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PENSION PLAN COMPLEXITY

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

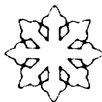
SECOND SESSION

ON

S. 2901 and S. 2902

AUGUST 3, 1990

(Part 2 of 2)



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PENSION PLAN COMPLEXITY

FRIDAY, AUGUST 3, 1990

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-214, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Also present: Senator Heinz.

[The press release announcing the hearing follows:]

[Press Release No 48, July 27, 1990]

FINANCE SUBCOMMITTEE TO HOLD HEARING ON EMPLOYEE BENEFITS; CHURCH PENSIONS SIMPLIFICATION, FLEXIBILITY AND WORKER PROTECTION ARE GOALS, PRYOR SAYS

WASHINGTON, DC.—Senator David Pryor (D., Arkansas), Chairman of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Friday announced a Subcommittee hearing on S. 2901, the Employee Benefits Simplification Act, and S. 2902, the Church Retirement Benefits Simplification Act.

The hearing is scheduled for *Friday, August 3, 1990 at 9:30 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

"Since ERISA's enactment in 1974, the private pension system has become increasingly burdensome as Congress and the Executive Branch have added layer after layer of complexity and regulation. This bill attempts to peel back some of those layers," Pryor said.

"In drafting this legislation, we have attempted to juggle the often conflicting policy goals of simplification, flexibility and worker protection. I believe we have reached the proper balance. I anticipate that as the process unfolds, we will find additional pension rules ripe for simplification. I look forward to working with all interested parties to rationalize and simplify the existing pension rules," Pryor said.

"This legislation is not pro-labor or pro-business in its approach; it is pro-simplicity and should have a positive effect on the entire pension system for everyone involved," Pryor said.

S. 2902 would help simplify pension rules for churches.

"The bill would consolidate and rationalize the often complex and unworkable pension rules as they apply to churches. The bill recognizes the unique structure and role of the church in our society and makes changes in the pension rules so that they can be applied to churches in an appropriate and workable manner," Pryor said.

OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS, CHAIRMAN OF THE SUBCOMMITTEE

Senator PRYOR. Good morning, ladies and gentlemen. We welcome you to this hearing. I did not in my wildest imagination know that there were so many people interested in pensions and retirement, but evidently, Senator Jeffords, there is a large number.

Last March this subcommittee held a hearing on the administration and the complexity of current pension law. We heard from witnesses with a wide range of interest and virtually all agreed that current pension law is enormously complex. It is very costly, and very confusing.

Since that hearing in March we have consulted with a wide range of interested parties to develop legislation which would simplify major components of current law. We have learned that simplification is not simple. Balancing flexibility, simplicity, and worker protection are not easy. We believe, however, that the Employee Benefits Simplification Act, S. 2901, which I introduced last week constitutes a significant first step toward reducing the complexity of present pension rules.

I am also pleased to announce that 11 members of the Finance Committee are co-sponsors of this legislation. The majority of S. 2901 focuses on areas of current law, where considerable complexity and inconsistencies could be eliminated. These include the definitions of compensation, highly compensated employees, modification of planned participation requirements and simplification of distribution rules that generally permit beneficiaries to roll over any portion of a distribution to an IRA or another qualified plan.

In addition, the legislation addresses a number of policy issues which will correct problems or clarify the law in areas such as the full funding limit of multi-employer plans, permitting excess benefit plans for State and local governments and the right to have VEBA's on a national scale.

Finally, the Employee Benefits Simplification Plan contains a provision which would encourage savings, an issue that has been of great concern to the Chairman of this committee. The bill would require preretirement lump sum distributions to be rolled over to an IRA or other qualified pension plan. Recent evidence suggests that preretirement distributions are becoming more prevalent and that these distributions are frequently not saved until retirement.

Secretary Dole has raised important questions on this issue about the need to preserve retirement income and to expand pension coverage. We look forward to hearing the Department of Labor's views on S. 2901 as it relates to these particular provisions.

This morning we will also hear a panel discussing S. 2902, the Church Retirement Benefits Simplifications Act. This legislation would modify existing law to bring greater consistency and clarity. Because of the unique organizational structure of churches, current pension law is often inappropriate and unadministrable, but we believe S. 2902 would correct these problems.

We are pleased this morning to be joined by Senator John Heinz of Pennsylvania, who has been long active in this area. I would like to just say to Senator Heinz, it is been a pleasure to work with him. I hope to have his support on this bill and I hope that his support will be forthcoming. He may have some particular issues that he may want to raise about specific parts of the legislation.

I would just say to my friend, John Heinz, that I'm very pleased that we have several organizations now in support of this legislation. Just to name a few: the American Federation of State, County, and Municipal Employees; the International Association of Firefighters; The National League of Cities; the National Confer-

ences of State Legislatures. This morning I also received an endorsement from the Mail Handlers Union, and on and on.

We will have other organizations this morning testifying who will be in support of this legislation. We do look forward to Senator Heinz' involvement and now his statement, and then we will hear from Senator Jeffords.

[The prepared statement of Senator Pryor appears in the appendix.]

Senator PRYOR. Senator Heinz, we welcome you.

OPENING STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM PENNSYLVANIA

Senator HEINZ. Mr. Chairman, I almost sense you are sending to me an offer that you would like me to accept, and indeed at some point I may take you up on that. I do thank you for calling these hearings and for introducing the two bills. It is clear that overly complex regulations have created serious problems for pension plans in this country, and if I might just say so on a personal note, Mr. Chairman, it is always a pleasure working with you, not only on this subcommittee but on the other committee you Chair and on which I am ranking, the Special Committee on Aging. Over the years, I think we have made a significant contribution. You have helped me many times and, I trust, I have reciprocated.

Senator PRYOR. Thank you, sir.

Senator HEINZ. I would like to observe that even experts in the employee benefits area often throw up their hands in disgust at the paper barriers of pronouncements, rules and regulations that block the portal to effective plan formulation for the small business. The task often proves far too cumbersome.

In addition, as Senator Pryor mentioned, places of worship have found that pension rules are generally lengthy and complex and are for the most part designed for for-profit, commercial employers. Such rules are inappropriate to the special needs that these institutions have, and they do inordinately strain their meager administrative resources.

On this point, I'm looking forward to hearing the testimony of my constituent, Mr. Arthur Ryan of Bala-Cynwyd, PA, chairman of the Church Alliance Steering Committee, and the testimony of others on this important issue, although I would note that the Senate is not going to be very cooperative and various votes are expected this morning.

Mr. Chairman, small businesses in Pennsylvania have been adversely affected by overly complex regulations. For example, one of my constituents, who owns a foundry employing 70 workers, has had to change his company's pension plan three times since 1976 and now faced with yet additional changes to comply with the law, he is considering canceling his company's plan altogether. That is clearly a counterproductive effect. The Federal Government's apparent inability to write simple, effective tax laws could leave, in this case, some 70 working Americans without the umbrella of pension protection in retirement. Much of the blame for lack of guidance lies with the Internal Revenue Service for dragging its feet on drafting final regulations.

The IRS puts Congress in the position of legislating in a vacuum and it is America's workers who suffer, but Congress deserves some of the blame, too, because we are the ones who increasingly change the law. Our goal should be to increase, not reduce pension coverage by small business. Small businesses create, as we know, the vast majority of new jobs in this country, but the data also shows that workers in small firms are only half as likely as those in large companies to be covered by pensions.

On this point, I should like to compliment Secretary of Labor, Elizabeth Dole, for the work she has done in suggesting ways to improve pension portability, a crucial step in the direction of increasing pension coverage by small businesses.

Increasing pension portability has been an important goal for me over the years and I continue to consider options to achieve that goal. I also share the concern that Secretary Dole has expressed about the use of lump sum distributions. The data reflects that roughly 80 percent of these lump sum distributions are spent rather than being saved in a new retirement plan and we need to resolve the issue of distribution rollovers so that pension benefits are accrued as workers move from job to job in our increasingly mobile society.

Mr. Chairman, I also want to note that I am somewhat troubled by criticism of Section 105 of the Employee Benefits Simplification Act, providing for a 401(k) safe harbor provision that reduces the minimum number of employees required for a plan to be qualified. I am concerned that reducing the minimum number may cause lesser pension coverage of lower compensated employees in some small business pension plans.

In addition, the employer matching provisions might even discourage employers from including lower compensated employees in a plan. That is clearly not the direction any of us want to go and we should try and find a solution to that problem.

I also want to thank you, Mr. Chairman, for considering the important issue of Section 415 limits in pension benefits for State and local Governments, and no doubt that is why you had such a sterling list of endorsements. I too have received correspondence, in this case a joint letter from the Pennsylvania State Employees Retirement System and the Pennsylvania Public School Employees Retirement System criticizing the application of the 415 limits to State and local government pension plans. Those two organizations have a combined membership of nearly half a million people and if a single member's pension violates the Section 415 limits, then the entire benefit plan could lose its qualified status. That is a serious problem and it needs to be addressed.

Finally, Mr. Chairman, I just want you to be aware that the Pennsylvania Rural Electric Association, and I know you have a very strong Association in your State of Arkansas, supports the affiliation requirement provisions for a Voluntary Employee Benefit Association (VEBA), found in Section 305 of the bill, as well as the in-service distribution provision found in section 309. These are the kinds of simplification initiatives we do need in order to enable small employers to band together to reduce their employee benefit costs and, of course, rural Americans have a long tradition of banding together for the common good. Simplifying employee benefit

laws, such as these two provisions do, can help rural American take part in the economic expansion that has benefited the rest of the Nation.

So, while these bills do deal with some very important and substantive aspects of the Internal Revenue Code in a positive way, generally, I just want to also observe that the bills do not address two other issues: One, why small businesses do not offer more in the way of pension plans or two, the issue of real portability, which is necessary to increase retirement security.

I hope we can find ways to address those two issues as well, because if we do not, the pension system may well grow bigger, but it will not necessarily grow better.

Mr. Chairman, thank you very much.

Senator PRYOR. Senator Heinz, we thank you.

Senator Heinz, we are joined this morning by Senator Jeffords of Vermont. When Senator Jeffords was Congressman Jeffords, he was a leader in this whole field of pensions and retirement. He is not only very knowledgeable, he is very committed to a more simplified and a fairer system.

Senator Jeffords, we appreciate you here. We also deeply appreciate your co-sponsorship of this legislation. We look forward to hearing your statement.

STATEMENT OF HON. JAMES JEFFORDS, A U.S. SENATOR FROM VERMONT

Senator JEFFORDS. Thank you, Mr. Chairman. I will be brief. We have enjoyed working with you and your committee in trying to bring forth a piece of legislation which we believe will be very helpful and I think we have succeeded in doing that. I am proud to be part of it.

Senator PRYOR. Thank you.

Senator JEFFORDS. I am sure that Senator Heinz will recognize its great value very quickly and join with us.

The Employee Benefits Simplification Act is an idea whose time has really come. I just cannot tell you how important, I think, this piece of legislation is. Furthermore, I am delighted that you have also included pension portability provisions in this bill. For a successful national retirement income policy we need greater portability of pension assets.

Portability is best achieved by encouraging the preservation of pension income and the development of portable pension plan accounts. The distribution and Simplified Employee Pension (SEP), rules contained in S. 2901, will go a long way toward achieving this objective, and thus, help ensure retirement income security for millions of Americans. As you know, and you have already mentioned, I am outspoken advocate of the need to encourage the portability pension assets. I have had portability legislation passed twice by the House, and marked up twice by the Senate Labor Committee. In the course of my efforts, I also testified before this Senate Subcommittee on Taxation Debt Management on pension portability in 1988. It is a pleasure to be here today to testify on specific Senate Finance legislation to deal with the issue.

I commend you, Senator Pryor, for your initiative and am pleased, as I said, to be a co-sponsor. I would also like to acknowledge Secretary of Labor, Elizabeth Dole, for her diligent examination of the pension portability issue. This bill in many respects parallels both the Secretary's and my own previous recommendations in this area. I firmly believe that S. 2901's distribution rules, nondiscrimination safe harbors, and qualification requirements for salary reduction steps are a step forward in the development of a sound pension policy.

I do, however, have two suggestions in modifications and the remainder of my remarks will concentrate on these, and, again, I will be brief.

My first point is related to my belief that it is important to encourage the retention of spousal distribution rights for pension money transferred to IRA accounts. Statistics from the Older Americans League show that divorced and widowed women over 65 are the poorest people in the Nation. At present 70 percent of all older non-married women rely on Social Security as their primary source of income. In order to encourage spousal protection, and at the same time provide employers some flexibility, I would allow employers the option of directly transferring the pension accounts of terminated employees into other pension plans or IRA's that provide for the same joint and survivor annuity options as provided by the plan. I am deeply concerned about the general law in this regard, which provides for inadequate protection of spouses.

Secondly, in addition, I wish to point out that S. 2901 in its current form does not permit the transfer of after-tax employee contributions into eligible transferee plans. Employee after-tax contributions were especially popular in the manufacturing companies prior to 1986. Employees who saved after-tax monies for their retirement should not be forced to spend their after-tax distribution money because they cannot put the money into an IRA account. This makes no sense, especially since non-deductible contributions to IRA's are permitted and must be accounted for separately under current law.

It is ironic that instead of encouraging people to save after-tax money for retirement purposes, current law instead discourage them. Certainly this is no way to further our main pension policy goals regarding the preservation of pension assets and pension income for retirement purposes.

I understand the reason for this is, the revenue ramifications and I am somewhat confused about this because when we successfully got the bill passed by the House, the revenue ramifications were considered not to be a major concern. Now I understand that the ruling has been reversed. However, I believe this ruling is an example of the very serious problem of allowing a revenue policy to dictate pension policy.

In conclusion, I would just like to point out that we are—as a nation, we must prepare to successfully meet the challenge posed by our Naticn's challenging demographics. By the year 2025, the average life expectancy of a 65 year old will be 20 years. In addition, the ratio of active workers to retirees is expected to go from 4 to 1 to 2 to 1. Given these facts, intelligent public policy necessitates we do all we can to ensure that baby-boomers prepare now

for when they retire tomorrow. This means we must legislate in an unaccustomed way with an eye towards long-term results rather than just short term problems.

The distribution, nondiscrimination and covered rule changes proposed in the Employee Benefits Simplification Act are important steps in this direction. These provisions will help reverse two disturbing pension policy trends. One, the high rate of consumption of cashed-out pension contributions. And, two, the stagnation in pension plan coverage.

I deeply appreciate this opportunity to be before you. I look towards working with you on your committee and on my committee to make sure that we do make this bill a reality, and especially as I mentioned on the pension portability aspects of the bill.

[The prepared statement of Senator Jeffords appears in the appendix.]

Senator PRYOR. We are honored to have your participation, Senator Jeffords.

Senator JEFFORDS. Thank you, Mr. Chairman.

Senator PRYOR. We are also very pleased to have your constructive thoughts on how we might improve this legislation. This legislation had a gestation period, I think, of about 7 or 8 months. We talked to a large number of groups and individuals throughout the country, trying to find that balance simplicity in the system that, in fairness, you have always sought to achieve.

We thank you for your help.

Senator JEFFORDS. Thank you, Mr. Chairman.

Senator PRYOR. Thank you, sir.

Senator JEFFORDS. I just want say that I am as impressed as you are with the number of people here today. Unfortunately, pension policy usually brings ho-hums and a sleep period when you talked about, but the enthusiasm that I see in the eyes of the people here demonstrates that perhaps we are moving in the right direction.

Thank you very much.

Senator PRYOR. These issues are an alphabet soup, and I am constantly having to be reminded and educated on what all these terms mean and I am not sure I know yet, but I am trying to learn.

Thank you, Senator.

Senator JEFFORDS. Thank you.

Senator HEINZ. Mr. Chairman, before the Senator from Vermont leaves, may I just make a comment?

Senator PRYOR. Senator Heinz.

Senator HEINZ. You quite correctly observed that the Senator from Vermont, when he was in the House, was a great leader in these issues, and I do not want anyone to think that Senator Pryor meant that just because he moved from the House to the Senate, that he did not also bring with him the same diligence, expertise, creativity, and thoughtfulness that he had in the House. Simply becoming a Member of the Senate did not, I do not feel, in any way detract from his ability or effectiveness. Indeed, he keeps growing and we are all very delighted to serve with him.

Senator JEFFORDS. Thank you very much. I appreciate those words and I look forward to working with you.

Senator HEINZ. Thank you.

Senator PRYOR. Thank you, Jim.

Ladies and gentlemen, now we will call our first witness, Mr. Thomas Terry, U.S. Treasury Department Employee Benefits Counsel.

Mr. Terry, we welcome your statement this morning. We are going to have the 5 minute rule. I think you have been advised of that. We will put the entirety of your, and every witnesses, statement in the record. If you would summarize your statement and position, we would appreciate it. I know on our first witness you have some concerns, and we look forward to your statement.

STATEMENT OF THOMAS D. TERRY, BENEFITS TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. TERRY. Thank you very much, Senator. I appreciate it.

As you know, S. 2901 has some 18 substantive provisions and the administration's position on each of those provisions is covered in my written statement. I appreciate your introducing my full statement in the record and I will, as you request, summarize my thoughts and the administration's position on certain portions of the bill which we feel are especially significant. I will also very briefly comment on S. 2902, the Church Retirement Benefits Simplification Act.

The Internal Revenue Code provisions relating to employee benefits have become increasingly complex in recent years. Although the diversity and sophistication of the entire employee benefit plan universe makes it impossible, I think, for these rules ever to be truly simple, we believe, as you do, that there is very much that can be done to simplify this state of affairs. I believe there is a growing recognition, both inside and outside of government, that we must accord a higher priority to simplification in this area than we have in the past. Of course, I must emphasize that in the current budgetary environment simplification initiatives like all other worthwhile legislation are constrained by the realities of the Federal Budget.

We would like to commend the Chairman and Representative Chandler, who has introduced the companion bill in the House for putting forward a series of specific proposals for simplification. I think the time has come for simplification.

The first specific provision of S. 2901 which I would like to address, is Section 201 dealing with the simplification of the taxation of distributions from tax-qualified plans. The administration believes that these rules are truly excellent candidates for simplification; one reason being that these rules are a burden under existing law for many unsophisticated taxpayers. We believe that in order to achieve really meaningful simplification in this area, consistent with tax and national retirement income policies, four things should be done.

First, the special averaging rules for taxing lump sum distributions ought to be eliminated.

Second, the ability to rollover otherwise taxable distributions ought to be expanded.

Third, the special rules for deferring tax on net unrealized appreciation on employer securities ought to be eliminated.

And finally, the grandfather rules, which were added by the Tax Reform Act of 1986, including the 10-year averaging grandfather rule that applies to some taxpayers, ought to be eliminated.

Section 201 of the bill accomplishes the first two objectives. However, the bill would leave intact the complicated special rules for employer securities and the 1986 grandfather rules. And we believe strongly the elimination of those rules is also necessary to complete the simplification job in this area.

The next area I would like to comment on briefly is Section 105 of the bill. Under current law, contributions to 401(k) plans and plans with matching contributions are required to satisfy certain objective nondiscrimination tests. These are the so-called ADP and ACP tests. The bill would add a design based safe harbor as an alternative to these testing procedures. The bill zeros in on these tests as the predominate source of complexity in the operation of 401(k) plans, apparently on the premise that the recordkeeping and computations involved are unnecessarily burdensome.

We believe the problem is somewhat narrower, and the narrower problem can and should be fixed without abandoning the tests themselves. Specifically, we think the mechanisms allowing correction of mechanical test failures which are available after the end of the year may be the most serious problem.

All of the data that we have seen points to the continuing growth in popularity of these 401(k) plans, and that is true even after the 1986 act tightened up the rules considerably. Employers continue to adopt these plans and to encourage their lower paid employees to participate in order to satisfy the nondiscrimination tests in current law. We believe this system of providing incentives to encourage lower paid employees to save for their retirement is working well and should not be changed.

Basically, we believe strongly that a test which ensures actual participation by lower paid employees is essential to justify the tax expenditure which is associated with these plans. Therefore, we must oppose Section 105 of the bill. However, we would be very happy to work with the subcommittee to improve the way existing law works and we have some specific ideas, Senator, which we have included in my written statement.

I might add, Mr. Chairman, that we are now in the process of finalizing our own regulations under Section 401(k) and the bill that you have introduced has been very helpful in focusing our attention on some of the problem areas.

Senator, if I could have——

Senator PRYOR. Go ahead and take another minute.

Mr. TERRY. Thank you, Senator.

I would mention two other areas on the simplification front. We believe the improvement in definition of "highly compensated employee," which is contained in Section 101, is very sound and we encourage a change in that direction. We have a couple of specific comments on the proposal which are included in my written statement.

Section 102 of the bill would adopt a uniform definition of "compensation" for various employee benefit provisions of the Code. We looked at this issue very carefully when we were preparing our regulations and we struck a different balance than the section in the

bill did. We believe that the current definitions and regulations are better under the circumstances and, therefore, we see no need for legislation in that particular area.

Finally, with respect to church plans, we do not believe that a case has been made for the exemption and special rules that appear in the bill. From our standpoint, church employees are entitled to the same safeguards as employees of other organizations. Therefore, we oppose S. 2902.

Senator, we welcome the opportunity to work with you and the subcommittee and we think there are a number of things about S. 2901 which are very helpful and merit careful consideration. Thank you very much, sir. That completes my statement. I would be happy to answer any questions.

Senator PRYOR. Mr. Terry, during the process of developing this legislation and evolving to this point, we have attempted, and I must say without any success, to have the Treasury Department become involved in the development, of a legislative proposal. This morning you come to the committee with a few words of praise, but basically, about 90 percent of criticism, and I think it is a very unfair situation that you present.

For one thing, you State that you are in the process now of doing more regulations. This has been going on for as long as I can remember. All I can assume is, if history is going to repeat itself, that we're going to see another 100 pages of regulations on an area that is already over-regulated.

Do you have a comment on this?

Mr. TERRY. Yes, sir, Mr. Chairman, I do.

With due respect, I don't believe the number of pages in the regulation necessarily indicates the complexity. From my experience—I just got out of private practice last February, I sometimes felt that more specificity was helpful and was more simplifying than perhaps just a few pages. So I think in a sense, Senator, simplicity is in the eye of the beholder.

