 of the Bank Holding Company Act of 1956." And Sections 1242-43 prescribe special tax treatment for companies operating under the Small Business Investment Act of 1958. If Congress provides such a structure for the new legislation, it will meet the administrative needs of pension reform, without creating insuperable interagency difficulties.

Objections to Labor Department Administration of Pension Reform

A number of critics have raised various objections to the concept of conferring primary administrative responsibility for the new pension law on the Department of Labor, as that concept is presently reflected in the provisions of S. 4. Many of these objections have substance, as applied to S. 4. However, each of the substantial difficulties with Labor Department primacy will be eliminated by the administrative framework outlined above.

Many critics of S. 4 have argued that turning the new legislation over to Labor will squander the expertise acquired by the IRS in its administration of existing pension standards in Sections 401-07 of the Internal Revenue Code. This, plainly, is a weighty objection. But it can be met. The way to avoid wasting the expertise of IRS' Pension Trust Branch is not to burden IRS with administrative duties which it is ill prepared to discharge. Much less is it to rob the new pension law of essential enforcement support. The proper solution is to consider transfer of these experts to Labor, where they would become a major part of the larger office devoted to pension plan administration. Numerous such transfers have been accomplished in recent years. Various units, for example, have been transferred from the United States Department of Agriculture, from the Food and Drug Administration, and from the United States Public Health Service to form the new Environmental Protection Agency. Similarly, bureaucratic relocations were part of the formation of the Department of Housing and Urban Development and the Department of Transportation. Such moves are underway right now, as the Nixon Administration dismantles the Office of Economic Opportunity and assigns its programs to older departments. There is no particular reason why such a transfer could not be arranged to make pension reform work as the American people expect it to.

A second set of objections to S. 4 expresses fears that employers and plan administrators will be subjected to the burden of complying with dual regulatory requirements, of filing dual reports, of meeting differences in coverage, and possibly even of coping with conflicting agency demands. Even without the consolidation of substantive standards and administration which is urged herein, much of the burden of dual administration could be eliminated by sensitive interagency cooperation. Even under present practice, Labor and IRS have attempted with general success to coordinate overlapping requirements of existing law. For example, the Service has ruled that the information forms filed with Labor pursuant to the Welfare and Pension Plans Disclosure Act will partially satisfy the requirements of the Internal Revenue Code with regard to information that employers must furnish in claiming deductions under Section 404. Rev. Proc. 66-51, 1966-2 Cum. Bull. 1261.

However, as noted previously, it would be a disservice to the beneficiaries of this legislation, the taxpayers, and to regulated individuals and organizations, to leave the job of coordination to the two agencies involved. The proper way to solve the problem of dual requirements is to eliminate the problem here and now. Congress should set forth one set of substantive standards to guide pension regulation, making necessary modifications and deletions from the pertinent existing sections of the Internal Revenue Code in the process, and confer primary authority to administer this unified body of standards on one expert agency, the Department of Labor. In this event, fears about the chore of coping with two sets of requirements and two sets of bureaucratic officials will, for virtually all intents and purposes, disappear.[1/]

Finally, the objection has been raised that Labor Department Administration of the legislation would forsake the valuable enforcement device of tax incentives. This objection is set out with particular cogency in the pamphlet summarizing the proposals for private pension plan reform prepared for the use of this Subcommittee by the staff of the Joint Committee on Internal Revenue Taxation:

> S. 4 would . . . adopt a fundamental change in the approach toward enforcing the pension provisions. For over three decades, withdrawal of the tax advantages associated with qualification has been the basic method of

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1/ For example, concern has been raised about conflict between the present S.4, which covers only plans with 25 or more participants, and the qualification standards in the Code, which extend to all plans. The proper way to deal with such problems is to give Labor authority to set standards for all plans, with authority to relax the generally applicable requirements in the case of plans below a certain size. The break-point of 25 participants would be a sensible distinction.

> enforcing the nondiscrimination rules of the Internal Revenue Code, which are designed to insure that pension plans are actually for the benefit of the rank and file employees. In general, this has been an effective tool since the withdrawal of qualification can result in the denial of deductions for employer contributions to the plan and the loss of exemption of the plan's earnings. The fact that such drastic penalties may be imposed for noncompliance provides a substantial inducement to meet the required tests for qualificiation. In contrast, under S. 4 the Labor Department would have to get a court order to enforce compliance where plans are not living up to these requirements. It is not clear how large an investigative staff would be required for this. In part this is because it is not clear whether employers would make changes voluntarily (as they do to avoid loss of tax deduction) or whether in the case of many of the requirements they would wait until an investigation is made by the Labor Department personnel. 1/

As stated previously, this criticism of S. 4 is justified. It would be folly not to use a tax incentive strategy as part of the enforcement program for the new provisions of the legislation. But this conclusion does not compel us to keep administrative responsibility for setting standards and invoking either tax sanctions or other necessary sanctions and regulatory devices in the

1/ Joint Committee On Revenue Citation Summary of Proposals for Private Pension Plan Reform 14 (Comm. Print, May 16, 1973).

Internal Revenue Service. This authority can and should be housed in Labor. Residual authority to determine primarily tax matters (an area to be worked out after adoption of general standards and after further study) would remain with IRS. But the basic responsibility for interpreting Congressional standards for pension plans, and applying them to determine whether individual plans qualify, should go to Labor.

Traditional tax incentives are necessary to make pension reform work, but they are not sufficient. Without a full complement of sanctions, remedies, and without active regulatory supervision, the aims of this legislation will not be wholly achieved. The proper institution to equip with this array of enforcement tools is that agency in our government whose main mission it is to regulate on behalf of the working man -- the Department of Labor.

Afterword: Limitations on Contributions and Deductions

This statement, as suggested in the invitation in Chairman Nelson's letter of May 18, concentrates on the first of the two questions with which this Panel will deal. A few words should be added, however, with regard to the second question -- whether and how Congress ought to set limitations on the amounts which can be contributed to qualifying pension plans of the various types included in the present Code provisions and in the proposals before us, and/or whether there should be similar limitations on deductions for such contributions. Answering this general question involves two sub-issues: first, whether there should be equality of treatment for all taxpayers, whether they are self-employed, or employed by large corporations, small corporations, or professional corporations; and, second, whether limitations should be set in order to confine the tax subsidy involved to individuals who would probably not be able or likely to set aside adequate retirement savings without the incentive -- that is to say, whether wealthy individuals deferring large amounts of income should be barred from making use of a subsidy except on a limited portion of the income deferred.

On the first of these two questions, there is no apparent reason why there should not be equlaity of tax treatment. If it is important to the society to encourage providing for retirement through tax subsidies, then it is important to encourage such provision for all individuals, whether or not they happen to work for a particular type of employer, or whether they are self-employed. With regard to the second question, whether there should be maximum limits on the sums of deferred income benefiting from tax subsidies, it seems that in principle at least, the answer is equally clear. There is no justification for a tax-break to help the wealthy save for their retirement -- when they would be able to provide for a secure and comfortable retirement without any assistance from the tax code. It is simply a device for taking money out of the pocket of the ordinary taxpayer and putting it in the already well-filled pocket of the rich man. Such wealth transfers serve no legitimate individual or social needs. Hence, in order to establish equality of treatment for variously employed taxpayers regarding the tax status of deferred income, Congress should revise downward the limits on contributions and deductions in areas where they are presently high, rather than revising upward these limits in areas where they are low.