Senator PRYOR. I have never seen the Treasury Department do anything simple and I don't think this is going to be any exception. I really feel that you have come this morning to sort of slow down the process—not you yourself, but speaking generally for the Department that you represent and for the executive branch—that you have come here to nit-pick what I truly believe has been a constructive attempt to deal with a very, very complex problem.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I would like to return to the substance of the 401(k) safe harbor provision that you mentioned a moment ago. I think that is Section 104 or 105. Which section is that?

Mr. TERRY. The Section dealing with 401(k), Senator Heinz, is Section 105.

Senator HEINZ. 401(k) plan tests, as I understand them, currently require a certain percentage of non-highly compensated employees to participate in order to qualify. Senator Pryor's bill proposes a safe harbor employer matching contribution which as I understand it is 100 percent of the first 3 percent; 50 percent of next 2 percent to qualify.

Thus, coverage is reduced for lower-income employees or at least that is my surmise as to the big risk here. The employer's incentive will actually change from encouraging low-income participation in order to qualify to discourage participation to save money on the matching contribution.

Am I correct in my analysis or am I off base?

Mr. TERRY. Mr. Heinz, I agree with your analysis. I believe that one of the most important things, given the great success that we have for 401(k) plans, that is the expansion of those plans, is the incentives which this existing system has to encourage low-paid people to come into the plan.

I agree with your analysis.

Senator HEINZ. Having provided that analysis, nevertheless, I want to do what Senator Pryor wants to achieve, which is to increase plan formation. But I am equally concerned about lowering participation and benefits for lower income employees. Is there some way we could make adjustments to his proposal that will achieve both goals?

Mr. TERRY. I think there is, Senator Heinz, and we have suggested it in our written statement. I believe that if you were to keep the ADP/ACP tests of existing law, but to calculate the test by looking at last year's results, that would provide a certainty, which I believe S. 2901 is looking for and still maintain the incentive for participation by the low-income individual. So I think we do have an idea which, I believe, does achieve both objectives, your objectives and the objective of certainty that S. 2901 desires.

Senator HEINZ. But if all we do is look at last year's results, that may encourage people who now have plans to continue them but it may not solve the other issue, which is how do we get additional plan formation?

Mr. TERRY. There has been to date no problem with additional plan formations as far as Section 401(k) is concerned. There is included, for example, in my written statement some statistics that we have from the Internal Revenue Service that show these plans are just continuing to expand. So I do——

Senator HEINZ. That may be, but often they are expanding because people are getting out of defined benefit plans and are setting up alternative plans: 401(k)s. I would not say that 401(k)s are working wonderfully well. It may be that other parts of pension law are terribly burdensome which is something that I know Senator Pryor and I believe.

Mr. TERRY. Certainly the regulatory requirements on defined benefit plans are more burdensome. However, my experience is that many of these 401(k) plans are add-on plans. They do not replace a defined benefit plan, a traditional defined benefit plan, but they are added on in addition to a defined benefit plan. So I'm not sure that the statistics, Senator, will bear out that the 401(k) plans inevitably replaced defined benefit plans. That would not be my sense.

Senator HEINZ. I did not say that either. I was just saying that there are people drifting into 401(k)s as they drift out of defined benefit plans. Like you, I do not have the exact statistics and obviously that is not the only reason for the formation of 401(k)s, but I

would like to have an idea of how many people who have formed 401(k)s, once were covered by defined benefit plans.

Mr. TERRY. I do not have those statistics today.

Senator HEINZ. Maybe you could get that for us?

Mr. TERRY. Yes, sir.

Senator HEINZ. All right.

Mr. TERRY. Thank you.

Senator HEINZ. Mr. Chairman, thank you.

Senator PRYOR. Thank you, Senator Heinz.

I think one of the real important concepts here that we are dealing with is the safe harbor provisions in the 401(k) area, and that is when the employer provides a very generous matching contribution to that plan for the employee or a non-elective contribution into 401(k), it is very likely, I think, that the plan would satisfy in probably 80 to 90 percent of the cases, the ADP, that is the averages we know deferred percentage test anyway.

My question to Mr. Terry is: Does the Treasury have any data as to what percentage of plans are satisfying the safe harbor would fail to satisfy the ADP test? Do you have those statistics and those figures?

Mr. TERRY. Well, you know, we do not have the statistics, Senator, because the idea of a safe harbor test, at least in the private sector—we just do not have that sort of test, so it is impossible to give you those results.

It is, of course, true that the safe harbor system, which is described in your bill, is very similar to the Federal system, the Federal Thrift Plan System. It has a safe harbor matching system which is very similar to your bill, with one exception. There is a 1-percent contribution which is made across the board for all Federal employees. So in the Federal plan there is a contribution which differs, and perhaps importantly, from the match that your system has.

But we do believe, based upon the figures that I have seen in a report published by the Federal Retirement Thrift Investment Board in August of 1989, that as far as the Federal Plan is concerned the participation is not such that would pass the existing law, ADP test.

So if you generalize from that experience it appears that you might not get as good participation from non-highly compensated employees under your matching scheme as you do today under the Actual Deferral Percentage test.

Senator PRYOR. In your testimony you state that many of the provisions of present law can be simplified. I am wondering if you would list for the subcommittee the Code sections not touched by this bill, which clearly could be made simpler. Can you do that? Are you prepared to do that at this hearing or would you like to submit that for the record?

Mr. TERRY. I'd be certainly happy to submit that for the record. I think it is best if I submit it for the record, Senator.

Senator PRYOR. Senator Heinz, any more questions?

Senator HEINZ. Not at this time.

Senator PRYOR. Mr. Terry, I am pleading with you. Let us get together on this. You have been very elusive. We cannot seem to get any real answers. You say, "Well, we will come up with something

when the time comes" or "We will get our regulations and we will have those done before next year." That might mean the next decade or next century, who knows?

There are a lot of people who want to make some decisions about this. We are affecting the everyday lives of people. There is sort of a parallel here. I'm on the Agriculture Committee and all year we begged the Department of Agriculture to submit the administration proposal. They never did so we prepared our own proposal. It was the first time in history of writing Agriculture legislation that the U.S. Department of Agriculture and the President did not lay down a plan for us to work from, so we started working on our own. We had nothing to go by. And then at the last moment our friend, Secretary Yeutter, comes up the day before the bill goes before the Senate with a 12-page blast at the program and tells us everything that was wrong with it. They were never a real player in developing the legislation and it is very, very frustrating. I see a pattern here. I hope we can change that.

Mr. TERRY. Senator, could I——

Senator PRYOR. Yes.

Mr. TERRY. I guess I am surprised that you have read our attitude as one of head in the sand or not helpful. Because I can assure you on our side, I have been encouraged by the work of this committee. I have found some things in going through your bill that have been very helpful to us and I think we can use them in regulations.

I would just like to say that when I came on board in February—I have been in private practice for 20 years in the pension area—Assistant Secretary Gideon asked me to work on simplification, so I can tell you that our view is to do the best we can on simplification and we do want to work with you.

Senator PRYOR. Can you give us some sort of a time as to when you might make specific recommendations on this bill?

Mr. Terry. Senator, could I defer on that for the moment. I will let you know. [Laughter.]

As you know, we are now a period with the Budget Summit going on.

Senator PRYOR. I have heard about that.

Mr. TERRY. Yes, sir. There are just a lot of things going on. And if you will permit me, I think I can probably do a better job for you if you will let me respond to your request later.

Senator PRYOR. What about the day after Labor Day, would that be a good time? We will all be gone and we will not be calling you and harassing you during that period.

Mr. TERRY. We can certainly supply the list, if you are referring to list of code sections.

Senator PRYOR. I would like that. But I would like your general comments, section by section, and also, your suggestions.

Mr. TERRY. On this bill, Senator?

Senator PRYOR. Yes.

Mr. TERRY. I think we have given you a section-by-section analysis of this bill. We are pleased to give you any additional sections. That is what I thought you were——

Senator PRYOR. Well, there are some that you did not make reference to in your opening.

Mr. TERRY. That is correct in my oral statement. But I think you will find in our written testimony, I have addressed each and every substantive section.

Senator PRYOR. I will tell you what. I have put a plan on the table and I have 11 members on this committee, the majority of this committee, who have signed on plus other members of the Senate like Senator Jeffords. Now, I am asking you a very simple thing. Put your plan on the table. Let us compare them and let us work out something. Is that a deal?

Mr. TERRY. Yes.

Senator PRYOR. I will see you right after Labor Day, Mr. Terry. Thank you very much.

Senator HEINZ. Mr. Chairman, in all fairness to Mr. Terry, I do not know that he can commit Elizabeth Dole and President Bush to a plan. I would like to ask him a question, if I might.

Has the Secretary or the President committed to sending down a plan?

Mr. TERRY. No, sir. That is to say we have indicated our interest in simplification at this point, but there has been no commitment on the part of the administration, to my knowledge, to submit a simplification program at this point.

Senator HEINZ. Well, two points, then. First, I would join Senator Pryor in his request to the Secretary and the President that they do make such a commitment. But also recognizing that they as the policy makers have not made such a commitment, that we cannot legitimately insist that you make such a commitment on their behalf. I think just to be fair to you, you were not in a position to submit something on behalf of the President or the Secretary without their telling you to do so.

Mr. TERRY. That is correct. Also, of course, revenue constraints are a very, very important part of anything that we do these days.

Senator HEINZ. But nonetheless, hopefully, you will reflect the interest of the subcommittee in obtaining a proposal from the administration. It would be very useful.

Mr. TERRY. I will certainly discuss it. Yes, sir.

Senator HEINZ. Thank you.

Mr. TERRY. Thank you.

Senator PRYOR. Mr. Terry, thank you for your visit with us this morning.

Mr. TERRY. Thank you, Senator.

[The prepared statement of Mr. Terry appears in the appendix.]

Senator PRYOR. Speaking of the Department of Labor and Secretary Dole, we have a representative today, the Assistant Secretary of Labor, Mr. David Ball.

Mr. Ball, we appreciate you being with being here. We look forward to your statement. Your entire statement will be placed in the record. We are trying to build a very thorough record of this hearing, Mr. Ball, and we will put the entirety of your statement in the record. We look forward to your summary.

STATEMENT OF DAVID GEORGE BALL, ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS, U.S. DEPARTMENT OF LABOR

Mr. BALL. Thank you, Mr. Chairman. I would first like to applaud your efforts, Senator Pryor, in drafting and introducing your bill.

While the pension laws are included on everyone's list of tax code areas which are ripe for simplification, we believe that such simplification can also improve pension portability. As you know, this is an area which Secretary Dole has identified as a priority. We are very pleased that this is also an area which you and the cosponsors of your bill have chosen to address.

I would like to say, second, it is a great pleasure for me to testify before Senator Heinz in view of his abiding interest in insuring retirement income security for working Americans.

Third, I would like to especially acknowledge Senator Jefford's continued leadership in the pension portability area.

Secretary Dole has a great interest in developing a comprehensive policy to enhance pension portability. The Labor Department is currently considering a pension portability proposal, and is studying many components that are quite similar in concept to the provisions in your bill. We are pleased to see that you share our concerns, as well as some of the ideas about how we might solve the problem.

Pension portability remains one of the toughest challenges facing the pension system. Pension portability is generally defined as the ability to limit pension losses workers suffer when they change jobs. During her Senate confirmation hearings, in January of 1989, Secretary Dole expressed her intention to carefully study the issue of pension portability. Since that time, we have pursued the issue in depth with pension experts from government, business and labor. Today, I would like to comment on those sections of S. 2901 designed to improve pension portability and expanded coverage.

There are two major sources of potential portability losses. First, for defined benefit plans, if an employee switches jobs frequently, the net build-up of benefits over his working life time will be reduced.

Second, for both defined benefit and defined contribution plans, where an employee spends all or part of his or her pension before retirement, the ultimate benefit available at retirement will be reduced. This is most likely to be a problem with younger workers who may not be inclined to plan adequately for their retirement.

Our best preliminary estimates, based on Department of Labor and U.S. Census Bureau data, indicate that preretirement consumption of pension savings may represent up to two-thirds of all portability losses. This occurs when workers change jobs and take their retirement savings in a lump sum; that is, they receive a check equal to the present value of their accumulated pension benefits. The problem is that roughly 80 percent of these lump sum distributions are being spent. Other amounts, however, may be used for savings, such as the purchase of a first or second home.

Retirement savings have been granted tax-favored status on the condition that they be used for retirement income. Adequate retire-

ment income is an important national objective which justifies these generous tax benefits for private pension plans. Spending these savings before retirement frustrates this objective.

Stated quite simply, portability, to the greatest extent possible, should ideally allow a worker to maintain all of his or her savings in retirement income form. Therefore, we should encourage employees to keep retirement savings in tax-favored retirement accounts. Section 201 of your bill would generally relax restrictions on transfers to an IRA or other qualified plan and eliminate forward averaging for lump sum distributions. These changes would simplify the extremely complex rules governing the taxation of distributions from qualified plans and, by improving the rollover mechanism, contribute to the retirement income policy goal or portability.

In addition, section 202 of your bill would require the direct transfer of certain benefits that would otherwise be distributed to an IRA. The Secretary is examining transfer proposals, including proposals similar to those contained in S. 2901. Of course, any such proposals must be administratively feasible and subject to our overall concerns about proposals that would lose revenue.

Rollovers and transfers are just two of the ways we could help workers preserve their retirement savings until retirement. Pension portability is meaningless for the half of American's work force which is not covered by pension plans. Therefore, during our discussions, we have also examined ways to expand coverage and retirement savings by workers.

One natural idea would be to increase the number of pensions offered by America's small businesses which will provide many job opportunities in the future. Smaller businesses are often unable to institute complicated and expensive pension plans and, as a result, are at a disadvantage in recruiting and retaining qualified workers.

Current law partially addresses these concerns with Simplified Employee Pensions, or SEP's. If a SEP covers 25 or fewer employees, a worker can defer almost $8,000 of his or her salary by having it contributed to an IRA account in his or her name.

Senator PRYOR. Mr. Ball, we are going to put the entirety of your statement in the record. I would like to thank you and your Department, and especially Secretary Dole, for being a very constructive player in this. We have put Secretary Dole's provisions on transfers to IRA's, basically, intact in this legislation.

[The prepared statement of Mr. Ball appears in the appendix.]

Senator PRYOR. I just would like to ask from a policy perspective: Do you believe that expanding the eligibility for salary reduction SEP's to 100 would greatly encourage small business employers to establish pension plans?

Mr. BALL. The problem with raising the savings plan number to 100 is really a revenue problem, and that is the only objection we have to it. We do agree with you that the number should be increased from 25. The Secretary has been considering the number of 50 because of trying to balance revenue concerns with the benefit. By expanding the number to 50, we will bring in 95 percent of America's businesses and 5½ million additional workers would be eligible for that kind of plan. That is quite a significant increase in pension coverage.

Senator PRYOR. I agree.

We are doing everything that we can to have a thrust in the small business area to encourage and provide that incentive, not only for savings, but for retirement plans and we look forward to working with you in that area.

I also think that the transfer of the preretirement lump sum distribution to an IRA is important, and I certainly agree with Secretary Dole on that. I think it is going to reduce dramatically these sort of impulse cash-outs by the workers. I know if I got my check and I retired from this place and it was all in a lump sum that I would probably go out and buy a new bass boat or something like that. I think that is happening all over the country. I certainly think that this is a safeguard.

Senator Heinz.

Senator HEINZ. Mr. Chairman, I just want to agree with you that, Mr. Ball, who I am delighted is with the administration and who is an expert in the pension area, has, together with Secretary Dole, played an able and constructive role. I think we are all in agreement that it would be very desirable to increase the number from 25 up and as he says, "The main constraint is the money."

It is nice that it is simple, even if it is not easy.

Thank you, Mr. Chairman.

Senator PRYOR. Mr. Ball, we thank you.

I am going to also, Senator Heinz, place in the record at this time, a summary of a speech Mrs. Dole made. I believe she was speaking to the Association of Private Pension and Welfare Plans, a few weeks ago. I am going to place that summary in the record at this point.

[The information appears in the appendix.]

Mr. BALL. Thank you very much, Chairman.

Senator PRYOR. Mr. Ball, we thank you.

We are going to call our next panel now. That panel will be Mr. Larry Zimpleman, the second vice president of the Principal Financial Group; Mr. Ron Hovis, the director of benefits, Southwestern Bell Corp. Mr. Hovis is representing the Association of Private Pension and Welfare Plans this morning before the committee; David Kautter, representing the American Institute of Certified Public Accountants, the CPA's.

Mr. Zimpleman, we will hear from you first. We will observe the 5 minute rule. The entirety of your statement and those of your colleagues to your right and left will be placed in the record.

Thank you for coming and we look forward to your statement.

STATEMENT OF LARRY ZIMPLEMAN, SECOND VICE PRESIDENT, PENSION OPERATIONS, THE PRINCIPAL FINANCIAL GROUP, DES MOINES, IA

Mr. ZIMPLEMAN. Thank you. Good morning, Mr. Chairman. My name is Larry Zimpleman and I am second vice president with the Principal Financial Group in Des Moines, IA. I appreciate the opportunity to be here to share our comments on the Employee Benefits Simplification Act as introduced by Senator Pryor and Representative Chandler. We appreciate your invitation to testify on this legislation.

The Principal Financial Group is a Des Moines based family of insurance and financial services companies with more than $26 billion of assets under management. Of special interest for this hearing is that we have over 21,000 pension contract holders, with most of those looking to us for help with ongoing record keeping and administration of their retirement plan.

I believe, Mr. Chairman, that the Principal brings to this hearing a point of view that may not often be heard in debates and discussions on pension law changes, the voice of the smaller plan sponsor. The bulk of our business is in the under 500 employee market. Our written statement provides detailed comments on the proposed bill. In my few minutes of testimony I will highlight a couple of areas.

The Principal applauds Senator Pryor and Representative Chandler for what we feel is a significant turn in the direction of legislative change over the last 16 years.

The Employee Benefits Simplification Act is the first serious attempt to restructure the rules for maintaining qualified plans to make them more workable. I would emphasis the word "restructure." We do not believe that the private sector and the plans sponsor community are seeking more liberal rules under the guise of simplification. We are at the point where plan sponsors welcome simplicity for simplicity's sake. Everyone recognizes that the Congress is in a delicate position between a budget deficit-driven tax policy and social policy when it makes changes to the private pension system.

Some may wonder if simplification is really needed. After all there are many professionals who provide plan compliance help and design assistance. We believe the answer is clearly "Yes." This is reflected in what we see on the macro level, which is declining rates of pension coverage among active workers, primarily younger men, and on the level of the Principal, which is a significant shift in the type of pension promise that sponsors are making towards the defined contribution promise and away from the defined benefit promise.

During 1989, for example, for every two new defined benefit customers we added, we terminated seven. Even more astounding is that for every new defined benefit customer we added during 1989, we added 27 new defined contribution or 401(k) customers. Anytime the pendulum has swung that dramatically it is time to assess the environment within which qualified plans operate. While we do not know the extent to which this bill may help remove some of these obstacles, we would urge the Congress to study this issue further to see what other adjustments may be appropriate.

There are several aspects of the legislation we particularly support. Two simplifications at the top of our list are the highly compensated employee definitions under section 414(q) of the code and the compensation definition under section 414(s) of the code. We also support the proposed changes in the minimum participation rules. We believe this is an example of bringing the regulatory process back into line with what the Congress originally intended when it introduced this provision back in 1986.

There are two other areas that I would like to comment on. In both of these we applaud the authors for the proposals that they

have put forth and hope the Congress would consider even further action.

The first is the safe harbor alternatives under sections 401 (k) and (m). These safe harbors are very welcomed by small plans. We believe they will encourage smaller plan sponsors to contribute more for non-highly compensated employees in order to avoid the discrimination test. That makes this a win-win change. We hope the Congress would push even further by eliminating the 401 (k) and (m) tests, so long as any matching or non-elective contributions are made in the same percentage for all participants. The current limit on elective deferrals under section 402(g) of the code is sufficient in our opinion to protect against significant discrimination in these plans.

The second area is the proposed change in the distribution rules under code section 402. We support the change to encourage rollovers of partial distributions to IRA's and to encourage plan-to-plan transfers. We also support the repeal of the 5-year forward averaging rules. These changes should result in more dollars being saved for true retirement purposes.

In the spirit of preserving plan assets for retirement we suggest that the bill go even further and eliminate all lump sum cash benefits above a certain threshold, such as $5,000. With the availability of rollover IRA vehicles, as well as other arrangements that allow plan sponsors to pass along the expenses of handling vested terminated accounts, there are no longer any administrative reasons to encourage cash-outs.

In conclusion, there are many features to the legislation we support. Our comments about areas where further steps might be taken is not meant to dull our enthusiasm for what has been introduced. We believe simplicity is needed and we think this is a reasonable first step. We look forward to working with this subcommittee and its staff to develop other proposals in the future.

I would like to again express my thanks to the Chairman for the opportunity to be here this morning and I would be happy to answer any questions you or your staff may have. Thank you.

[The prepared statement of Mr. Zimpleman appears in the appendix.]

Senator PRYOR. Mr. Zimpleman, I thank you for your support and your thoughts on this legislation. I think at this moment we are having a vote on the Senate floor and I think it might be best at this time if I leave and recess the committee for about 10 minutes, and then I will return and we will have further statements and questions. We will stand in recess for a few moments.

[Whereupon at 10:39 a.m., a recess was taken.]

Senator PRYOR. The committee will now resume and I apologize for the delay. I was detained on the Senate floor for few moments.

Mr. Hovis is the director of benefits, Southwestern Bell. Do I pronounce that Hovis or Hovis.

Mr. HOVIS. Hovis.

Senator PRYOR. Hovis, I apologize.

You are representing the Association of Private Pensions and Welfare Plans. We look forward to your statement.

STATEMENT OF RONALD D. HOVIS, DIRECTOR OF BENEFITS, SOUTHWESTERN BELL CORP., TESTIFYING ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, ST. LOUIS, MO

Mr. Hovis. Mr. Chairman, I am pleased to be here today to testify on Senate 2901, the "Employee Benefits Simplification Act." I am accompanied today by Howard Weizmann, the executive director of the APPWP. As you mentioned, I am director of benefits at Southwestern Bell. My company provides benefits to 65,000 employees and 28,000 retirees. The Association's members sponsor or administer employee benefit plans covering more than 100 million Americans.

Mr. Chairman, you are to be commended for advancing the effort to simplify the pension system. Nearly a year ago, the APPWP issued a report entitled "Gridlock: Pension Law in Crisis and the Road to Simplification." Senate 2901 represents a first step down that long road to simplification and should be enacted. From the association's perspective the bill contains several very important elements, a number of minor positive changes and a few areas that we would prefer to see removed.

If the important simplification provisions cannot be sustained during the next steps of the legislative process, then we may need to forego this effort to simplify at this time and concentrate on doable and positive simplification at a later date.

We further feel that Senate 2901, like the "Gridlock" report, should be confined to simplifying the operation of current pension policy rather than creating new policy. Clearly, there are several elements of Senate 2901 that are vital if meaningful simplification is to be achieved. These include the safe harbor for the average deferrals and average contribution percentage tests, the better process for returning excess contributions from the highly compensated, the long-awaited simplification of leased employee rules, narrowing the application of Internal Revenue Code 401(a)(26) minimum participation rules to defined benefit plans only, improvement of the required beginning dates for plan distributions under Internal Revenue Code 401(a)(9), and a better, more manageable definition of "highly compensated employee." At the same time, the bill contains provisions that greatly concern some of our members including the provision requiring the transfer of distributions from qualified plans to IRA's.

Further, there are some simplification measures not included in this bill that we would like to see enacted. These include: Relief from the top-heavy rules, repeal of either the excise tax or combined plan limitation rule; and the streamlining of a wide array of reporting and disclosure requirements that were outlined in "Gridlock." What I would like to do now is to discuss three of the items that are included in the bill in greater detail.

The association commends the inclusion in the bill of a safe harbor for relief from the ADP and ACP tests; 401(k) plans are among the most popular retirement savings vehicles available in a nation sorely in need of greater savings. Contrary to some earlier comments, the current tests are very complex. They unfairly operate against the opportunities for savings among the lower paid of

the highly compensated group and they are simply not needed following the Tax Reform Act of 1986 which severely restricted the dollar contributions to 401(k) plans. Accordingly, we have called for the outright appeal of these tests.

Notwithstanding our desire for repeal, the move toward design based tests is very positive. The safe harbor will be helpful to some sponsors and participants of 401(k) plans. However, the level of employer contributions required to qualify for the safe harbor will be more than most employers can afford and, therefore, the safe harbor will prove unusable for most employers.

At Southwestern Bell, our two largest subsidiaries have bargained a 401(k) plan with a two-thirds matching contribution covering over 45,000 employees. The match applies to all covered employees, regardless of pay level. The match does not increase with pay or service. We have over 70 percent participation and the plan passed the current tests. Yet the safe harbor will exclude this plan and we will need to continue to test. If the safe harbor matching rate were set at 50 percent and the other requirements were retained, the safe harbor would fulfill the congressional intent to encourage non-discriminatory retirement savings and ease the compliance burden on sponsors and participants. This should increase coverage. We would appreciate your review of these ideas.

Due to time constraints, the last item I will mention is the required beginning date of distributions. The absurdity of the current 401(a)(9) distribution rules is evident from their application to my company. We devoted a significant amount of time to understand and implement these rules. Yet, out of a workforce of 65,000 employees, only two were effected by the rules when the first payments were required in April of 1989. More importantly, these were not high-paid executives. In fact, they were rank and file employees who were working to receive a paycheck, not to defer the taxes

I will skip the third item and simply conclude by saying, we commend you for advancing the effort to simplify the pension system. This is essential in order to preserve the system. We like many features of the bill and we are ready to work with you on the items that we have discussed as well as others in the bill.

[The prepared statement of Mr. Hovis appears in the appendix.]

Senator PRYOR. Mr. Hovis, I want to thank you and I appreciate you being here this morning. Once again I thank you for your constructive opinions on how you think we might make this bill better.

We will now call on Mr. David Kautter, representing the CPA's. We welcome you, David.

STATEMENT OF DAVID KAUTTER, CHAIRMAN, EMPLOYEE BENEFITS TAXATION COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. KAUTTER. Thank you, Mr. Chairman, for the opportunity to testify today on a matter of considerable importance to the American public and to our members. I am the chairman of the Employee Benefits Taxation Committee of the American Institute of Certified Public Accountants. The AICPA is the national, professional organization of CPA's with over 290,000 members. My testimony

today is from the perspective of a CPA-tax practitioner who on a daily basis observes the behavior of both plan participants and plan sponsors.

First and foremost we would like to compliment you, Mr. Chairman, on endeavoring to simplify the rules in this area. We believe the existing rules are encouraging some plans to be terminated, discouraging the establishment of other plans and diverting money from plan benefits to plan administration. We think they are resulting in significant noncompliance. In our view, simpler tax rules would enhance the viability of our Nation's private pension system. We view S. 2901 as a positive first step in the process of simplifying the rules governing qualified retirement plans and we pledge our continuing support in this effort. More needs to be done and we hope that you and your staff will continue with the same diligence in the upcoming months that you have exhibited in the recent months.

In testimony before the subcommittee in March, we proposed that Congress use as a test in determining which rules of existing law should be retained and which should be changed; whether the incremental contribution to equity made by the rule is outweighed by its incremental contribution to complexity.

We believe this test is still the appropriate test to apply in judging the appropriateness of a statutory provision from a simplification point of view. We have applied this test to the various provisions of S. 2901. Our conclusions are set forth in our written testimony.

I would like to focus on what we think are some of the most significant provisions. In overall terms, we enthusiastically support S. 2901. Specifically, we support the provisions which deal with the definition of "Highly Compensated Employee" and "Compensation." We think they will ease plan administration and reduce the cost of operating a plan. They will also add to certainty and ease administrative burdens.

Second, we support most of the distribution provisions in the bill. We support the repeal of averaging treatment and the changes in the rollover rules. The treatment of distributions is an area where CPA's spend a substantial amount of time advising clients. We believe the proposals will substantially simplify the rules, avoid confusion, and reduce expense for taxpayers. There are two provisions in the bill with which we have concern.

First is the proposed changes in the 401(k) discrimination test. Contrary to Treasury's testimony this morning, I believe that this test is one of the most misunderstood and misapplied provisions in the Internal Revenue Code today. We are reluctant to advocate the retention of the existing nondiscrimination test in 401(k) even as an alternative to a safe harbor. We believe that the committee should consider a safe harbor, design-based safe harbor, which would say a plan, a 401(k) plan has to be available to every employee age 21 and with a year of service and that the employer annually has to notify all employees of the availability of the plan. We then advocate repeal of the actual deferral percentage test.

Second, we oppose section 202 of the bill requiring trustee-to-trustee transfers of certain distributions. We feel that this fails to meet the test of whether the incremental contribution to equity is

outweighed by its incremental contribution to complexity. For example, if an individual participated in a plan and made after-tax contributions to the plan, today if that individual wanted a distribution one check would be written. Under this proposal three would be written: one to the individual for the after-tax contributions, a second to the trustee of a transferee plan for the employer contributions, and the earnings on the employer and employee contributions, and a third check out of that transferee plan to the participant if they still wanted to get the distribution. We believe this results in unneeded complexity. However, if this provision is enacted we think that section 72(t), which is the additional income tax on early distributions from qualified plans, should be repealed. We think that both provisions are aimed at the same purpose and that including both in the law would be redundant.

Finally, we think that much more needs to be done. We have included some additional proposals in our testimony for you and your staff to consider. That concludes my statement.

[The prepared statement of Mr. Kautter appears in the appendix.]

Senator PRYOR. Mr. Kautter, thank you very much.

Well, we have heard from all three of the members of this very distinguished panel. Let me ask just a couple of questions.

First, Mr. Zimpleman, I think if I understand your role, you administer many of these plans that are under discussion today.

Mr. ZIMPLEMAN. Yes, sir.

Senator PRYOR. Now, if we pass this bill that is pending, what would that do: (1), to try to bring in or try to give an incentive to smaller employees to become involved; and (2), to reduce or add to the cost of administering these programs?

Mr. ZIMPLEMAN. Mr. Chairman, I think there are, on balance, as we said in our testimony earlier, very positive things that would be done here. In particular, the safe harbors would be, from the perspective of the small plan, very helpful. I think it would encourage participation in 401(k) arrangements by small plans. Again, I would like to emphasize that the issue in our opinion is perhaps even a little broader than just 401(k) plans. As I said, for every two new defined benefit plans, we write 27 401(k) plans. We think that perhaps there ought to be some greater balance there. So while it would perhaps help small employers of 401(k)s, there is a larger picture there as well.

Senator PRYOR. I appreciate that comment.

Now, Mr. Hovis, let me ask you—I want to admit to you I am not a tax attorney, in fact, I am barely an attorney—but I am not quite sure why the organization recommends the retention of the 5-year averaging rule. I am not quite sure why you are taking that position. I wonder if you could explain that?

Mr. HOVIS. Mr. Chairman, the feeling was that it has some economic benefits to the participants that are involved in receiving those distributions. We certainly would have to agree that the elimination of 5-year averaging would create a simpler system, so your proposal does meet the goal of simplicity.

Senator PRYOR. But would not the new rollover rules pretty well supersede this in a more efficient manner?

Mr. WEIZMANN. Senator, if I might add?

Senator PRYOR. Sure.

Mr. WEIZMANN. With regard to the distribution of lump sums, and that is what we are really dealing with here, the kind of tax treatment that is accorded to those. Favorable tax treatment for distributions of lump sums apply generally, only for people who are retirement eligible since the law penalizes people who take what we call a "premature distribution" and 5-year averaging is not available to those who are not retirement eligible. The issue is: is Congress in a position as a policy matter"—and again we have tried to keep the simplification process away from policy—"is Congress as a policy matter going to make the determination that people shouldn't take a lump sum distribution or, in effect, incent people away from lump sums at the time of retirement? We happen to feel that the policy matter, from our own association's viewpoint, that at retirement, people should be free to choose between a lump sum and an annuity. We are not talking about somebody who is taking in service distribution. We are simply talking about someone who is at retirement, decides to do whatever they do at retirement. We think that choice for or against a lump sum should not be disincented by government tax policy. And that is in effect what would happen if you eliminate the 5-year averaging. We have no feel, at least at this point, as to whether the rollover provisions are a fair trade for elimination of the 5-year averaging.

One area though you are to be commended for, Senator, and I want to make sure that it is underscored, is the retention of net unrealized appreciation in our view is absolutely essential, and you are to be commended and your staff have sought to do so. The elimination of unrealized appreciation, since it is part of current tax treatment, would change in effect the promise that has been made to folks who have received employer stock in these kinds of plans.

I hope that answers your question.

Senator PRYOR. Thank you.

Mr. Kautter, I would like to get your comments on this same question as to the retention of the 5-year rule. Should we retain it? Should we do away with it?

Mr. KAUTTER. Well, I think from a simplification point of view, repeal is the right answer. The definition of a "lump sum distribution," which is what you need in order to average, is an exceedingly difficult definition. The IRS has not issued regulations since ERISA passed in 1974 that help you define what is a lump sum distribution. The problem with trying to figure it out is to the extent there is any law, it is all in private letter rulings that the IRS has issued. And the only access into those private rulings is through some sort of word-searching technique.

So from a simplification point of view, it is difficult to figure out what is a lump sum distribution. And the basic purpose of those rules, as I understand them, originally was to prevent a bunching of income: to prevent a large amount of income from being taxed through marginal rates in 1 year, where had it been spread out it would have been taxed at a lower rate. With the rate structure we have now, the problem with bunching is largely gone. So I think when you balance everything and the simplification you can

achieve by eliminating the definition of a lump sum distribution for averaging, it should be repealed.

Senator PRYOR. You are constantly administering or advising plans. If we pass this legislation that is before the committee, would this reduce or increase the cost to most employers that provide pension plans?

Mr. KAUTTER. I believe it would reduce the cost. I think the simplification of the definitions, the simplification of the averaging rules, and a lot of employers spend money and time advising their employees on how they should treat these distributions from plans, that cost would be eliminated. There is always more you can do. But this bill would on average, I believe, reduce the cost of maintaining and operating a plan.

Senator PRYOR. As we know, this bill was introduced to get comments just like we are receiving this morning, and I do very much appreciate the comments of all of you and your instructive thoughts about it.

Mr. Hovis, did you have a final word?

Mr. HOVIS. May I add that I would just like to agree with those comments, that overall this bill would be a very positive step in terms of reducing the expense of plan administration. Probably the only exception would be with regard to the mandatory transfers. But overall it is very positive in terms of its impact.

Senator PRYOR. Thank you.

Mr. Zimpleman, any final words?

Mr. ZIMPLEMAN. No. I just agree with everything that has been said. Thank you again for the opportunity to be here.

Senator PRYOR. Well, thank you very much, all three of you. We appreciate it very much.

We will call our panel number 3 now. Mr. Anthony Williams, director of retirement, safety and insurance, National Rural Electric Cooperative Association; Mr. Harold Schaitberger, who is the executive assistant to the president, International Association of Fire Fighters; Kenneth Simonson, vice president, the American Trucking Association.

We appreciate the panelists coming this morning. We look forward to your comments. Once again, we will observe the 5 minute rule and we want to thank the three of you coming. You represent fine organizations. We appreciate your involvement in helping to develop this piece of legislation.

Mr. Williams, we will ask you to go first.

STATEMENT OF ANTHONY C. WILLIAMS, DIRECTOR, RETIREMENT, SAFETY AND INSURANCE DEPARTMENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, WASHINGTON, DC

Mr. WILLIAMS. Thank you, Mr. Chairman. My name is Tony Williams. I am the director of the retirement, safety and insurance department of the National Rural Electric Cooperative Association. I am here to express in the strongest terms our support for S. 2901, the "Employee Benefits Simplification Act." NRECA is a national service organization of the approximately 1,000 rural electric service organizations in the United States. I can assure you that you

have their unequivocal support to this bill. That support is attributable to the bill's historic simplification of retirement plan rules and major advance in health policy.

I would like to begin my more specific remarks with a brief discussion of what we mean by "simplification of retirement plan rules," and why we believe such simplification is so important. Stated briefly, we view simplification as the elimination or modification of rules which have been created through the accumulative effect of years of legislation and that poses an administrative burden that is not justifiable either for tax policy or retirement policy.

The need for this type of simplification is particularly acute with respect to smaller employers. Our 1987 survey of small employers in rural America reveals that less than 19 percent provided a retirement plan and that the primary reason was administrative costs. A simplification bill that would reduce this cost would have a major impact on raising the number of small employers that can afford pension plans.

We believe that S. 2901, if enacted, would achieve precisely this type of simplification. A prime example is the modification of 401(k) plan discrimination rules. NRECA supports the policy objective of the nondiscrimination rules, however, we believe these policy objectives can be achieved without the administrative burdens of present law. S. 2901 accomplishes precisely this by deeming the nondiscrimination rules to be satisfied when an employer provides such significant contributions to a plan that the plan could be expected to substantially satisfy the nondiscrimination rules, there is little justification for requiring such plan to apply the burdensome nondiscrimination rules.

The bill's clarification of VEBA rules is another provision we would like to comment on specifically because it provides a major advance in terms of health policy. In general, VEBA's are trusts through which employers provide welfare benefits, such as health insurance, to their employees. The most important advantage of a VEBA is not found in tax law, but rather in the fact that VEBA's provide smaller employers with the means of pooling their buying power and thereby reducing their health insurance costs. This reduction of cost of health insurance is crucial to expanding health insurance coverage for employees of small employers.

This bill clarifies that small employers may band together to maintain a common VEBA if they are in the same line of business and in a closely related as measured by their joint activities. We believe this provision would serve important health policy objectives. We also believe that this provision should have little or no effect on Federal tax revenues. Based on the only court decision to apply on this key issue, we strongly believe that the provision simply is a clarification of present law.

In conclusion, we have 1,000 rural electric cooperatives that enthusiastically support this bill.

Thank you, sir.

Senator PRYOR. Mr. Williams, thank you very much. We appreciate your support of this legislation. It has been a pleasure working with you and your group in developing it.

Mr. WILLIAMS. Thank you.

[The prepared statement of Mr. Williams appears in the appendix.]

Senator PRYOR. Mr. Schaitberger.

STATEMENT OF HAROLD A. SCHAITBERGER, EXECUTIVE ASSISTANT TO THE PRESIDENT, INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS, WASHINGTON, DC

Mr. SCHAITBERGER. Thank you, Mr. Chairman, and good morning.

I would like to mention at the outset that in addition to having the privilege of representing my international union with over 180,000 professional fire fighters for the last 15 years, my comments are also drawn from 13 years experience as a professional career fire fighter, as well as serving currently on a retirement board system as a trustee for the public workers in the community where I live.

I am here this morning representing the views of public sector unions, retirement and deferred compensation associations, and employer organizations concerned about and affected by laws impacting pension funds of State and local government employees. The following organizations support the statement that follows regarding provisions in your bill affecting State and local pension funds: The American Federation of State, County and Municipal Employees; the IFF; National League of Cities; the National Conference of State Legislatures; the National Association of Counties; the Government Finance Officers Association; the National Association of State Retirement Administrators; the National Association of Government Deferred Compensation Administrators; the National Conference on Public Employee Retirement Systems; as well as the National Council on Teacher Retirement.

Mr. Chairman, on behalf of these 10 organizations, we would like to personally thank you for introducing S. 2901, the Employee Benefits Simplification Act. We would especially like to thank you for including in this comprehensive bill provisions addressing the problems of State and local goyernment pension plans caused by the Internal Revenue Code section 415 limitations.

As you know, State and local government pension plans differ from private sector pension plans in several ways. Because of these differences, the application of the IRC section 415 pension limits adversely affect the pensions of government employees. The greatest problem facing the plans is the fact that if just one retiree's pension benefit exceeds the section 415 limits, the entire plan is exposed to disqualification, thus placing an unfair burden on both plan participants and the plan itself. Such action would result in both current and future employees being taxed annually on the value of benefits earned each year and the earnings of the trust would be subject to Federal taxation.

The proposed changes in your bill to the existing section 415 requirements will simplify compliance for State and local government and enable them to pay the level of benefits promised without jeopardizing the tax status of the trust.

Federal regulation of State and local government pension benefits is an area of continuing change and concern to State and local

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governments as well as organizations representing those employees. Although public plans are exempt from ERISA, most plans operate as "qualified" plans under the Internal Revenue Code for the purpose of maintaining preferred tax treatment of the pension trust and employee contributions. As a result, the maximum benefit and contribution limits of IRC section 415 present special problems for these plans.

Section 415 limits the annual pension contribution or benefit level a public and private employer may fund. To clarify this point on the problems generated and experienced in section 415 by State and local government, I would like to point out in my testimony, particularly on pages 5 and 6, a simple example of how a typical fire fighter with 35 years of service could be entitled to a pension benefit that currently exceeds section 415 pension limits. This is not a problem that only affects high-rollers. This is currently a problem that affects low-wage and medium-wage income employees in State and local government.

Mr. Chairman, because of your efforts and that of other members of this committee, the problems associated with 415 limits in State and local government pension plans have been successfully addressed in your legislation. I would like to briefly discuss each in turn.

First, under section 102, you have addressed the problem of a standardized definition of compensation for 415 purposes. Your bill modifies the employer election to take salary reduction contributions into account by permitting deferrals under sections 457 and 414(h)(2) to be taken into account and providing that an election to take salary reduction into account is to apply for all purposes, to all employees, and to all salary reductions.

Second, under section 306, the compensation limitation under 415 on limits under a defined benefit plan does not apply to plans maintained by State or local government. This provision will be especially helpful to many low income employees who find themselves receiving a very small pension that actually exceeds the 100 percent compensation rule.

Third, the defined benefit plan limits do not apply to disability or survivorship benefits provided under such plans. This problem is especially experienced by those engaged in fire fighting and law enforcement activities.

Mr. Chairman, these provisions will certainly simplify the administration of State and local government pension plans. Most importantly, these changes will allow plans to pay benefits to retirees—benefits that have been promised to them—and not cause any adverse impact on the tax status qualification of the plans.

The organizations listed above enthusiastically endorse these provisions and hope that you can expedite their passage to prevent any further confusion or problems in this area.

I would be happy to answer any questions you may have at the end of the panel's presentation.

Senator PRYOR. We not only thank you for your statement, we appreciate your support for these concepts as expressed in this legislation. Thank you very, very much. I will have a couple of questions.

[The prepared statement of Mr. Schaitberger appears in the appendix.]

STATEMENT OF KENNETH D. SIMONSON, VICE PRESIDENT AND CHIEF ECONOMIST, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, DC

Mr. SIMONSON. Thank you, Mr. Chairman. We appreciate your leadership in tackling this extremely difficult problem of benefit simplification. I want to focus on one particular aspect, namely, employee leasing.

I am vice president and chief economist of the American Trucking Associations, which has approximately 4,000 carrier members. We also have 51 State associations and 10 conferences representing trucking specialties, and together these associations have more than 30,000 trucking company members. Among the members are a great many companies that make use of owner-operators, individuals who are considered independent contractors for tax purposes and who want to remain as independent small businesses for all purposes, including benefits.

Until the issuance of IRS regulations in 1987 interpreting section 414(n) on employee leasing, there was little question that an owner-operator who owned his own vehicle, often costing $100,000 or more, who was responsible for payments on that vehicle, for operating expenses, who was at significant risk at loss as well as an opportunity for profit, there was little question that that individual was in a separate business, was performing a service under an arm's length contractual relationship with a trucking company or directly with a shipper.

However, the IRS regulations that were issued in August of 1987 threw into doubt that entire arm's length relationship. They did not take cognizance of the factors I mentioned of significant operating assets or of a significant risk of loss, and merely looked to the fact that the owner-operator was performing a service that is indeed performed by employees in the trucking industry, that is, driving a truck. Quite often these relationships would last for more than 1,500 hours of service, particularly if all of the time that an owner-operator was with the vehicle in transporting freight across country was counted.

The proposed regulations also ignored a very important aspect of the statute which laid out a requirement for a third party to be involved before someone was considered a leased employee.

In summary, these proposed regulations would have turned many of the 100,000 to 150,000 owner-operators and many other independent business people in this country into leased employees, more often than not against their will. In fact, when hearings were held at the IRS in February of 1988 a number of owner-operators, as well as organizations representing owner-operators, took time to come in and testify to say they did not want to be employees for benefit purposes any more than for withholding tax purposes. They regarded themselves as independent business people who have the right and the desire to make their own arrangements about compensation and retirement benefits.

We would like to see provisions in S. 2901 make clear that this kind of relationship is not contemplated by Congress to be covered by employee leasing, and in fact, unless greater clarification is added to the statute now we are afraid that many of the other beneficial aspects of the pension simplification provisions of your bill will be for naught, because companies still will not know how many workers they are required to cover.

While we have heard oral assurances from Treasury and IRS officials that the proposed regulations in 1987 went too far, we have been unable, as you have, to pin them down on exactly what sort of simplification and clarification they support. That continues to Mr. Terry's testimony today. In his written statement he makes reference to the one change that you proposed in employee leasing, to say he does not believe the control standard you have proposed should be the same one used for employment tax purposes. We think that is totally wrong headed, that "control" is a well-defined term in determining whether a worker is an independent contractor or an employee for employment taxes. And it would be extremely unfortunate if a separate definition of "control" were then used for deciding if someone was under the control of a recipient for pension purposes. In fact, the whole area of employee leasing has undergone a great change in the 8 years since this was added to the tax code. There is a very vibrant industry now providing significant benefits to workers who are then leased to small businesses, generally. I am not an expert on this. It is not used widely in the trucking industry, but I am persuaded that employee leasing as an industry is one that deserves support.

I believe that your bill has made a good start on clarifying what workers are meant to be included. My written testimony includes a number of other changes that I think would add to that clarity, and I hope that they will be adopted.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Simonson appears in the appendix.]

Senator PRYOR. Mr. Simonson, I appreciate that and I thank you once again for getting into this very important issue of leased employees. I am amazed by one thing and that is that there is any business out there today in our country that has a retirement program or a pension program for their employees. And I know we have seen a great deal of confusion in the leased employee section. The IRS, I think, is really zeroing in out there on this area and it concerns me to a great extent.

Do you think that the control test that our bill would establish is a better test than the test that we apply now, which I guess you would say is the "historical performance test." Would you say the control test is the better avenue to take?

Mr. SIMONSON. I do, Senator. Certainly for the trucking industry. The firms that I have dealt with, and I get calls every week asking about independent contractor tax status. I know the IRS is very vigorously auditing. By and large, those rules are being applied in an understandable fashion. There has been a great deal of effort by ATA and other industry associations to make clear to businesses whether or not they are going to be treated as employers, and "control" is an intuitive notion that I think people can follow quite

readily whereas, "historically performed" is inherently a very subjective and fuzzy notion.

I think though that some additional language and quite a number of specific examples might be added in report language to the bill to make it clearer what Congress does mean by "control."

Senator PRYOR. It is also strange to me that the Congress would have to deal with this problem. This could have been done so easily by the Treasury Department and by the Internal Revenue Service. They could do it in a regulation, but, evidently, they do not want to do it so we are going to have to do it.

Mr. SIMONSON. Well, that is right. In fact, the only time they have offered to fix things up through a regulation is with the threat of legislation coming. Now they are saying, "Oh, we do not think that it is appropriate to do this through a bill. We will take care of it."

Senator PRYOR. I have had some experiences like that.

Mr. Schaitberger, we appreciate you being here and, once again, the support from the Fire Fighters. I just want to ask about one area. When we talk about public employees versus private employees, why is it that we need to have the Excess Benefit Plan for the public versus the private sector. Why is that?

Mr. SCHAITBERGER. Well, first of all, we would like the same opportunity to have access to an excess plan as the private sector currently is provided. We need the use of the excess plan because of the dilemma that has been created by the application of section 415, where there are some individuals or maybe an individual that because of the formula of a retirement system which is Constitutionally guaranteed in most cases, that individual is entitled to a benefit that takes them over the limitation.

The use of excess plans in the context of your legislation in the way that we have suggested will allow this excess benefit or this benefit that exceeds the limitation to now flow into an excess benefit plan and then relieving the pressure and not jeopardizing tax status of the trust. But we are really looking to use that similarly as those in the private sector currently have available to them.

Senator PRYOR. I want to thank you for that explanation.

Mr. Williams, on the 401(k) safe harbor section of the legislation, do you think that most of the rural electric members would be able to qualify if legislation were enacted?

Mr. WILLIAMS. No, sir. I do not think most would qualify. I think a significant number would. But I would say we definitely support the safe harbors.

I would agree with Mr. Terry this morning that most large organizations use 401(k) as a supplement, and, therefore, are not likely to get contributions at the level that the safe harbor anticipates. But many small employers, who would use it as primary plan, might go to that level of contribution if they knew they did not have to go through all the other testing that would be required.

Senator PRYOR. Once again, we are trying to build this record because a lot of our colleagues are going to want to refer back to this hearing and the testimony that we have elicited. I think for the record, it would not only help me, but help my colleagues as well, if you would explain the distinction between VEBA's and the Multi-Employer Trusts. Why do we have that distinction?

Mr. WILLIAMS. There were definitely problems with some multi-employer trusts in the seventies. I think that has largely been eliminated now by allowing the States to regulate them. A VEBA, particularly, as the participation rules are clarified in this bill, provides the ability for a group of employers, presumably smaller ones, to band together and to use the pooling that is available for a larger group that would not necessarily be available for a smaller group.

Most MET's would not qualify as VEBA's, or most single employer MET's certainly would not qualify as VEBA's as it is defined in this act.

Senator PRYOR. Well, we appreciate this panel being with us this morning. I wonder if there will be any final comments from Mr. Simonson, Mr. Schaitberger or Mr. Williams? If you have any final comments, I will give you the last word.

Mr. WILLIAMS. I would just say we enthusiastically support the bill.

Senator PRYOR. We thank you very much.

Mr. SIMONSON. I would like to add one thing about the need for legislation here. It was in 1987 that we started hearing that the IRS was going to take this very sweeping view of who was a leased employee. We met twice with Treasury officials; the second time we were assured that our concerns would be taken care of. They were addressed through a five-part exception that had so many conditions I do not know of a single company that would have been able to make use of that.

I have no ill will toward Mr. Terry and his crew. I hope that this time they can get it right, but as a safeguard I would like to see Congress get it right for them.

Thank you.

Senator PRYOR. Thank you, Mr. Simonson.

Mr. SCHAITBERGER. And Mr. Chairman, I would just like to emphasize that not only do we support the bill, but we want to emphasize how critical it is to see its passage and enactment into law. State and local government needs desperately the relief provided in this bill so we encourage its movement forward.

Senator PRYOR. We thank you for that comment.

We thank all the members of the panel and we appreciate your testimony.

We will call our final panel this morning: Arthur Ryan, president of the Board of Pensions of the Presbyterian Church; Gary Nash, general counsel, the Southern Baptist Convention of the Annuity Board; Mr. Leo Landes, United Synagogue of America; Dr. John Ordway, Pension Boards, United Church of Christ; Reverend Dr. Allen Mayes, senior associate general secretary, United Methodist Church; Hugh Picket, director of benefit plans of the Ministers and Missionaries Benefit Board of the American Baptist Churches.

If we could have order in the committee, please.

Thank you.

We are not here only to talk about S. 2901 this morning but also S. 2902, which is a first cousin to the other legislation that we have been considering this morning. We thank all of our members of the panel this morning. We appreciate so much your patience in wait-

ing your turn. You have been waiting a long time. You see how some of these committee hearings become drawn out from time to time. I am sure you know and understand that.

We have also heard this morning from the Department of the Treasury, which has come out in opposition to S. 2902. Now we would like to hear from you why S. 2902 is important. We would like to know what is good about it, what is bad about it and what suggestions you might have.

Let us see, I believe Mr. Ryan was first, I will call on you. Being a fellow Presbyterian, I will yield to you.

STATEMENT OF ARTHUR M. RYAN, PRESIDENT, BOARD OF PENSIONS, PRESBYTERIAN CHURCH (U.S.A.), AND CHAIRMAN, STEERING COMMITTEE, CHURCH ALLIANCE, BALA-CYNWYD, PA

Mr. RYAN. Thank you. Good morning, Mr. Chairman. My name is Arthur M. Ryan. I am president of the board of pensions of the Presbyterian Church (U.S.A.). But I am here today in my capacity as chairman of the steering committee of the Church Alliance, and I am here to express our strongest possible support for the proposed legislation S. 2902, the Church Retirement Benefits Simplification Act of 1990.

The Church Alliance is composed of representatives of all of the major mainstream Protestant and Jewish denominations. Together, our churches have about 66 million members in the United States. Our pension plans have been in existence for many years, some of them for centuries, and cover hundreds of thousands of participants.

We formed the Church Alliance many years ago because of problems our churches are having with applying the pension laws to their unique situations. The proposed legislation will simplify matters and address the problem primarily by creating a new section of the Internal Revenue Code.

Mr. Chairman, as you pointed out at the beginning of this hearing, the current rules for church plans are administratively complex and in some cases unworkable.

I certainly want to express my appreciation on behalf of the Church Alliance and myself, and I know the minutes will reflect this, to Senator Pryor, for sponsoring this legislation. We appreciate very much the opportunity to be here with you and to testify at this meeting.

While I recognize the time does not permit us all to testify, I would like, if I might, Mr. Chairman, to identify specifically the members of the panel here and then to identify some other members in the audience who represent some of the other denominations.

Senator PRYOR. Thank you, Mr. Ryan.

Mr. RYAN. On my far right, Bishop Alexander Stewart of the Episcopal Church. On my near right, Mr. Gary Nash who is general counsel of the Southern Baptist Annuity Board and is also executive secretary of the Church Alliance. On my near left, Mr. Leo Landes of the United Synagogue of America. On my far left, Dr. John Ordway of the United Church of Christ. Next to him, Rever-

end Hugh Pickett of the American Baptist Churches. Next to him, the Reverend David Steele of the of the Evangelical Lutheran Church in America. And on my far right, the Rev. Dr. Allen Mayes of the United Methodist Church.

Time does not permit all of these gentlemen to testify.

Oh, I am sorry. I did forget one, Mr. Earl Patrick, vice chairman of the Annuity Board of the Southern Baptist Convention.

Time does not permit all of these gentlemen to testify, Mr. Chairman, I know that, but I wanted to recognize them and I would also like to recognize Mr. Gary Nash to continue our testimony.

Senator PRYOR. Thank you.

[The prepared statement of Mr. Ryan appears in the index.]

Senator PRYOR. Mr. Nash.

STATEMENT OF GARY S. NASH, ESQUIRE, GENERAL COUNSEL AND SECRETARY, ANNUITY BOARD, SOUTHERN BAPTIST CONVENTION, DALLAS, TX

Mr. NASH. Thank you. Senator Pryor, my name is Gary Nash, and I am secretary of the Church Alliance and the general counsel and secretary of the annuity board of the Southern Baptist Convention.

During the past 15 years that I have served as secretary of the Church Alliance, churches have been faced with a tremendous volume of increasingly complex employee benefits legislation. Whenever a new piece of legislation is proposed, it typically does not recognize the unique structure and needs of church retirement and welfare plans, and the members of the Church Alliance have consequently had to spend a significant amount of time and money and energy in explaining to Congress why a particular rule is unworkable or simply not needed.

Despite what some may think, churches do have problems and considerations that simply are not applicable in the private sector and S. 2902 attempts to address these difficulties. Present law recognizes these differences and S. 2902 would bring the rules as now applied to various church denominations into harmony.

The Church Retirement Benefits Simplification Act of 1990 which you are sponsoring is an important step for the churches in dealing with this constant onslaught of employee benefits legislation.

Over the last decade, staff members of the tax-writing committees of Congress and aides of several concerned Members have discussed with representatives of the Church Alliance the need for rules that apply to church plans to take into account the unique needs and characteristics of church retirement and welfare benefit programs.

Most importantly, S. 2902 provides that a new section 401A, and a portion of section 403(b) that applies to churches will be "walled off," so that future changes made for non-church employers in section 401(a) and section 403(b) will not apply to church retirement plans unless specifically made applicable thereto. This provision is the cornerstone of S. 2902.

S. 2902 simplifies and brings workable consistency to the rules applicable to church plans. S. 2902 would resolve another impor-

tant problem churches face in administering their retirement and welfare benefit plans. It would cure problems dealing with ministers that are employed as chaplains in hospitals, halfway houses, and in government prisons. These programs typically provide portability throughout a religious denomination.

S. 2902 would also permit IRA-type qualified voluntary employee contributions to be made to church plans. Ministers and lay workers would rather contribute to such programs than to IRA's due to their greater confidence in and familiarity with the denominational church pension board.

A detailed explanation of S. 2902 is being filed today in the record.

The members of the Church Alliance support S. 2902 and stand ready to work with you and other members of the Senate Finance Committee to ensure that this important piece of legislation is passed. I will be happy to answer any questions you may have about the legislation.

Senator PRYOR. Thank you, Mr. Nash.

Are there other members of the panel that——

Yes, Reverend Stewart.

Reverend Stewart let me just make note. We are having another vote on the Senate vote and probably in about 6 minutes I will have to go back to the Capitol.

[The prepared statement of Mr. Nash appears in the appendix.]

STATEMENT OF RT. REV. ALEXANDER D. STEWART, D.D., EXECUTIVE VICE PRESIDENT, THE CHURCH PENSION FUND, LONG MEADOW, MA

Bishop STEWART. As executive vice president of The Pension Fund—we serve the Episcopal Chruch. I can assure you this legislation is wholeheartedly endorsed by us. This legislation eliminates for church pension plans requirements particularly appropriate for corporate conglomerates. To conform to existing rules requires of us additional accounting personnel, legal expertise, and in-house auditors to make sure every section of every statute is fulfilled. In all but 3 years since ERISA was enacted there have been changes in regulations on pension funds.

Excellent but expensive law firms have often concluded that we were not subject to a particular section, but we could not take the chance.

This act does, indeed, provide, in Section 401A, a cornerstone which we all thoroughly endorse. For simplification, the pension funds will thank you, Senator; for simplification, the volunteer church treasurers who try to understand these rules will certainly thank you; for simplification, the beneficiaries will thank you.

This act will simplify the administrative machinery of the church pension funds. It will result in savings which benefit the retirees, who are now living longer, longer in fact then Methuselah. In particular, in our pension fund, a woman who has been on it since 1917, I know, will rejoice, and likewise dependent children. God bless you for your efforts. And He will.

Senator PRYOR. Thank you. Thank you. I may need you to seek a little divine help for me as we go forward with not only with this

but also S. 2901, with especially some of the concerns that have been expressed here today.

[The prepared statement of Bishop Stewart appears in the appendix.]

Senator PRYOR. Are there others on the panel desiring to speak? Yes, Mr. Landes.

STATEMENT OF LEO J. LANDES, C.L.U., UNITED SYNAGOGUE OF AMERICA, ROCKVILLE CENTER, NY

Mr. LANDES. I represent the Joint Retirement Board of the United Synagogue of America. I come from a rabbinical family; my two brothers are rabbis, my father was a rabbi and my grandfather was a rabbi.

Most people do not realize that over 50 percent of our rabbis serve small congregations where they are the only full-time employee. All the other employees are part-time, seasonal or volunteer. There is no way these congregations can cope. I am sure most other denominations have the same problem. These congregations cannot cope with the complex requirements of the formal pension plan laws that exist today.

We appreciate your sponsoring the bill S. 2902 and hope that this will simplify the problem for us so that we can continue to offer pensions to our clergy.

[The prepared statement of Mr. Landes appears in the appendix.]

Senator PRYOR. Thank you so much.

Are there others on the panel?

[No response.]

Senator PRYOR. Mr. Ryan, let me make a comment, if I may. I have a brother who has just retired from the Presbyterian ministry, after some 35 or so years. About 5 years ago, when he was contemplating retirement he came to me and told me about all the horrors about the people out in the churches trying to figure out these plans—the ministers, their families, not knowing what the rules were and it was absolute bedlam. So to make a long story short he has been lobbying me for some time.

In June, he actually did officially retire as a Presbyterian minister, and in September, 1 month from now, at age 62 he will be a first-year law student at the University of Arkansas. He is going to be a lawyer now in his next career. And I asked him, "Bill, why in the world would you at age 62 want to go to law school knowing that it is going to be a 3-year grind?" He said, "This country needs another Perry Mason and I am it." [Laughter.]

Senator PRYOR. So he is now enrolled; he is starting to polish up on his learning skills once again. He is excited about this, and I know that he, too, will share with those people that you represent in supporting this concept.

I have six questions. I am going to submit these questions, if I might, to Mr. Nash.

I am going to have your answers entered into the record because ultimately when this legislation gets to floor, I know what my colleagues are going to say. They are going to say, "Now wait a minute. Why do these churches out there and these church groups out there have to have separate rules, say, for example, the Truck-

ing Associations or the Fire Fighters." We are going to have to make that point. I think once we make that point, I think it will be acceptable. But you have to give me some fodder and some ammunition that we can place on the record and disseminate properly to them.

Mr. NASH. We will be happy to do that, Senator.

[The questions appear in the appendix.]

Senator PRYOR. Thank you.

So I will have my good friends, Steve and Jeff, here, who—I want to compliment these two young men. They have put this legislation together. We have been benefitted wonderfully to have Steve in our office. He has been what we call a "loaner" from the Department of Labor to help to develop some of these concepts that we are bringing before the committee and to your attention this morning.

And Jeff, also, is a full-time member of our staff. He is the fellow—I don't know if you have heard about it in recent years, the Taxpayers Bill of Rights that we finally got the Congress to enact—he is the guy who really figured all that legislation out and so we are very proud of these two fine young men who have worked, I know, with you and with the other groups coming before the committee today.

We are going to continue trying to get both of these pieces of legislation passed at the appropriate time.

We want to thank you very much for coming this morning and at this time our meeting stands adjourned.

[Whereupon, at 11:55 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted

Prepared Statement of David George Ball

Good morning Chairman Pryor and members of the Committee. My name is David George Ball and I am the Assistant Secretary of Labor for Pension and Welfare Benefits. I would like to thank you for the opportunity to appear before you today to discuss the pension portability and simplification provisions of S. 2901, the Employee Benefits Simplification Act.

I would first like to applaud your efforts, Senator Pryor, in drafting and introducing your bill. While the pension laws are included on everyone's list of tax code areas which are ripe for simplification, we believe that such simplification can also improve pension portability. As you know, this is an area which Secretary Dole has identified as one of her priorities. We are very pleased that this is also an area which you and the cosponsors of your bill have chosen to address. In addition to the members of the Committee, I would like to especially acknowledge Senator Jeffords's continued leadership in this area.

Secretary Dole has a great interest in developing a comprehensive policy to enhance pension portability. The Labor Department is currently considering a pension portability proposal, and is studying many components that are quite similar in concept to the provisions in your bill. We are pleased to see that you share our concerns, as well as some of the ideas about how we might solve the problem.

Pension portability remains one of the toughest challenges facing the private pension system. Pension portability is generally defined as the ability to limit pension losses workers suffer when they change jobs. During her Senate confirmation hearings in January 1989, Secretary Dole expressed her intention to carefully study the issue of pension portability. Since that time, we have pursued the issue in depth with pension experts from government, business and labor. Today, I would like to comment on those sections of S. 2901 designed to improve pension portability and expand coverage.

There are two major sources of potential portability losses. First, for defined benefit plans, if an employee switches jobs frequently, the net build-up of benefits over his working life will be reduced. Second, for both defined benefit and defined contribution plans, where an employee spends all or part of his or her pension before retirement, the ultimate benefit available at retirement will be reduced. This is most likely to be a problem with younger workers who may not be inclined to plan adequately for their retirement.

Our best preliminary estimates, based on Department of Labor and U.S. Census Bureau data, indicate that pre-retirement consumption of pension savings may represent up to two-thirds of all portability losses. This occurs when workers change jobs and take their retirement savings in a lump sum. That is, they receive a check equal to the present value of their accumulated pension benefits. The problem is that roughly 80 percent of these lump sum distributions are being spent. Some of this spending is for purely consumption purposes. Other amounts, however, may be used for savings, such as the purchase of a first or second home.

Retirement savings have been granted tax-favored status on the condition that they be used for retirement income. Adequate retirement income is an important national objective which justifies these generous tax benefits for private pension plans. Spending these savings before retirement frustrates this objective.

Stated quite simply, portability, to the greatest extent possible, should ideally allow a worker to maintain all of his or her savings in retirement income form. Therefore, we should encourage employees to keep retirement savings in tax-favored

retirement accounts. Section 201 of your bill would generally relax restrictions on transfers to an IRA or other qualified plan and eliminate forward averaging for lump sum distributions. These changes would simplify the extremely complex rules governing the taxation of distributions from qualified plans and, by improving the rollover mechanism, contribute to the retirement income policy goal of portability.

In addition, section 202 of your bill would require the direct transfer of certain benefits that would otherwise be distributed to an IRA. The Secretary is examining transfer proposals, including proposals similar to those contained in S. 2901. Of course, any such proposals must be administratively feasible and subject to our overall concerns about proposals that would lose revenue.

Rollovers and transfers are just two of the ways we could help workers preserve their savings until retirement. Pension portability is meaningless for the half of America's workforce which is not covered by private pension plans. Therefore, during our discussions, we have also examined ways to expand pension coverage and retirement savings by workers.

One natural idea would be to increase the number of pensions offered by America's small businesses, which will provide many job opportunities in the future. Smaller businesses are often unable to institute complicated and expensive pension plans, and, as a result, are at a disadvantage in recruiting and retaining quality workers.

Current law partially addresses these concerns with simplified employee pensions, or SEPs. If a SEP covers 25 or fewer employees, a worker can defer almost $8,000 of salary annually by having it contributed it to an IRA account in his or her name.

Many believe that these plans are ideal savings vehicles for smaller firms to sponsor, because they are not subject to portability losses when employees change jobs. They are also easier for employers to administer due to their simplified reporting and disclosure requirements.

Therefore, we are studying the desirability of making tax- deductible contributions available to SEPs which cover more than 25 employees. Data indicate that if you were to increase coverage to employee groups of 50 or less, SEPs would be available to nearly 95 percent of America's businesses. This would potentially allow an additional five and one-half million workers to accumulate savings through pre-tax payroll deductions. We are continuing to examine such an increase in SEP coverage, but we are mindful that any increase in the limit is likely to lose revenue. Because of the current budget constraints under which we all must operate, we cannot support your proposal to expand salary reduction SEPs to employers with 100 or fewer employees.

In conclusion, enhanced pension portability and incentives for expanded coverage are necessary to maintain the flexibility and adaptability of the voluntary private pension system. Several provisions of your bill, particularly the simplification of the distribution rules and repeal of forward averaging, would improve pension portability. The Administration will continue to study other proposals intended to enhance pension portability, retirement savings preservation, and expanded coverage. Of course, in order for the Administration to endorse any legislative proposals in the current budgetary climate, revenue considerations must be taken into account. Therefore, because the Treasury Department anticipates that S. 2901 could lose significant revenue, the Administration cannot support the bill as currently drafted.

Secretary Dole and I are committed to the integrity of our retirement system. We are dedicated to meeting these challenges to the future, and we look forward to working with the Committee to reach these goals.

Thank you for the opportunity to present my testimony. I will be happy to answer any questions you may have.

Prepared Statement of Ronald D. Hovis

Mr. Chairman and members of the Subcommittee, my name is Ronald D. Hovis, Director-Benefits, Southwestern Bell Corporation. I am pleased to testify today on S. 2901, the "Employee Benefits Simplification Act," on behalf of the Association of Private Pension and Welfare Plans (APPWP) on whose Board of Directors I serve. The APPWP's members either directly sponsor or administer employee benefit plans covering more than 100 million Americans. Thus, the APPWP's members are keenly interested in the operation of the nation's employee benefit system.

Mr. Chairman, you are to be commended for moving forward the effort to simplify the private pension system. Nearly a year ago, the APPWP issued a report entitled "Gridlock: Pension Law in Crisis and the Road to Simplification " S. 2901 represents a first step down that long road to simplification. No one should be misled into be-

lieving that enactment of S. 2901 will make the pension system simple. It won't. But the bill, and the hearings you have convened on this topic last March and again today, begin to properly draw attention to the compelling need for simplification of the pension system.

The Employee Benefits Simplification Act should be enacted. But while we feel that S. 2901 is a good first start, it is not a perfect bill. It does not address certain matters that are important to simplify the pension system and it includes some features that concern us. But if S. 2901 will not make the pension system simple it will at least make it simpler. After years and years of legislation and regulation that have added layers of costly and cumbersome complexity to the pension system, it is refreshing for the employee benefits community to see that a good faith effort is being made to unpeel some of those needless and duplicative layers.

Enactment of S. 2901 must not be the final word on pension simplification. If it is, it will be an inadequate response to a pervasive crisis that is infecting the system that is so vital to the retirement income security of millions of Americans. Rather, passage of S. 2901 should be the opening volley in a long-term battle to restore logic, simplicity and vibrancy to the private pension system.

THE PENSION SIMPLIFICATION LEGISLATIVE PROCESS

Before I turn my attention to the specifics of the legislation, allow me to make a few general comments about the process by which S. 2901 will be considered. Obviously, if the bill is to be enacted at all this year, it will be as part of some broader budget reconciliation measure. That process is always fraught with difficulties for the employee benefits system and it is the budget process that has brought us most of the worst pension policy results and complexity over the past decade. Thus, the importance of the Congress and especially the Finance Committee and Ways & Means Committee members keeping their eye on the objective of pension simplification as the broader budget deficit bill is crafted cannot be overstated.

From the APPWP's perspective, S. 2901 contains a few very important elements, a number of minor positive changes and a few problem areas that we would prefer to see removed from the bill. As the budget process unfolds and efforts are made to append whatever provisions of pension simplification possible to the greater budget package, advocates of pension simplification must stand firm in their commitment to the provisions of S. 2901 that really provide an opportunity to help simplify the system. If these provisions cannot be sustained—or if those who would thwart simplification want to extract too great a price in terms of watering down the important elements of the bill or making other employee benefits policy changes that are harmful to the system—then we would strongly urge the supporters of pension simplification to forego the effort and concentrate on doable and positive simplification at a later date.

The APPWP was very careful in developing the 29 recommendations for simplification contained in our "Gridlock" report to avoid changes that represented policy shifts. Rather, we stressed that for purposes of the simplification effort, whatever the policy enunciated by the Congress, we want to help ensure that it is achieved in a way that is less burdensome to the sponsors and participants of pension plans.

Thus, for example, in calling for the repeal of the Internal Revenue Code (IRC) Section 4980A excise tax on excess distributions, the APPWP was not arguing against the policy decision to limit tax favored treatment of very large pension benefits. Congress has already decided that issue. Rather, our point was to stress that that policy is already achieved by means of the IRC Section 415(e) combined plans limitation. As such, IRC 4980A and IRC 415(e) represent a classic example of needless duplication in the tax code which makes the operation of pension plans more complex. One or the other section should be removed.

We cite this in order to underscore that while pension simplification is very important—not just to the APPWP and its members but to the benefits community and plan participants as well—other agendas in the pension arena should not be allowed to be interjected into the discussions of achieving meaningful simplification.

S. 2901: ROADMAP FOR A SIMPLER PENSION SYSTEM

Clearly, there are certain elements of S. 2901 that are vital if meaningful simplification is to be achieved. These include: the safe harbor for the Average Deferral Percentage (ADP) and the Average Contribution Percentage (ACP) tests, the long-awaited simplification of the leased employee rules, narrowing the application of the IRC 401(a)(26) minimum participation rules, improvement of the required beginning date rules for plan distributions under IRC 401(a)(9), and a redefinition of "highly compensated employee."

At the same time, the bill contains provisions that greatly concern the APPWP's members including the provision requiring the transfer of distributions from qualified plans to IRs and the repeal of five year forward averaging tax treatment of distributions.

Further, there are other simplification measures not included in S. 2901 that we would like to see enacted. These include: relief from the top-heavy rules, repeal of either the IRC 4980A excise tax or the IRC 415(e) combined plan limitation described above, repeal of the hardship withdrawal rules for 401(k) plans, and the streamlining of a wide array of reporting and disclosure requirements that we outlined in "Gridlock." I would now like to turn my attention to discussing a few of these matters in greater detail.

Safe Harbor Alternative for ADP and ACP Tests

The APPWP commends the inclusion in the bill of a safe harbor for relief from the ADP and ACP tests. 401(k) plans are among the most popular retirement savings vehicles available in a nation sorely in need of greater savings. The current tests are very complex, they unfairly operate against the opportunities for savings among the lower paid of the highly compensated group and they are simply not needed following the Tax Reform Act of 1986 which severely restricted the dollar contributions to 401(k) plans. Accordingly, we have called for the outright repeal of the ADP test.

The safe harbor will be helpful to some sponsors and participants of 401(k) plans. I want to note that, as written, the safe harbor alternative will not be useful for a number of plans with generous employer contributions, including Southwestern Bell. For those whom the safe harbor works and makes economic sense, relief from applying the ADP and ACP tests and from the need to satisfy the 401(a)(4) nondiscrimination tests will mean significant simplification and the opportunity for more workers to participate in 401(k) plans. However, the level of employer contributions required to qualify for the safe harbor will be more than many employers can afford and, therefore, the safe harbor will prove unusable for many firms. We are compelled to note that the notice requirement associated with use of the safe harbor is an extra administrative burden, providing little, if any, value to participants and it is contrary to the goal of simplification.

We are pleased to note that the bill changes the anomalous rule governing the distribution of excess contributions to 401(k) plans. Current law penalizes those workers who are among the lowest paid of the so-called highly compensated group by deeming the excess contributions to be attributable first to those deferring the highest percentage of compensation. By changing the rule to deem the excess contributions first to the employees who have made the greatest dollar contributions, it will be the highest income earners rather than the middle income earners who will feel the full brunt of the rules.

Leased Employee Rules

The rules governing leased employees under IRC 414(n) have been in need of simplification for some time. Presently, one of the requirements for a person to be considered a leased employee is that the services performed by the individual "are of a type historically performed, in the business field of the recipient by employees." Last year the Senate passed a measure that would have corrected these complex and impractical rules.

The APPWP "Gridlock" report called for simplification of the leased employee rules and we commend you for including in S. 2901, as we requested, a provision that replaces the "historically performed" test with a test that determines whether the individual is performing services under the control of the recipient

Required Beginning Date of Distributions

There seems to be some general consensus that simplification is needed with respect to the rules governing distribution of benefits. We were disappointed that neither the Treasury Department, the Ways & Means Committee staff nor the Joint Committee on Taxation staff included revisions to the 401(a)(9) required beginning date rules among their recommendations for simplification of the distribution rules. You are to be applauded, Mr. Chairman, for recognizing the immense complexity of these rules by modifying them in S. 2901.

The absurdity of the 401(a)(9) rules is evident from their application to my company. Southwestern Bell devoted a significant amount of time, energy and money to understand and implement these rules. Yet, out of a workforce of 64,000 employees, only two employees were effected by the rules when the first payments were required under these rules in April 1989. Moreover, these two employees were not high-paid executives attempting to build-up their estates or extend indefinitely the

tax deferral advantage of their pension funds—as is often charged as the justification for these rules—but rather, were rank and file employees who continued to work past age 70 in order to continue receiving a paycheck. These rules must be fixed.

Minimum Participation Rules

The original focus of the IRC 401(a)(26) minimum participation rules was aimed at the elimination of individual defined benefit plans which only covered the highest paid employee of the employer. Through regulations these rules have grown a life of their own and now appear so broad that virtually all plans are affected by them. The APPWP has called for repeal or modification of the rules.

The complexity of the rules would be reduced considerably under recently published proposed IRS regulations. Section 104 of S. 2901 appropriately goes further by statutorily restricting the application of the 401(a)(26) rules to defined benefit plans and by reducing the minimum number of people who must be covered to qualify under 401(a)(26) Both of these changes are consistent with Congress' original intent in passing this section of the tax code and represent a significant improvement.

Redefinition of Highly Compensated Employee

The complex definitions of who is a highly compensated employee (HCE) was another area identified in "Gridlock" as ripe for correction. S. 2901 wisely replaces the four-pronged test for determining who is an HCE with a two part test. This is a very helpful improvement which we support.

Redefinition of Compensation

The complex definition of what constitutes "compensation" was another area identified last year in "Gridlock" as appropriate for simplification. We are pleased to report that the IRS has responded to the APPWP and the business community's calls for simplification with recently proposed rules defining compensation which are improved and simplified. Accordingly, we believe that when you compare the rules proposed by IRS with the new standards set forth in S. 2901, the proposed rules are preferable. Accordingly, we commend you for identifying this area as certainly ripe for simplification but would urge you to drop this change from the bill in favor of the standards set forth in the proposed IRS rules.

Mandatory Transfers of Plan Distributions

We are at a loss to understand why a "simplification" bill contains extensive provisions requiring transfers of most pre-retirement distributions to an IRA or to another qualified plan. Clearly, this provision adds complexity to the pension system. We recognize that there currently is a desire in some quarters in Congress and the Administration to try to further pension portability. Reasonable people may differ as to whether that concept is a sound one and whether in practice it can be achieved. One thing is certain: advancing pension portability is a major policy shift deserving of thorough debate. We do not see it as appropriate for a simplification bill that is not trying to change fundamental pension policy.

The proposal itself has a number of problems. It would require ongoing communication between employers and terminated participants as transfer IRs are identified and arrangements are made to transfer account balances. This is especially bothersome where the termination has not been a cordial one.

The proposal also would change the availability of in-service distributions from profit-sharing plans. Currently, deferred profit sharing plans may permit in-service distributions of employer contributions without requiring "hardship" as in a 401(k) plan. The bill appears to impose the 401(k) hardship requirements on deferred profit sharing plans. This change would significantly alter the relationship between the company and participants in thousands of profit sharing plans. It is a fundamental policy shift. In addition, as we mentioned previously, and as fully described in "Gridlock," the APPWP strongly believes that the broader withdrawal rules available to non-401(k) plans should be substituted for the complex and administratively cumbersome hardship rules currently applicable to 401(k) plans.

Finally, the mandatory transfer provision would have the effect of diminishing voluntary contributions to plans. Due to restrictions imposed on pre-retirement distributions under the Tax Reform Act of 1986, lower-paid employees are already reluctant to make voluntary contributions to deferred plans. Many participants with pre-1988 contributions were understandably upset that rules were changed after contributions had been made. The passage of this proposal would underscore that concern that the rules in operation today may be replaced by even more restrictive rules in the future—thus resulting in a reduced willingness to make contributions to plans.

Five Year Averaging

The APPWP is also concerned about the inclusion of the provision to repeal five year averaging tax treatment of lump sum distributions. Without five year averaging, it would appear that many retiring employees who take lump sum distributions will be paying taxes at the highest rate even though their contributions and employer contributions were made when the employee was at a lower effective rate. It would be unfair to tax the distribution of an employee at the highest rate when the employee's tax rate at the time of the original contribution was perhaps 15 percent. This will reduce the attractiveness of employees making voluntary contributions. Moreover, the same applies for employer contributions. Many employees will simply want their benefits in cash rather than wait for a benefit later when it will be taxed at a higher rate. We do want to note that the liberalization of the rollover rules represents a positive change.

CONCLUSION

Again, we commend you for advancing the momentum on the effort to simplify the pension system. This is essential in order to preserve that system. Many features of S. 2901 are laudable. A few are problematic. We pledge to work with you to help craft simplification legislation that will provide necessary relief to the overly burdened system—not just this year but into the future as further simplification is sought.

PREPARED STATEMENT OF SENATOR JAMES M. JEFFORDS

Mr. Chairman, and members of the Oversight Subcommittee, I come before you today to commend you for initiating important changes to ease the administration of pensions. The Employee Benefits Simplification Act, S. 2901, is an idea whose time has truly come. Furthermore, I am delighted that you have also included pension portability provisions in this bill. For a successful national retirement income policy, we need greater portability of pension assets. Portability is best achieved by encouraging the preservation of pension income and the development of portable pension plan accounts. The distribution and simplified employee pension (SEP) rules contained in S. 2901 will go a long way toward achieving these objectives and thus help ensure retirement income security for millions of American workers.

As you know, I am an outspoken advocate of the need to encourage the portability of pension assets. I have had portability legislation passed twice by the House and marked up twice by the Senate Labor Committee. In the course of my efforts, I also testified before the Senate Subcommittee on Taxation and Debt Management on pension portability in 1988. It is a pleasure to be here today to testify on specific Senate Finance committee legislation to deal with this issue. I commend you, Senator Pryor, for your initiative and I am pleased to be a cosponsor of S. 2901.

I would also like to acknowledge Secretary of Labor Elizabeth Dole for her diligent examination of the pension portability issue. S. 2901, in many respects, parallels both the Secretary's and my own previous recommendations in this area. I firmly believe S. 2901's distribution rules, nondiscrimination safe harbors and qualification requirements for salary reduction SEPs are a step forward in the development of sound pension policy. I do however, have two modifications to suggest and the remainder of my remarks will concern these points.

(1) My first point is related to my belief that it is important to encourage the retention of spousal distribution rights for pension money transferred to IRA accounts.

Statistics from the Older Women's League show that divorced and widowed women, over 65, are the poorest people in our nation. At present, 70% of all older, non-married women rely on Social Security as their primary source of income. In order to encourage spousal protections and at the same employers the option of directly transferring the pension accounts of terminated employees into other pension plans or IRAs that provide for the same joint and survivor annuity options as provided by the plan. time provide employers some flexibility, I would allow

(2) In addition, I wish to point out that S. 2901 in its current form doesn't permit the transfer of after-tax employee contributions into eligible transferee plans. Employee after-tax contributions were especially popular in manufacturing companies before 1986. Employees who saved after-tax monies for their retirement should not be forced to spend their after-tax distribution money because they can't put this money into an IRA account. This makes no sense, especially since non-deductible contributions to IRAs are permitted and must be accounted for separately under

current law. It is ironic that instead of rewarding people for saving after-tax money for retirement purposes, current law instead penalizes them. Certainly this is no way to encourage the preservation of pension income for retirement purposes—one of our main pension policy goals.

In conclusion, I would just like to point out that we as a nation must prepare to successfully meet the challenge posed by our nation's changing demographics. By the year 2025, the average life expectancy for a 65 year old will be twenty years. In addition, the ratio of active workers to retirees is expected to go from 4:1 to 2:1. Given these facts, intelligent public policy necessitates that we do all we can to ensure that baby boomers prepare now for when they retire tomorrow. This means we must legislate in an unaccustomed way: with an eye towards long term results.

The distribution, non-discrimination and coverage rule changes proposed in the Employee Benefits Simplification Act are important steps in this direction. These provisions will help reverse two disturbing pension policy trends: (1) the high rate of consumption of cashed out pension contributions; and (2) the stagnation in pension plan coverage.

I appreciate the opportunity to testify today and look forward to working with you in an effort to make the Employee Benefits Simplification Act public law.

Prepared Statement of David J. Kautter

Thank you, Mr. Chairman, for the opportunity to testify today on a subject of considerable importance to the American Public and to our membership. I am David J. Kautter, Chairman of the Employee Benefits Taxation Committee of the American Institute of Certified Public Accountants Federal Tax Division.

The AICPA is the national, professional organization of CPAs with 290,000 members. Our testimony is from the perspective of CPA—tax practitioners who constantly observe the conduct of taxpayers, both individual and business.

First and foremost we would like to compliment Senator Pryor for endeavoring to simplify the tax rules governing the treatment of private pension plans. We believe that the existing rules are discouraging the establishment of new retirement plans, encouraging the termination of existing plans and diverting money to plan administration costs and away from plan benefits. We also believe that they are resulting in significant unintentional noncompliance. In our view, simpler tax rules will enhance the viability of our nation's private pension system. We view S. 2901, the "Employee Benefits Simplification Act" as a positive first step in the process of simplifying the tax rules governing qualified retirement plans. We view this step as a first but important step and we pledge our continuing support in this endeavor.

In testimony before this Subcommittee in March, we proposed that Congress use the following test as a guide in determining which rules of existing law should be retained and which should be changed:

> Is the incremental contribution to equity made by the rule outweighed by its incremental contribution to complexity of the law?

We submit that this test is still the appropriate test to apply in judging the appropriateness of a statutory provision from a simplification point of view. We have applied it to the various sections of S. 2901 and have reached the following conclusions and observations:

TITLE I—NONDISCRIMINATION PROVISIONS

§101 Definition of Highly Compensated Employee.

We support this provision. It would substantially simplify the determination of who is a highly compensated employee for qualified plan purposes. We also support the concept of making this determination on the basis of the compensation paid during the preceding calendar year. This will allow employers to determine who is a highly compensated employee" early in the plan year and eliminate much of the uncertainty of current law.

We question, however, whether an employer should be precluded from being able to determine who is a highly compensated employee on the basis of base pay, especially since base pay may be used to determine compensation for purposes of §414(s).

§102 Definition of Compensation.

We support this provision. We believe that it will substantially simplify the determination of compensation. We also believe that the three choices available to employers: (1) W-2 wages, (2) W-2 wages plus deferrals under sections 125,

402(a)(8), 402(h), 403(b), 457, 414(h) and 501(c)(18), and (3) base pay allows significant flexibility to employers in determining compensation.

§103 Modification of Cost of Living Adjustments.

We support this provision. It should provide greater certainty for many plans by allowing them to know the appropriate indexed limits when their year begins. The rounding rules will also simplify certain calculations.

§104 Modification of Additional Participation Requirements.

We support this provision. In our view, eliminating the application of §401(a)(26) to defined contribution plans will simplify the tax rules without sacrificing significant tax policy concerns. We also support the bill's modifications of the test with respect to the number of employees that must be covered under a defined benefit plan.

In view of the revised section 401(a)(26) regulations issued by the Treasury Department and the proposed §401(a)(4) and §410(b) regulations, we question whether §401(a)(26) is necessary at all. We are willing to wait until these regulations are finalized before making a final decision on whether we believe §401(a)(26) should be repealed entirely.

§105 Nondiscrimination Rules for Qualified Cash or Deferred Arrangements and Matching Contributions.

We are reluctant to advocate retention of the current actual deferral percentage (ADP) test, even as an alternative to a design based rule. In general, design-based safe harbor rules contribute to simplicity in plan design and operation. One of the most frequently misunderstood and misapplied provisions of current law is the ADP of section 401(k) which is not a design-based test but requires annual testing of actual elective contributions by eligible participants.

In lieu of the design-based test contained in the proposed legislation, we believe consideration should be given to a design based rule which would require: (1) that all employees with a requisite age and year(s) of service and not otherwise excluded under section 410(b) be permitted to make deferrals under a section 401(k) plan and (2) that notice be given to all eligible employees of their right to participate in the plan. The ADP test could then be repealed.

As for matching contributions, a design-based rule which requires: (1) all employees with requisite age and service and not excluded under §410(b) be eligible to make contributions qualifying for matching employer contributions, (2) notice be given to all eligible participants, and (3) a uniform rate of employer match, would effectively preclude matching contributions from being provided in a discriminatory manner. This rule would also allow repeal of the special rules now provided in section 401(m) which require testing of actual plan operation. If there is still concern about discrimination, contributions eligible to be matched could be capped, for example, at 10% of compensation.

TITLE II—DISTRIBUTIONS

§201 Taxability of Beneficiary of Employees' Trust.

We support the rollover provisions of S. 2901. Allowing any distribution from a qualified plan, other than a required minimum distribution under §401(a)(9), to be eligible for rollover treatment will substantially simplify the taxation of distributions and distribution planning for a large number of taxpayers. It will also encourage retention of funds originally contributed to retirement plans for retirement purposes.

We also support the repeal of five year averaging treatment for distributions from qualified retirement plans. This change coupled with the change in the rollover rules contained in S. 2901 would substantially simplify the rules governing the taxation of distributions while encouraging distributions from retirement plans to be used for retirement purposes.

We are concerned with the retention of the definition of a "lump sum distribution" by the bill for purposes of the net unrealized appreciation rules and the §401(k) distribution rules. The primary simplification achieved by eliminating averaging treatment is the elimination of the definition of Up sum distribution," not the elimination of the averaging computation. Retention of the definition of "lump sum distribution" for the above purposes undercuts the substantial simplification that elimination of averaging achieves. We believe the definition should be eliminated for all purposes.

§202 Qualified Plans Must Provide for Transfers of Certain Distributions to Other Plans.

We strongly oppose this provision. We believe that the incremental contribution to complexity of this proposal is outweighed by its incremental contribution to equity.

In our view, this provision would add unneeded complexity to the tax law. It will increase the complexity of administering retirement plans, and will require all plans to be amended.

For example, the portion of a distribution which represents an employee's after-tax contribution would not be required to be transferred while employer contributions and earnings would. This will require plans with employee contributions to make two distributions instead of one. It will also require two distributions in most other cases, one to the transferee plan and a subsequent one to the participant. This will not simplify plan administration.

We believe that if this provision is enacted, however, section 72(t) should be repealed. In our view, the two sections overlap and including both in the law would result in unnecessary complexity.

§203 Required Distributions.

We support this provision but we believe additional changes can be made which would further simplify the rules of §401(a)(9).

First, at death, distributions could be required to be paid over the life expectancy of the beneficiary beginning at the decedent's death. There would be no distinction between situations where an individual dies before or after his required beginning date. There would also be no distinction between types of beneficiaries as there is under current law. Second, the calculation of life expectancy should not be recalculated. The only method of determining life expectancy would be reducing the initial calculated life expectancy by one each year. Both of these suggestions are intended to streamline §401(a)(9) without altering the underlying concept.

TITLE III—MISCELLANEOUS PROVISIONS

§301 Treatment of Leased Employees.

No position.

The "historically performed" standard of section 414(n) has led to substantial confusion. It is unclear to us whether a "control" test would provide any additional certainty. To the extent the "control" standard is based on a similarly-worded standard which has developed as part of the common law employment test, a body of law would be available to help make this determination. This may provide certainty. We do propose, however, that §414(n) be amended so that it does not cover independent contractors where no third party leasing organization is involved and the current reference to §144(a)(3) be eliminated.

§302 Elimination of Half-Year Requirements.

We support this provision.

§303 Plans Covering Self-Employed Individuals.

We support this provision. This change would simplify the law and eliminate a trap for the unwary.

We also believe that consideration should be given to eliminating the last two sentences in §4975(d) that prohibit loans from qualified plans to owner-employees.

§304 Full-Funding Limitation of Multiemployer Plans.

No position.

§305 Affiliation Requirements for Employers Jointly Maintaining a Voluntary Employees Beneficiary Association.

No position.

§300 Treatment of Certain Governmental Plans.

No position.

It is unclear to us why these rules, at least the rules relating to excess benefit plans, do not apply to all not-for-profit organizations, e.g., §501(c)(3) organizations.

§307 Modifications of Simplified Employee Pensions.

We support this provision with the caveat that we believe salary reduction SEPs should be subject to the same rules as §401(k) arrangements.

§308 Contributions on Behalf of Disabled Employees.

We support this provision.

§309 Distributions Under Rural Cooperative Plans.

We support this provision since it would conform the rules of §401(k) plans maintained by rural cooperatives to that applicable to other §401(k) plans.

§310 Reports of Pension and Annuity Payments.

We support this provision.

§311 Date for Adoption of Plan Amendments.

We support this provision but would propose plan years beginning after January 1, 1993.

The balance of my testimony identifies other specific areas of the law where we believe substantial simplification can be achieved while retaining virtually all the underlying legislative policy behind current law. The proposals were submitted to this Subcommittee as part of our March 23, 1990 testimony. We continue to believe that these proposals should be considered by the Subcommittee.

GENERAL PROPOSALS

A. Proposal: Use a single set of terms to describe qualified retirement plans in the Internal Revenue Code—Defined Contribution Plans and Defined Benefit Plans

1. **Proposal and Rationale**—The Code should be structured around the ERISA terms—defined contribution and defined benefit plans. The elimination of the "profits" requirement for a profit-sharing plan leaves very little distinction between the types of defined contribution plans from a definitional point of view. It is difficult to see what policy purpose is now served by using two terms in the Code to describe each plan (defined contribution and defined benefit v. profit sharing, stock bonus and pension). While distinctions would continue to be permitted between the types of defined contribution plans, those distinctions would be meaningless in applying the qualification, deduction, and distribution rules. For example, an employer could still establish a plan calling for either fixed or discretionary contributions or one that mandates distributions in employer stock.

2. **Reduction of Complexity Achieved**—This proposal would allow taxpayers to use one set of terms to apply the qualification, deduction and distribution rules. This proposal would also conform the terminology of the Code to the terminology of Title I of ERISA (the rules administered by the Department of Labor) facilitating the ability of taxpayers to understand both the non-tax and tax consequences of their actions.

Specifically, §§401(a)(27) and 401(a)(23) would be repealed. The changes required to §404 will be discussed later in the paper.

B. Proposal: Segregate leveraged ESOPs from the qualified plan requirements and treat them as a separate financing vehicle

1. **Proposal and Rationale**—The leveraged ESOP requirements should be removed from the qualified plan rules and collected in a separate subchapter of the Code. The rationale is that, in substance, leveraged ESOPs have tended to be a financing vehicle rather than a retirement vehicle, although they have attributes of both. There are a number of requirements that are unique to leveraged ESOPs which appear throughout the qualified plan rules. Unless someone is intimately familiar with all these rules and their location in the Code, the chance of their overlooking a particular requirement is unnecessarily high. Isolating these rules from the qualified plan rules would eliminate a source of complexity in the qualified plan rules, recognize the unique nature of leveraged ESOPs, and collect all the related rules in one subchapter.

It is not being proposed that the leveraged ESOP rules be repealed. What is being proposed is that these requirements be collected separately in their own subchapter so that someone need not be an ESOP expert in order to answer a question with reset to them.

2. **Reduction of Complexity Achieved**—When dealing with qualified retirement plans, the following sections would no longer need to be considered: §§401(a)(28), 409, 404(a)(9), 404(k), 415(c)(6), 4975(e)(7), and 4975(d)(3). These sections would be collected in a separate subchapter of the code.

PLAN QUALIFICATION PROPOSALS

A. Proposal: Repeal the top-heavy rules

1. **Proposal and Rationale**—The special rules of §416 should be repealed. While §416 served a purpose when it was passed, one limitation imposed by §416 ($200,000 cap on compensation) now applies to all plans and another (faster vesting) is virtually the same for top-heavy and non-top-heavy plans. The other significant difference between top-heavy and non-top-heavy plans involves benefit accrual, and with recent changes in the permitted disparity rules in TRA 86, this difference is significantly less than it was in 1982. The regulations to be issued under §401(a)(4) could provide further guidance if any perceived gaps exist.

The top-heavy rules also contain their own definition of the employees in whose favor discrimination is prohibited ("key employee"). Following TRA 86, most Code sections affecting discrimination use the term "highly compensated employee." At a minimum, the use of the term "key employee" should be eliminated and the TRA 86 definition of highly compensated employee substituted.

In view of the fact that virtually all plans must include these provisions, and that the incremental benefit of the top-heavy rules has been diminished by subsequent changes in the Code, these provisions could be eliminated with little adverse impact on participants and reduce complexity in the law and plan documents.

2. **Reduction of Complexity Achieved**—Repeal of §§416 and 401(a)(10)(B) and the yearly testing that is required under the provision.

B. Proposal: Eliminate the ability to provide medical benefits to retirees from qualified plans

1. **Proposal and Rationale**—Provided other adequate means are available for pre-funding retiree medical expense, qualified retirement plans should not be allowed to provide medical benefits for retirees. Qualified retirement plans should be plans of deferred compensation designed to replace wages upon retirement, not plans designed to replace an employee's entire compensation arrangement. These accounts cause additional complication in plan documents, plan administration, and plan design.

It is not being proposed that employers not be allowed to pre-fund any of their retiree medical liability. Those who wish to pre-fund this obligation could do so on a tax-preferred basis by utilizing a voluntary employee beneficiary association (VEBA) described in §501(c)(9). In order for this to be an adequate alternative, however, the VEBA rules need to be amended so that employers can more adequately fund their retiree health obligations, e.g., earnings on funds set aside for retiree health obligations should not be subject to unrelated business income tax.

2. **Reduction of Complexity Achieved**—The elimination of §§401(h) and 415(l) and modification of §404(e).

C. Proposal: Simplify the distribution of qualified pre-retirement survivor annuity (QPSA) notices

1. **Proposal and Rationale**—The QPSA notice should be required to be provided only to individuals within a reasonable period after they become plan participants. There is little logic in providing this notice only at the current age range, since most employees are sophisticated enough to understand the notice at any age. This provision has simply resulted in an increased compliance burden for plan sponsors without a commensurate return, either in understanding on the part of the participants, or in achieving effective disclosure.

2. **Reduction of Complexity Achieved**—This would result in the repeal of §417(a)(3)(B)(ii)(I).

BENEFIT ACCRUAL PROPOSALS

A. Proposal: Expand the coverage rules for 401(k) plans to include employees of tax-exempt organizations and eliminate the separate rules in §403(b)

1. **Proposal and Rationale**—It is difficult to understand why tax-exempt organizations are prevented from making salary deferrals available under §401(k), and yet can make salary deferral elections available in an even more liberal fashion under §403(b).

In addition, there appears to be no compelling policy justification for requiring employees of tax-exempt organizations to participate in annuity contracts or custodial accounts rather than in the investments available to employees of non-tax-exempt organizations. The repeal of §403(b) should be considered In an age where self-directed accounts are very commonly available through any of the large, national brokerage firms or other financial institutions, individual accounts are relatively

easy to establish, not very costly, and much more convenient for employees of tax-exempt organizations than when §403(b) was enacted.

In order to simplify the Code, tax-exempt organization employees should be treated the same as all other employees for salary deferral purposes. Thus, employees of both types of organizations should participate in identical plans, have the same salary deferral amount as a ceiling, and have the same plan investment alternatives available to them. This proposal, when combined with the previous proposal concerning section 401(k) plans, would provide for a uniform set of rules which could easily be administered by plan sponsors and the IRS.

2. **Reduction of Complexity Achieved**—This would have the effect of repealing §403(b) and extending the 401(k) plan rules to employees of tax-exempt organizations.

B. Proposal: Eliminate the ability of employees to make after-tax contributions to qualified retirement plans

1. **Proposal and Rationale**—The ability of a qualified plan to accept voluntary after-tax employee contributions should be eliminated and §401(m) should be repealed. The rationale is one that is motivated solely by a desire for reducing complexity.

Allowing after-tax employee contributions to be made to qualified plans now requires plan administrators to separately account for these amounts annually to ensure that the tests of §401(m) are met. These amounts must be separately identified when distributed to participants and involve a separate subset of rules in the distribution area to determine what is taxable to a participant and what is a recovery of the participant's basis. These rules are complicated both from a technical and a plan administration perspective.

The elimination of voluntary after-tax contributions would not only reduce complexity in the statute but would also reduce complexity in the administration of qualified plans. Adoption of this proposal would not leave employees without tax-deferred investments because individual Retirement Accounts (IRAs) on a non-deductible basis under §408(o) (which were not available until tax years beginning after 1986), tax-deferred annuities, and other investment products such as municipal bonds are offered in this category. Further, the existence and rapid acceptance nationally of pre-tax deferrals in 401(k) plans has made the after-tax contribution a less attractive alternative for employees.

If Congress decides that employees should be allowed to fund larger tax deferred savings accounts for their retirement by using after-tax contributions, the existing rules for IRA after-tax contributions could be amended to increase the allowable level of contribution.

With §401(m) repealed, matching contributions would be subject to the nondiscrimination principles in §401(a)(4). The statute could provide that if matching contributions are available at the same rate for all employees, the matching contributions would be deemed to be nondiscriminatory.

2. **Reduction of Complexity Achieved**—The following Code sections governing plan qualification can be repealed if voluntary after-tax employee contributions are eliminated: §§401(a)(19), 401(m), 411(c), and 411(d)(5). In addition to reducing complexity in the qualification area, the elimination of voluntary after-tax employee contributions will reduce complexity in the area of distribution planning and the taxation of distributions. For example, if voluntary after-tax employee contributions are repealed, the portion of §72 which deals with the recovery of the employee's basis could be eliminated, §402(a)(5)(B) could be repealed and the second sentence of §402(a)(1) could be repealed. A transitional rule could be provided to facilitate the distribution of existing voluntary after-tax contributions from qualified plans. For example, participants could be allowed to transfer these amounts, with or without earnings, to an IRA.

C. Proposal: Eliminate the permitted disparity rules (Social Security integration rules) or return to a modified version pre-87 integration

1. **Proposal and Rationale**—The concept of permitted disparity should either be altogether eliminated or substantially simplified. A complete repeal of permitted disparity rules would reduce the complexity of the qualified plan area and would generally provide greater benefits to employees in those plans currently using the permitted disparity rules. Repeal of the disparity rules could, however, lead to termination of existing plans. Therefore, if complete repeal is not desired, the rules should be simplified. For example, the pre-TRA 86 rules could be reinstated with a minimum benefit required for all plan participants.

2. **Reduction of Complexity Achieved**—This proposal would repeal §§401(l), 401(a)(5), and 401(a)(15).

D. Proposal: Simplify the combined plan limitations of §415(e) and repeal §4980A

1. **Proposal and Rationale**—Employees who are benefited by a defined benefit and defined contribution plan of the same employer should be subject to either §415(e) or §4980A but not both.

If §415(e) is to be retained, then §4980A should be repealed. If §415(e) is retained, it should be revised to be based on a plan design approach rather than on an actual accrued benefit a-roach. For example, if 100% of the defined benefit plan limit is being accrued for an individual, then only 25% of the maximum defined contribution limit would be provided for an individual under a defined contribution plan. (These percentages are used for illustrative purposes only.) This would eliminate the need for the annual cumulative calculation that is required under current law.

If, however, §4980A is maintained in the law, then §415(e) should be repealed and the maximum benefit should be allowed to accrue in both defined benefit and defined contribution plans.

We believe that the better course of action is to repeal section 4980A.

2. **Reduction of Complexity Achieved**—The simplification achieved is the repeal of either §415(e) or §4980A.

E. Proposal: Simplify the coverage rules by repealing the second part of the average benefits test

1. **Proposal and Rationale**—The average benefits test should be repealed. Section 410(b) is designed to test coverage and not benefit accrual. There are other sections of the Code that deal with nondiscrimination in benefit accrual and that concept should not be tested with coverage. This approach adds complexity and substantially overlaps with other requirements of the law such as §401(a)(4).

An alternative approach would be to conform the §401(a)(4) test to the §401(b) test by statute so employees would have a uniform set of values to apply.

2. **Reduction of Complexity Achieved**—The simplification achieved is the repeal of the average benefits test found in §410(b)(2)(A)(ii).

DEDUCTION PROPOSALS

A. Proposal: Apply §404(a)(1) only to defined benefit plans

1. **Proposal and Rationale**—Given the earlier proposal to classify all plans as either defined benefit or defined contribution plans, §404(a)(1) would only apply to defined benefit pension plans.

2. **Reduction of Complexity Achieved**—The reduction in complexity achieved would be the consistent treatment of money purchase pension plans throughout the Code.

B. Proposal: Apply §404(a)(3) to all defined contribution plans

1. Proposal and Rationale—Section 404(a)(3) should limit the deduction for all types of defined contribution plans instead of for just profit-sharing and stock bonus plans. After this change, the deduction limit for money purchase plans would be found in §404(a)(3). A further simplification is the coordination between the 15% deductibility limit in §404(a)(3) and the 25% contribution limit in §415(c). The §415(c) and §404(a)(3) limits would be the same, for example, 25% of compensation.

2. **Reduction of Complexity Achieved**—Again, one set of terms would be used consistently throughout the Code. This proposal would also eliminate the necessity of maintaining two plans, a money purchase pension plan and a profit-sharing plan to achieve the maximum level of contribution allowable under law for defined contribution plans, while retaining maximum flexibility.

DISTRIBUTION PROPOSALS

A. Proposal: Simplify hardship withdrawals from 401(k) plans

1. **Proposal and Rationale**—The rules governing hardship distributions from qualified plans could be substantially simplified by specifying certain situations in the statute which would be considered a hardship for distribution purposes, e.g., purchase of a principal residence, education, or medical expense. In addition, no suspension from plan participation would be imposed on account of a hardship withdrawal.

An alternative to simplification would be elimination of hardship withdrawals. Elimination of hardship withdrawals, however, might discourage nonhighly compensated employees from participating in §401(k) plans.

2. **Reduction of Complexity Achieved**—The complicated plan amendments required as a result of the proposed and final regulations on hardship withdrawals in 401(k) plans which were issued on August 8, 1988 would no longer be needed and

the role of plan administrators in administering affected 401(k) plans both now and in future years would be simplified.

CONTROLLED GROUP PROPOSALS

Proposal: Better define the terminology used in §§414(m) and 414(n) and repeal §414(o).

1. **Proposal and Rationale**—The §414(m) affiliated service group definitions under the Code and the regulations are extremely complex. If Congress wishes to prevent the perceived abuse at which §414(m)(2) was aimed, it appears that much of the complexity would have to remain. However, it would be helpful if some of the terms used in the Code were more clearly defined. The use of too many qualitative terms causes plan sponsors and their advisors to spend extra time and effort in attempting to interpret them.

First, the definition under §414(m)(2)(A)(ii) could be changed to state that "if more than 25% of the services performed by the A organization are for the first service organization" instead of using the amorphous term of "regularly performed." Also, deminimis ownership should be ignored under §414(m)(2)(A)(i), e.g. ownership of less than 1%. Under the B organization definition, the phrase "significant portion" should be defined as 25% or more.

With respect to §414(m)(5), the "principal business" should be defined in the Code as the business constituting 50% of gross revenues. In addition, firm management functions should be defined as executive type functions rather than permitting the regulations to expand that definition to include professional services. Simply rendering professional services for another organization should not cause the individual providing the service to be aggregated with the recipient organization on that basis alone.

Finally, §414(o) should be eliminated entirely as it has made it virtually impossible for a sole proprietor and other small businesses to determine eligibility for pension plan contributions when it is involved in any way with any other entity. For example, an employee who is a 5% owner of a company and who also works for another company must determine whether the two companies are recipients under §1.414(n)-1 (b)(2) and (b)(6), which in turn, requires an analysis under §§414(b), (c), (m), and (o) and also under §144(a)(3), and with respect to any organization under §§414(b), (m), and (o) and §144(a)(3) requires an analysis of whether there is aggregation under §§267, 707(b) or members of controlled groups as defined in §1563 substituting 50% for 80%. This analysis is beyond the ability of most sole proprietors (and many practitioners), and would probably cost more in advisor's fees than what many sole proprietors would gain by taking the pension plan deduction.

2. **Reduction of Complexity Achieved**—Making the statute more specific will assist plan sponsors and their advisors in interpreting and applying these provisions.

PREPARED STATEMENT OF LEO J. LANDES

My name is Leo Landes. I represent the Joint Retirement Board of the United Synagogue of America. I have also been a member of the steering committee of the Church Alliance since its inception, some 12 years ago. Two years ago I was chosen as president of the Church Pensions Conference which includes over fifty religious denominations. I have two brothers who are rabbis. My father and grandfather were rabbis.

Our Synagogues support S. 2902 wholeheartedly. S. 2902 for the first time would collect in two separate places in the Code those rules relating to qualified church plans and retirement income accounts. If in the future Congress enacts legislation of general applicability, it will not by accident impinge on church plans.

Of great interest to us is that S. 2902 would simplify the retirement income account rules applying to churches and church ministry organizations. In the Jewish faith these organizations often tend to be very small, being staffed by a rabbi and perhaps a part-time secretary. We cannot handle complex rules and cannot afford to pay professionals for expertise.

We have also been concerned that ministers and rabbis who are self-employed or who are chaplains in hospitals and other institutions may be unable—because of technicalities in the Code—to participate in the church retirement plans of their denominations. S. 2902 resolves these technical problems that at present prevent such participation for no good reason.

The ability of ministers and rabbis to participate in unfunded deferred compensation plans of churches and church-related organizations has been of great impor-

tance to them. S. 2902 broadens the categories of organizations which are exempted from the stringent rules of Section 917. Under S. 2902 all churches and organizations which are associated with a church denomination, but not church-related universities and hospitals, are exempted from the rules of Section 457.

We will do everything we can to help carry through S. 2902 to enactment in 1990.

Prepared Statement of Gary S. Nash

My name is Gary Nash, and I am the Secretary of the Church Alliance and General Counsel of the Annuity Board of the Southern Baptist Convention.

During the 15 years that I have served as Secretary of the Church Alliance, churches have been faced with a tremendous volume of employee benefits legislation. Whenever a new piece of employee benefits legislation is proposed, the legislation typically does not recognize the unique structure and needs of church retirement and welfare benefits plans, and the members of the Church Alliance consequently have had to spend significant amounts of employee time and funds in explaining to Congress why a particular rule is unworkable or simply not needed.

The Church Retirement Benefits Simplification Act of 1990 (S. 2902) introduced by Senator David Pryor on July 25, 1990, is an important step for the churches in dealing with this constant onslaught of employee benefits legislation.

Over the last decade, staff members of the tax-writing committees of Congress and aides of several concerned Members of Congress have discussed with representatives of the Church Alliance the need for the rules that apply to church plans to take into account the unique needs and characteristics of church retirement and welfare benefit programs.

S. 2902 creates a new section 401A, applicable only to "qualified church plans," and modifies section 403(b) for churches. In addition, and most importantly, S. 2902 provides that new section 401A and the portion of section 403(b) that applies to churches will be "walled off," so that future changes made for non-church employers in section 401(a) and section 403(b) will not apply to church retirement plans unless specifically made applicable thereto. This provision is the cornerstone of S. 2902.

S. 2902 simplifies and brings workable consistency to the rules applicable to church plans. Under current law, plans of churches and "qualified church controlled organizations" are not subject to coverage rules under section 403(b). We think Congress was correct when in 1986 it determined that churches and church ministry organizations should not be subject to new coverage rules under section 403(b). S. 2902 would provide the same treatment under new section 401A for qualified church plans, other than for plans maintained by church hospitals, colleges and universities. S. 2902 would also level the playing field for plans of church hospitals, colleges and universities so that section 403(b) annuity programs and section 401A plans maintained by these organizations will be subject to the same set of coverage rules.

S. 2902 would also resolve another important problem churches face in administering their retirement and welfare benefit plans. For example, a number of ministers are employed as chaplains in hospitals, halfway houses, and government prisons. S. 2902 makes it clear that these ministers can continue to participate in church retirement and welfare benefit plans and also clarifies that their participation in these plans will not in any way affect the plan of the organization that is considered to be their actual employer under the tax laws. This is an extremely important provision to ministers who, at their church's encouragement, have stepped outside the pulpit to carry on their ministry in the secular arena.

S. 2902 would also permit IRA-type qualified voluntary employee contributions to be made to church plans (subject to the deduction limitations currently applicable to IRAs) Ministers and lay workers are more likely to contribute to such programs than to an IRA due to the greater confidence in and familiarity with the denominational church pension board.

S. 2902 would also deal with a number of other issues that prove troublesome to church pension boards administering their retirement and welfare benefit programs under present law. My comments here today have only provided a brief overview of certain portions of S. 2902. A detailed explanation of S. 2902 is being filed today in the record of this hearing.

The members of the Church Alliance and their counsel stand ready to work with members of the Senate Finance Committee to ensure that this important piece of legislation is passed. I will be happy to answer any questions you may have about the legislation at this time.

RESPONSES BY MR. NASH TO QUESTIONS SUBMITTED BY SENATOR PRYOR

Question No. 1. Would you briefly describe some of the problems churches have complying with existing pension law?

Answer. In general, the complexity of the tax laws with respect to retirement plans has caused churches and church pension boards to have to divert mission moneys and personnel and to spend significant time and financial resources in trying to understand often unworkable and unnecessary rules in the context of church organizations in efforts to comply with these rules instead of devoting such resources to the historic missions of churches. It is believed that these highly complicated rules were designed for tightly-knit corporate conglomerates or small organizations with high abuse potential and not with the church employee benefits community in mind.

Specifically, church denominations have problems complying with, among others: coverage testing rules; the required distribution rules; the additional participation requirements; the restrictions on coverage of self-employed ministers and ministers serving as chaplains for certain employers; the employee aggregation rules; and the artificial separation of church denominations into churches, qualified church-controlled organizations ("QCCOs"), and non-QCCOs, pursuant to the rules in an inappropriate Social Security provision.

Compliance problems emerge principally because of the manner in which church denominations have historically chosen to govern themselves and to carry out their missions effectively. In some denominations (those that reflect a hierarchical polity), the national pension board may be able to control the provision of retirement benefits to both ministers and lay workers. In other denominations (those of a Presbyterian, connectional or congregational polity), that control typically is not present. These different forms of government also make it difficult to determine which organization (or, more likely, organizations) are to be treated as a minister's or lay worker's employer for' purposes of applying certain coverage testing rules. Other problems also stem from these denominational organizational differences.

Question No. 2. Do you think it is important to have a separate Code section for pension rules?

Answer. Since 1974 when ERISA was enacted, there have been a number of Code amendments due to comprehensive legislation affecting retirement plans. These have created many problems for church retirement plans, both those described in section 401(a) and 403(b). It is felt that much of this legislation should not have been applied to church retirement plans.

The reason for creating a separate Code section for qualified church plans and also for isolating the provisions relating to church section 403(b) programs is that if Congress enacts legislation generally applicable to plans maintained by for-profit employers, this legislation would not inadvertently affect church retirement plans. Of course, Congress may decide to make any new legislation applicable to church retirement plans, but in such case the appropriateness of the legislation for church retirement plans would have been weighed. A separate Code section for church pension rules is very important to the churches.

Question No. 3. What would be the major accomplishments of S. 2902?

Answer. A major accomplishment of S. 2902 would be the simplification and making parallel the rules in the Code for qualified church plans and section 403(b) annuity plans, two primary means churches use to provide retirement benefits for ministers and lay employees. The simplified rules would not apply to church-related universities and hospitals. Another major accomplishment would be the isolation in the Code of rules affecting church retirement plans so that a change in the rules that apply to plans maintained by for-profit employers would not necessarily impact church retirement plans. A further major accomplishment would be the elimination of the artificial division of church denominations into churches, qualified church-controlled organizations ("QCCOs"), and non-QCCOs for purposes of applying the rules for section 403(b) annuity plans. S. 2902 would treat as part of the church all churches and church-related organizations described in section 414(e), but the simplified rules would not be extended to church-related universities and hospitals.

Question No. 4. Are the vesting requirements contained in S. 2902 appropriate for church plans?

Answer. The vesting requirements in S. 2902 would be the 10-year vesting and the 5- to 15-year vesting schedules. For qualified church plans, these schedules are more strict than current rules, but the churches believe that these vesting schedules are fair and appropriate for church retirement plans.

Question No. 5. What are the particular problems with self-employed ministers and chaplains?

Answer. Section 403(b) requires that a participant of an annuity plan described in such section must be an "employee" of a section 501(c)(3) organization. For this purpose, self-employed ministers are not considered "employees." Moreover, ministers may serve as chaplains in prisons and the uniformed services and thus are not employees of section 501(c)(3) organizations. There is no apparent policy rationale that suggests that self-employed ministers and chaplains, acting in the exercise of their ministry, should not be able to be covered by the church retirement plans of their denominations.

Question No. 6. Why are the restorations of "QVECs" so important to churches?

Answer. S. 2902 would restore qualified voluntary employee contributions ("QVECs") for church plans because ministers and lay employees have confidence in their denomination's pension board and may prefer to contribute to a church plan QVEC for retirement purposes rather than to a bank-administered IRA, because a church pension board may make investments that are more acceptable than those an administrator of an IRA may make. For example, a church pension board may decline to invest in industries whose product may conflict with religious beliefs.

The rules and limits in S. 2902 for QVECs are the same as those that apply to IRAs, and thus S. 2902 would not create a new retirement savings vehicle but merely an IRA alternative.

PREPARED STATEMENT OF SENATOR DAVID PRYOR

Last March, this subcommittee held a hearing on the administration and complexity of current pension law. We heard from witnesses with a wide range of interests and virtually all agreed that current pension law is enormously complex and costly.

Since the hearing, we have consulted with a wide range of interested parties to develop legislation which would simplify major components of current law. We have learned that simplification isn't simple: balancing flexibility, simplicity and worker protection are not easy. We believe, however, the Employee Benefits Simplification Act, S. 2901, which I introduced last week, constitutes a significant first step toward reducing the complexity of the present pension rules.

The majority of S. 2901 focuses on areas of current law where considerable complexity and inconsistencies could be eliminated. These include the definitions of compensation and highly compensated employees, modification of plan participation requirements, and simplification of distribution rules to generally permit beneficiaries to roll over any portion of a distribution to an IRA or another qualified plan. In addition, the legislation addresses a number of policy issues which will correct problems or clarify the law in areas such as the full funding limit for multi-employer plans, permitting excess benefit plans for State and local governments, and the right to have VEBAs on a national scale.

Finally, the Employee Benefits Simplification Act contains a provision to encourage savings, an issue that has been of great concern to the Chairman of the this committee. The bill would require pre-retirement lump sum distributions to be rolled over to an IRA or other qualified pension plan. Recent evidence suggests that pre-retirement distributions are becoming more prevalent and that these distributions are frequently not saved until retirement. Secretary Dole has raised important questions about the need to preserve retirement income and to expand pension coverage. We look forward to the Department of Labor's views on S. 2901 as it relates to these issues.

This morning will we also hear from a panel on S. 2902, the Church Retirement Benefits Simplification Act. This legislation would modify existing law to bring greater consistency and clarity to pension policy as it is applied to churches. Because of their unique organizational structure, current pension law is often inappropriate and unadministerable when applied to churches, but we believe S. 2902 would correct these problems.

Attachments.

[JOINT COMMITTEE PRINT]

SIMPLIFICATION OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS (S. 2901, THE EMPLOYEE BENEFITS SIMPLIFICATION ACT)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

ON AUGUST 3, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

AUGUST 3 1990

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101st Congress, 2d Session

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INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on August 3, 1990, to review the Internal Revenue Code rules relating to private pension plans and possible options for simplification of pension plan rules. The hearing will focus on S. 2901, the Employee Benefits Simplification Act, introduced by Senator Pryor and others on July 25, 1990, and S. 2902, the Church Retirement Benefits Simplification Act, introduced by Senator Pryor on July 25, 1990.[1]

This pamphlet,[2] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law and issues relating to simplification of the Federal income tax rules applicable to tax-qualified retirement plans and S. 2901. Part I of the pamphlet is a summary. This is followed by a discussion of the present-law Federal tax rules regarding tax-qualified plans (Part II), a description of S. 2901 (Part III), and discussion of pension plan simplification issues (Part IV).

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[1] For a description of S. 2902 the Church Retirement Benefits Simplification Act, see Joint Committee on Taxation, *Simplification of Tax Rules Relating to Employee Benefit Programs Maintained by Churches (S. 2902)* (JCX-24-90), August 3, 1990.

[2] This pamphlet may be cited as follows: Joint Committee on Taxation, *Simplification of Present-Law Tax Rules Relating to Qualified Pension Plans (S. 2901, the Employee Benefits Simplification Act)* (JCS-24-90), August 3, 1990.

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I. SUMMARY

Present-law rules relating to qualified plans

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. The employer maintaining the plan is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee is not required to include qualified plan benefits in income until the benefits are distributed from the plan. The purpose of the tax benefits for qualified plans is to encourage employers to establish nondiscriminatory retirement plans for their employees.

Qualified plans are broadly classified into two categories: defined contribution plans and defined benefit pension plans. There are several different types of defined contribution plans, including money purchase pension plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

The qualification standards and related rules governing qualified plans are generally designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as the employer's highly compensated employees. They also define the rights of plan participants and beneficiaries and provide limits on the tax deferral possible under qualified plans.

The qualification rules include minimum participation rules that limit the age and service requirements an employer can impose as a requirement of participation in a plan; coverage and nondiscrimination rules designed to prevent qualified plans from discriminating in favor of highly compensated employees; vesting and accrual rules which limit the period of service an employer can require before an employee earns or becomes entitled to a benefit under a plan; limitations on the contributions made on behalf of and benefits of a plan participant; and minimum funding rules designed to ensure the solvency of defined benefit pension plans. The Code also contains rules regarding the taxation of qualified plan benefits; terminations of qualified plans; and rules designed to prevent plan fiduciaries and others closely associated with a plan from misusing plan assets.

The present-law rules governing qualified plans originated in the Employee Retirement Income Security Act of 1974 (ERISA). ERISA forms the basis for the current private pension system. The rules enacted in ERISA have been revised several times. The most comprehensive revision to the qualification rules since the enactment of ERISA was made by the Tax Reform Act of 1986.

Summary of S. 2901

S. 2901, the Employee Benefits Simplification Act, modifies the present-law rules relating to qualified plans and certain other

types of employee benefit plans. In particular, the Act (1) modifies the definitions of highly compensated employee and compensation; (2) changes the timing of cost-of-living adjustments to dollar limits applicable to certain pension requirements and provides for rounding of such limits; (3) modifies the minimum participation rule (sec. 401(a)(26)) and provides that the rule (as modified) applies only to defined benefit pension plans; (4) provides design-based safe harbor rules for satisfying the special nondiscrimination rules applicable to qualified cash or deferred arrangements (sec. 401(k)) and employer matching contributions (sec. 401(m)); (5) modifies the distribution rules relating to pension plans by (a) liberalizing the circumstances in which a distribution may be rolled over tax free, (b) eliminating 5-year averaging for lump sum distributions from qualified plans, (c) requiring that certain distributions be transferred tax free in a trustee-to-trustee transfer to an eligible transferee plan, and (d) repeals the requirement that distributions to qualified plan participants begin by age 70-1/2 (sec. 401(a)(9)) and generally replaces it with the required beginning date in effect before the Tax Reform Act of 1986; (6) modifies the definition of leased employee; (7) provides that the 150 percent of current liability full funding limit does not apply to multiemployer plans; (8) expands the circumstances under which a group of unrelated employers may establish a voluntary employees' beneficiary association (VEBA); (9) modifies the limits on contributions and benefits (sec. 415) as they apply to governmental plans; and (10) makes other miscellaneous changes to the pension rules.

Simplification issues

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. There are several sources for this complexity, including the interaction of retirement policy and tax policy, the volume and frequency of employee benefits legislation, the structure of the workplace, the need to take into account the great variety of compensation and benefit packages, the desire for certainty in the law, and transition rules.

In analyzing any proposal to simplify the pension rules, the following issues are important: (1) the extent to which the proposed change is consistent with the underlying policy objectives of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and grandfather rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

II. PRESENT-LAW RULES [3]

A. Overview of Qualified Plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred. Contributions to a qualified plan are held in a tax-exempt trust.

The special tax benefits for qualified plans and qualified plan benefits represent a significant tax expenditure. For fiscal year 1991, the tax expenditure for the net exclusion for pension contributions and earnings is estimated to be $52.2 billion.[4]

The policy rationale for this tax expenditure is that the tax benefits for qualified plans encourage employers to provide retirement benefits for their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limit on the tax benefits for qualified plans.

Qualified plans are broadly classified into two categories based on the nature of the benefits provided: defined contribution plans and defined benefit pension plans.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.[5]

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[3] This pamphlet is limited to a discussion of the Internal Revenue Code rules relating to tax-qualified retirement plans. In addition to the rules in the Internal Revenue Code, the labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain extensive rules regarding employee benefit pension plans. For a more detailed description of the qualification rules, see Joint Committee on Taxation, *Present-Law Tax Rules Relating to Qualified Pension Plans* (JCS-9-90), March 22, 1990.

[4] *See* Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1991-1995* (JCS-7-90), March 9, 1990.

[5] Individual accounts may be maintained for after-tax employee contributions made to a defined benefit pension plan.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs). A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. The various different types of plans are in part historical and reflect the various different ways in which employers structure deferred compensation programs for their employees.

Sanction for failure to meet qualification rules

If a plan fails to meet the qualification standards, then the special tax benefits for qualified plans do not apply, and benefits and contributions are taxed under normal income tax rules. In general, if a plan fails to meet the qualification standards, then contributions to the plan are includible in employees' gross income when such contributions are no longer subject to a substantial risk of forfeiture (secs. 402(b) and 83). Amounts actually distributed or made available to an employee are generally includible in income in the year distributed or made available under the rules applicable to taxation of annuities (sec. 72). Special sanctions apply in the case of failure to meet certain qualification rules.

An employer is generally not entitled to a deduction for contributions to a nonqualified plan until the contributions are includible in an employee's gross income.

Simplified employee pensions

Under a simplified employee pension (SEP), contributions are made to individual retirement arrangements (IRAs) established on behalf of each participant. SEPs are not subject to the general qualification rules and are intended to provide an employer with a retirement savings arrangement for the employer's employees that requires a minimum of administrative work.

In general, employer contributions to a SEP are required to be made on behalf of each employee who has attained age 21, has performed service for the employer during at least 3 of the immediately preceding 5 years, and received at least $300 in compensation from the employer for the year. Present law permits employers with 25 or fewer employees to maintain salary reduction SEPs. As under a qualified cash or deferred arrangement, employees who participate in a salary reduction SEP are permitted to elect to have the employer make payments as contributions to the SEP or to receive the contributions in cash.

Present law provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average

deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate in the salary reduction SEP.

B. Plan Qualification Requirements

1. Coverage and nondiscrimination requirements

Key among the qualification standards are coverage and nondiscrimination rules designed to ensure that qualified plans benefit a significant number of an employer's rank-and-file employees as well as highly compensated employees. These rules include numerical minimum coverage rules (sec. 410(b)), a minimum participation rule requiring that a plan benefit a minimum number of employees (sec. 401(a)(26)), and a general nondiscrimination requirement (sec. 401(a)(4)). Special nondiscrimination rules apply to qualified cash or deferred arrangements, employer matching contributions, and after-tax employee contributions.

a. Minimum participation rule

A plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k)) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive contributions under the plan.

A special sanction applies to violations of the minimum participation rule. Under this sanction, if one of the reasons a plan fails to be a qualified plan is because it fails either the coverage rules or the minimum participation rule, then highly compensated employees are to include in income the value of their vested accrued benefit as of the close of the year in which the plan fails to qualify. Nonhighly compensated employees are not taxed on their benefits if the only reason a plan is not a qualified plan is a failure to satisfy the coverage requirements or the minimum participation rule.

b. Nondiscrimination in contributions or benefits

A qualified plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits under the plan (sec. 401(a)(4)). This general nondiscrimination requirement applies to all plan aspects, including those not addressed under the numerical coverage tests. Thus, it may apply not only with respect to contributions or benefits, but also with respect to optional forms of benefit and other benefits, rights, and plan features such as actuarial assumptions, rates of accrual methods of benefit calculation, loans, social security supplements, and disability benefits.

Whether or not a plan meets the general nondiscrimination test is a factual determination, based on the relevant facts and circumstances. A plan does not fail to meet the general nondiscrimination

test if contributions or benefits bear a uniform relationship to compensation. The Secretary has issued proposed regulations under the general nondiscrimination rules on May 14, 1990.

c. *Nondiscrimination rules relating to qualified cash or deferred arrangements*

In general

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $7,000 (indexed) ($7,979 for 1990). A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. The actual deferral percentage for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

If a cash or deferred arrangement satisfies the special nondiscrimination test, it is treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of elective deferrals. However, the group of employees eligible to participate in the arrangement is still required to satisfy the minimum coverage test (sec. 410(b)).

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, under Treasury regulations, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then contributed by the employee to the plan on an after-tax basis.

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination re-

quirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages.

Excise tax on excess contributions

An excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions (but not earnings on those contributions) under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions no later than 2-1/2 months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed or recharacterized within the applicable 2-1/2-month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions would have been received as cash, but for the employee's deferral election. For purposes of determining the employee's taxable year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a plan year. Of course, distributions of excess contributions (plus income) within the applicable 2-1/2-month period are not taxed a second time in the year of distribution.

d. Nondiscrimination rules relating to employer matching contributions and employee contributions

In general

A special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans (sec. 401(m)).[6] This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement.

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contri-

[6] These rules also apply to certain employee contributions to a defined benefit pension plan

bution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Treatment of excess aggregate contributions

As under the rules relating to qualified cash or deferred arrangements, if the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such excess aggregate contributions) are distributed before the close of the following plan year. Generally, the amount of excess aggregate contributions and their allocation to highly compensated employees is determined in the same manner as with respect to excess deferrals.

Excise tax on excess aggregate contributions

An excise tax is imposed on the employer with respect to excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year for which the contributions are made.

However, the tax does not apply to any excess aggregate contributions that, together with income allocable to the excess aggregate contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the excess aggregate contributions arose.

2. Limitations on contributions and benefits

In general

Under present law, overall limits are provided on contributions and benefits under qualified plans based on the type of plan (sec. 415). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer. However, certain special rules apply to governmental plans.

Defined contribution plans

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (sec. 415(c)). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit will be increased when $30,000 is less than one-fourth of the dollar limit on benefits under a defined benefit pension plan (see below).

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. An individual is considered permanently and totally disabled if the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which

can be expected to result in death or which has lasted or can be expected to last for a continuous period of at least 12 months.

For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled.

Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Defined benefit pension plans

In general

Under present law, the limit on the annual benefit payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation, or (2) $102,582, for 1990 (sec. 415(b)).[7] The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan.

The dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age so that the limit is actuarially equivalent to a benefit beginning at the social security retirement age. If retirement benefits provided by a defined benefit pension plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of the dollar limit applicable to a benefit beginning at the social security retirement age.

Present law provides that a minimum benefit can be paid even if the benefit exceeds the normally applicable benefit limitations. Thus, the overall limits on benefits are deemed to be satisfied if the retirement benefit of a participant under all defined benefit pension plans of the employer does not exceed $10,000 for a year or any prior year, and the participant has not participated in a defined contribution plan of the employer. The $10,000 limit is reduced for participants with less than 10 years of participation in the plan.

Special rules for plans of State and local governments

Special rules apply to State and local governmental plans. For such plans, the rules in effect prior to the Tax Reform Act of 1986 apply with respect to the limits on annual benefits. Accordingly, the actuarial reduction of the dollar limit on annual benefits for early retirement does not reduce the limit (1) for benefits commencing on or after the participant has attained age 62 (rather than the social security retirement age), (2) below $75,000 for benefits commencing on or after the participant has attained age 55, or (3) below the actuarial equivalent of $75,000 payable at age 55, for benefits commencing before age 55.

Present law also contains a special rule that permits a plan maintained by a State or local government to provide benefits to

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[7] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

qualified participants equal to the accrued benefit of the participant (without regard to any benefit increases pursuant to a plan amendment adopted after October 14, 1987) even though such benefit exceeds the otherwise applicable limits on benefits. A qualified participant is a participant who first became a participant in the plan before January 1, 1990.

The special rule does not apply unless the employer elects, by the close of the first plan year beginning after December 31, 1989, to have the normal limits on contributions and benefits apply to all plan participants other than qualified participants.

This special rule was enacted out of recognition that some governmental plans did not conform to the limit on contributions and benefits due to State constitutional prohibitions on impairment of contracts. The special rule was designed to bring State and local government plans into conformity with the general rules, and to provide temporary relief from such rules in the case of certain plans.

Combined plan limitation

An additional limitation applies if an employee participates in a defined benefit pension plan and a defined contribution plan maintained by the same employer. This combined plan limitation prevents avoidance of the separate plan limits through the creation of different types of plans. The limit permits an employee to obtain benefits greater than the single-plan limitation, but precludes an individual from obtaining the maximum possible benefits from both a defined contribution plan and a defined benefit pension plan of the same employer.

3. Definitions

a. Highly compensated employee

In general

For purposes of the qualification rules, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined under the top-heavy rules); (2) received more than $85,485 in annual compensation from the employer; (3) received more than $56,990 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer who receives compensation greater than 50 percent of the defined benefit plan dollar limit in effect for the year. The $85,485 and $56,990 thresholds are applicable for 1990; these dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).[8] Highly compensated employees are determined on an employer-wide basis.

[8] These dollar limits were initially set at $75,000 and $50,000, respectively, by the Tax Reform Act of 1986.

If, for any year, no officer has compensation in excess of 50 percent of the defined benefit plan dollar limit, then the highest paid officer of the employer for such year is treated as a highly compensated employee.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $56,990 in annual compensation from the employer as highly compensated employees in lieu of applying the $85,485 threshold and without regard to whether such employees are in the top-paid 20 percent. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

b. Compensation

The definition of compensation varies with the purpose for which the definition is used. The Tax Reform Act of 1986 attempted to provide a uniform definition of compensation (sec. 414(s)). This definition in turn is based on the definition of compensation for purposes of the limits on contribution and benefits (sec. 415).

For purposes of the limits on contributions and benefits (sec. 415), compensation generally includes all compensation includible in gross income. Thus, it includes amounts received for personal services actually rendered in the course of employment, amounts received under an accident or health plan (to the extent that such amounts are includible in gross income), nondeductible moving expenses paid or reimbursed by the employer, and the value of certain nonqualified stock options (to the extent includible in gross income). Compensation for this purpose also includes earned income from sources outside the United States whether or not excludable or deductible from gross income. Compensation does not include contributions to qualified plans and distributions from such plans (even if includible in gross income), amounts realized from the exercise of nonqualified stock options, amounts realized from the sale of stock acquired under a qualified stock option, or other

amounts that receive special tax benefits, such as premiums for group-term life insurance (to the extent not includible in gross income).

Compensation that is not currently taxable or that receives special tax treatment is generally excluded for purposes of calculating the limits on benefits and contributions because including such amounts would provide additional tax benefits to amounts that already receive tax-favored treatment.

Under the "uniform" definition of compensation that is used for nondiscrimination testing, compensation generally has the same definition as compensation for purposes of the limits on contributions and benefits. However, under this definition, an employer may elect to include elective deferrals by the employee. In addition, the Secretary of the Treasury is authorized to provide for alternative methods of defining compensation, provided such definitions do not discriminate in favor of highly compensated employees. The Secretary has issued proposed and temporary regulations specifying permissible definitions of compensation.

In determining who is a highly compensated employee (sec. 414(q)), compensation is defined as under the limits on contributions and benefits, except that compensation includes elective deferrals made by an employee. Elective deferrals are treated as compensation for this purpose because they reflect amounts that could have been paid in cash to the employee and are therefore part of the employee's economic income.

c. Employer and employee

In general

For purposes of plan qualification requirements, all employees of certain entities must be aggregated and treated as though employed by a single employer. Under these rules, all employees are considered employed by the same entity to the extent they are employed by corporations that are members of a controlled group (sec. 414(b)), trades or businesses under common control (e.g., related partnerships) (sec. 414(c)), or members of an affiliated service group (sec. 414(m)). In addition, individuals are treated as employees to the extent they are leased employees (sec. 414(n)). The Secretary of the Treasury is authorized to prescribe by regulations such additional aggregation rules as are necessary to prevent the avoidance of the qualification rules through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Leased employees

An individual (a leased employee) who performs services for another person (the recipient) may be treated as the recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis (i.e., at least 1500 hours) for a period of at least 12 months, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization. A plan is a safe harbor plan if it is a money purchase pension plan and if it provides that (1) an individual is a plan participant on the first day on which the individual becomes an employee of an employer maintaining the plan, (2) each employee's rights to or derived from employer contributions under the plan are nonforfeitable at the time the contributions are made, and (3) amounts are to be contributed by the employer on behalf of an employee at a rate not less than 10 percent of the employee's compensation for the year (the 10 percent contribution is not to be reduced by integration with social security).

Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased employees.

C. Treatment of Distributions

1. Uniform minimum distribution rules

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, individual retirement arrangements (IRAs), and tax-sheltered annuities (sec. 403(b)).

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally the April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Under present law, the sanction for failure to make a minimum required distribution to a participant (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed (sec. 4974). The tax is imposed on the individual required to take the distribution. However, a plan will not satisfy the applicable qualification requirements unless it expressly provides that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

2. Withdrawal rules

Present law limits the circumstances under which plan participants may obtain preretirement withdrawals from a qualified plan. In general, these restrictions recognize that qualified plans are intended to provide retirement income.

The least restrictive withdrawal rules apply to profit-sharing and stock bonus plans. Amounts may generally be withdrawn from such plans after they have been in the plan for 2 years. Distributions before the expiration of such 2-year period may also be made

in the event of retirement, death, disability, other separation from service, or hardship.

Distributions from qualified pension plans (i.e., defined benefit pension plans and money purchase pension plans) may generally be made only in the event of retirement, death, disability, or other separation from service. The same restrictions generally apply to plans that are integrated with social security.

Special rules apply to qualified cash or deferred arrangements (sec. 401(k)). Elective deferrals under a qualified cash or deferred arrangement (and earnings thereon) may only be distributed on account of separation from service, death, or disability, or attainment of age 59-1/2. Elective deferrals (but not earnings thereon) may also be distributed on account of a hardship of the employee.

Present law generally prohibits State or local governments or tax-exempt organizations from maintaining qualified cash or deferred arrangements. This prohibition does not apply to a pension plan maintained by a rural cooperative, which is generally defined as (1) any organization that is exempt from tax or which is a State or local government or instrumentality thereof, and which is engaged primarily in providing electric service on a mutual or cooperative basis, (2) a cooperative telephone company, (3) certain tax-exempt organizations, and (4) a national association of such organizations. Because a rural cooperative plan is a pension plan, the rule permitting hardship distributions and distributions after age 59-1/2 but before separation from service from a qualified cash or deferred arrangement does not apply.

3. Taxation of distributions [9]

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to taxation of annuities, unless the amount distributed represents the employee's investment in the contract (i.e., basis) (secs. 72 and 402). Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans and other tax-favored retirement vehicles are subject to an additional 10-percent income tax (sec. 72(t)). Excess distributions from qualified plans and other tax-favored retirement vehicles are subject to a 15-percent tax (sec. 4980A).

Rollovers

Under present law, a total or partial distribution of the balance to the credit of an employee under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity may, under certain conditions, be rolled over tax free to an IRA or another qualified plan or

[9] The rules relating to the taxation of pension distributions were substantially revised in the Tax Reform Act of 1986. The 1986 Act contains a number of detailed transition rules which preserve the pre-1986 Act tax treatment in certain circumstances. For a detailed description of these rules, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

annuity. A rollover of a partial distribution is permitted if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects rollover treatment. A partial distribution may only be rolled over to an IRA and not to another qualified plan.

The maximum amount of a distribution that can be rolled over is the amount of the distribution that is taxable. That is, employee contributions cannot be rolled over. The rollover must be made within 60 days after the distribution was received.

Lump-sum distributions

Under present-law, lump-sum distributions are eligible for special 5-year forward income averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee which becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-1/2, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution to an employee is treated as a lump-sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59-1/2 may be made with respect to any employee.

Net unrealized appreciation

Under present law, a taxpayer is not required to include in gross income amounts received in the form of a lump-sum distribution to the extent that the amounts are attributable to net unrealized appreciation in employer securities. Such unrealized appreciation is includible in gross income when the securities are sold or exchanged.

The special treatment of net unrealized appreciation applies only if a valid lump-sum distribution election is made, but disregarding the 5-plan years of participation requirement for lump-sum distributions.

In addition, gross income does not include net unrealized appreciation on employer securities attributable to employee contributions, regardless of whether the securities are received in a lump-sum distribution. Such appreciation is includible in income when the securities are disposed of.

D. Funding Rules

Under the Code, certain defined benefit pension plans and money purchase pension plans are required to meet a minimum funding standard for each plan year (sec. 412). The minimum funding standards are designed to ensure that pension plans have sufficient assets to pay benefits.

In the case of a money purchase pension plan, the contribution required by the minimum funding standard is generally the contribution rate specified by the plan. Defined benefit pension plans are funded on an actuarial basis. A special funding rule that requires faster funding applies to underfunded single-employer defined benefit pension plans.

No contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limitation. In addition, under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

E. Voluntary Employees' Beneficiary Associations (VEBAs)

Statutory requirements

A voluntary employees' beneficiary association (VEBA) that satisfies certain requirements is entitled to tax-exempt status. The Code describes VEBAs in the following broad terms: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual" (sec. 501(c)(9)). The requirements a VEBA must comply with in order to be tax exempt are further specified in regulations.

The tax-exempt status of a VEBA does not directly affect either (1) the timing or amount of an employer's deduction for contributions to the VEBA or (2) the timing or amount of the inclusion in income of a welfare benefit provided to an employee under a plan. Many VEBAs provide benefits to employees that are excluded from gross income under a specific statutory provision.

Eligibility for membership

Under Treasury regulations, membership in a VEBA is required to be limited to individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond is deemed to exist if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers), (2) coverage under one or more collective bargaining agreements, (3) membership in a labor union (or in one or more locals of a national or international labor union), or (4) employment by one or more employers in the same line of business in the same geographic locale. Under these standards, for example, a group of car dealers in the same city or other similarly restricted discrete geographical locale could form a VEBA to provide permissible benefits to their employees. In *Water*

Quality Assn. Employees' Benefit Corp. vs. U.S., the 7th Circuit found the geographic locale restriction invalid.[10]

The regulations do not provide guidance with respect to the determination of when a group of employers is considered to be affiliated and, therefore, eligible to contribute to the same VEBA. The Code generally defines affiliated organizations by reference to ownership. However, the IRS has at times taken the position that other factors may be relevant (see G.C.M. 39194, June 23, 1983).

Membership in a VEBA generally is limited to employees. Under the regulations, the term employee means an individual who has a legal and bona fide relationship of employer and employee (e.g., for employment tax purposes or for purposes of a collective bargaining agreement).

The regulations provide that membership in a VEBA must be voluntary, which requires an affirmative action by the employee to become a member. An employer may automatically include employees provided no detriment is incurred (e.g., deductions from pay) as a result of membership. Such a detriment can be incurred, however, if membership is imposed pursuant to a collective bargaining agreement or incident to membership in a labor organization.

Membership in a VEBA may not be limited to one employee.

Association of employees

A VEBA is not considered an association of employees unless the organization is controlled by (1) the membership, (2) independent trustees, or (3) trustees at least some of whom are designated by, or on behalf of, the membership. The regulations provide that a VEBA is treated as being controlled by independent trustees if it is an "employee welfare benefit plan" under title I of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA subjects employee welfare benefit plans to certain reporting and disclosure requirements and minimum fiduciary standards. If these standards are satisfied, the employer (or an officer of the employer) may serve as trustee of the VEBA.

F. Reporting of Pension and Annuity Payments

The penalty reform provisions of the Omnibus Budget Reconciliation Act of 1989 revised the penalties imposed for failures to file correct and timely information returns with the IRS, and to provide statements to payees. This revised penalty structure applies to 18 different types of reportable payments. However, this structure does not apply to reports of pension and annuity payments required under section 6047(d). It also does not apply to certain reports required by sections 408(i) and 408(l) relating to IRAs and SEPs.

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[10] 795 F. 2d 1303 (7th Cir. 1986).

III. DESCRIPTION OF S. 2901

A. Title I.—Nondiscrimination Provisions

Definition of highly compensated employee

The bill provides that an employee is highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) has compensation for the year in excess of $50,000. As under present law, the $50,000 threshold is adjusted for cost-of-living increases in the same manner as the limitations on contributions and benefits (sec. 415(d)). However, the bill provides that the dollar limit applicable for any year is the amount in effect for the calendar year with respect to which compensation is determined under the bill. Under the bill, as under present law, the dollar limit in effect for 1990 is $56,990.

For example, assume highly compensated employees are being determined for the 1991 plan year in the case of a calendar year plan. Under the bill, 1990 compensation is used to make this determination. Thus, the $50,000 figure as adjusted for 1990 ($56,990) is the applicable dollar limit, not the limit as adjusted for 1991.

Under the bill, if no employee is a 5-percent owner or has compensation in excess of $50,000 (indexed), then the employee with the highest compensation for the year is treated as a highly compensated employee. This special rule does not apply for purposes of the nondiscrimination rules applicable to elective deferrals, matching contributions, and employee contributions (secs. 401(k) and (m)).

The bill applies the present-law family member aggregation rule only in the case of family members of a 5-percent owner.

This provision is generally effective for years beginning after December 31, 1990. An employer may elect not to have the provision apply to years beginning in 1991.

Definition of compensation

The bill modifies the definition of compensation by generally providing a uniform statutory definition of compensation that is used for all purposes, including testing for nondiscrimination, the definition of highly compensated employee, and the limits on contributions and benefits. The bill generally repeals the authority of the Secretary to prescribe alternative definitions of compensation.

In general, the bill provides that compensation means, with respect to any year, the amount of wages shown on an employee's W-2 for the calendar year in which the year begins. In the case of a self-employed individual, the individual's earned income (within the meaning of sec. 401(c)(2)) for the calendar year in which the year begins is substituted for the wages shown on the W-2 form. If compensation is being determined for a period other than a calen-

dar year (e.g., in the case of a fiscal year plan year), the employer is to use the amount that would be shown on the W-2 form if it covered such period.

The bill modifies the employer election to take salary reduction contributions into account by (1) permitting deferrals under sections 457, 414(h)(2), and 501(c)(18) to be taken into account and (2) providing that an election to take salary reduction into account is to apply for all purposes, to all employees, and to all salary reduction amounts. Thus, such an election applies with respect to all plans maintained by the employer after application of all applicable aggregation rules. In addition, such an election is revocable only with the consent of the Secretary. Thus, for example, an employer could not elect to take into account elective deferrals for purposes of the limits on contributions and benefits and exclude them for purposes of identifying highly compensated employees.

The bill permits an employer to elect to use base pay instead of W-2 compensation for all purposes other than the definition of highly compensated employee. An employer making such an election may also elect to take into account employee elective and salary reduction contributions. It is intended that base pay is defined generally as under the temporary regulations (Treas. reg. sec. 1.414(s)-1T(d)). Thus, subject to the applicable facts and circumstances, the employer could exclude from the definition of compensation, on a consistent basis, certain types of compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums) and bonuses for individual performance. It is intended that the resulting definition may not discriminate in favor of highly compensated employees. The election applies for all purposes, with respect to all employees, and may be revoked only with the consent of the Secretary.

In addition, it is intended that, as under the proposed regulations, for the limited purposes of applying the nondiscrimination requirements with respect to the availability of elective contributions to eligible employees under a cash or deferred arrangement (Treas. reg. sec. 1.401(k)-1(e)(1)(ii)) and with respect to the availability of employee contributions and the availability of matching contributions under a defined contribution plan (Treas. reg. sec. 1.401(m)-1(c)(1)), any reasonable definition of compensation, such as regular or base salary or wages, is treated as nondiscriminatory and may be used. This special rule does not apply for any other purpose, including application of the actual deferral percentage test (sec. 401(k)(3)) or the actual contribution percentage test (sec. 401(m)(2)).

Solely for purposes of the definition of a highly compensated employee, the bill provides that the compensation of an employee for any year is determined on the basis of wages shown on the W-2 (1) that is required to be furnished no later than the end of the first 3 months of the year or (2) if (1) does not apply, for the calendar year preceding the calendar year in which the year begins. For example, in the case of a plan year beginning November 1, 1991, compensation for the plan year is wages shown on the W-2 required to be furnished on January 31, 1992.

The provision is generally effective for years beginning after December 31, 1990. An employer may elect not to have the provision apply to years beginning in 1991.

Modifications of cost-of-living adjustments

Under present law, the cost-of-living adjustments to the limitations on contributions and benefits under qualified plans are made in accordance with procedures consistent with the adjustment of benefits under the Social Security Act. The bill provides that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year. Thus, under the bill, adjusted dollar limits will be published before the beginning of the calendar year. In addition, the bill provides that, after cost-of-living adjustments, the resulting dollar limits are generally rounded to the nearest $1,000. Under the bill, dollar limits relating to elective deferrals and elective contributions to simplified employee pensions (SEPs) are rounded to the nearest $100.

The cost-of-living adjustment provisions apply to adjustments with respect to calendar years beginning after December 31, 1990.

Modification of additional participation requirements

The bill provides that the minimum participation rule (sec. 401(a)(26)) applies only to defined benefit pension plans. In addition, the bill provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 25 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee). The separate line of business and excludable employee rules apply as under present law. As an illustration of the operation of the modification of the minimum participation rule, assume that an employer has 150 nonexcludable employees. Under present law, any plan of the employer is required to cover a minimum of 50 employees. Under the bill, any defined benefit plan of the employer is required to cover a minimum of 25 employees.

In the case of an employer with only 2 employees, a plan satisfies the present-law minimum participation rule if the plan covers 1 employee. However, under the bill, a plan satisfies the minimum participation rule only if it covers both employees.

The provision is generally effective for years beginning after December 31, 1990. An employer may elect to have the provision apply as if it were included in section 1112(b) of the Tax Reform Act of 1986.

Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions

In general

The bill adds alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement is treated as satisfying the actual deferral percentage test if the plan of which the arrangement is a

part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan satisfies the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions. These safe harbors permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions to the plan.

Safe harbor for cash or deferred arrangements

Contribution requirements.—A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching contribution requirement or (2) the employer makes a nonelective contribution to the plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes an elective contribution under the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is not less than (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement is deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage requirements. For example, the alternative test is satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals of 4 percent of compensation and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions is at least equal to the matching contributions required under the general safe harbor rule.

Under the safe harbor, an employee's rights to employer matching contributions or nonelective contributions used to meet the contribution requirements are required to be 100-percent vested.

An arrangement does not satisfy the contribution requirements unless the requirements are met without regard to the permitted disparity rules (sec. 401(l)) and contributions used to satisfy the contribution requirements are not taken into account for purposes of determining whether a plan of the employer satisfies the permitted disparity rules.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

The contribution requirement may be satisfied with either matching or nonelective contributions to the cash or deferred arrangement or with contributions to another plan maintained by the employer for the same employees eligible to participate in the cash or deferred arrangement.

Notice requirement.—The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice within a reasonable period before any year of the employee's rights and obligations under the arrangement. This notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and must be written in a manner calculated to be understood by the average employee eligible to participate.

Alternative method of satisfying special nondiscrimination test for matching contributions

The bill provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if (1) matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Distribution of excess contributions

Under the bill, the total amount of excess contributions is determined in the same manner as under present law, but the distribution of excess contributions is required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, under the bill, excess contributions are deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan.

For example, assume that an employer maintains a qualified cash or deferred arrangement under section 410(k). Assume further that the actual deferral precentage ("ADP") for the eligible nonhighly compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly compensated employees:

Employees	Compensation	Deferral	Deferral (percent)
A	$200,000	$7,000	3.5
B	200,000	7,000	3.5
C	70,000	7,000	10.0
D	70,000	5,250	7.5
E	70,000	2,100	3.0
F	70,000	1,750	2.5

Under these facts, the highly compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under present law, the highly compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly compensated employees is 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e., a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the bill, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600.

Effective date

The provisions relating to the special nondiscrimination tests applicable to qualified cash or deferred arrangements and matching contributions are applicable to years beginning after December 31, 1990.

B. Title II.—Distributions

In general

The bill expands the circumstances in which a distribution may be rolled over tax free and eliminates 5-year averaging for lump-sum distributions from qualified plans. The bill also provides that certain distributions are required to be transferred directly into another tax-deferred retirement arrangement.

Rollovers

Under the bill, any distribution to the employee or the surviving spouse of the employee (other than a minimum required distribution (sec. 401(a)(9)) may be rolled over tax free to an IRA or another qualified plan or annuity. As under present law, employee contributions cannot be rolled over.

Special rules for lump-sum distributions

The bill repeals the special 5-year forward averaging rule. The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a tax-

payer received all of the benefits in a qualified plan in a single taxable year. Liberalization of the rollover rules increases the flexibility of taxpayers in determining the time of the income inclusion of pension distributions, and eliminates the need for special rules to prevent bunching of income. The bill preserves the transition rules adopted in the Tax Reform Act. The bill also retains the present-law treatment of net unrealized appreciation on employer securities and generally retains the definition of lump-sum distribution solely for such purpose.

The provisions are effective with respect to distributions after December 31, 1990.

Transfers to IRAs or other eligible transferee plans

The bill provides that any applicable distribution that would otherwise be distributed to an employee or the surviving spouse of the employee is to be transferred directly to an eligible transferee plan rather than distributed to the employee or surviving spouse. In general, an applicable distribution is any distribution in excess of $500 other than (1) distributions in the form of substantially equal periodic payments (as defined under sec. 72(t)), (2) a distribution made after the employee attains age 55, (3) a distribution attributable to the employee being disabled (as defined in sec. 72(m)(7)), (4) distributions of deductible dividends on employer securities (sec. 404(k)), (5) distributions to an alternate payee, (6) hardship distributions from a profit-sharing or stock bonus plan, or (7) distributions of employee contributions.

The transfer requirement applies only to amounts that, but for the transfer requirement, would otherwise be distributed to the recipient. Thus, for example, the transfer requirement does not apply to amounts that are deemed to be distributed under the rules relating to participant loans (sec. 72(p)). In addition, the transfer requirement applies after other rules relating to distributions. For example, if the plan is subject to the joint and survivor rules (secs. 401(a)(11) and 417) those rules would have to be complied with before the transfer is made.

The distribution may be transferred to an IRA or to a qualified defined contribution plan that provides for the acceptance of the transfer. The transfer is to be made to the IRA or qualified plan designated by the distributee within a reasonable period of time before the transfer in accordance with regulations. The plan is to provide a method by which the plan trustee is to designate the transferee plan in the event the distributee does not make a designation or transfer to the designated plan is impracticable.

Amounts transferred are includible in income when distributed from the transferee plan in accordance with the rules applicable to the transferee plan. However, if the distributee withdraws all or a portion of the amount transferred by the due date (including extensions) for filing the distributee's tax return for the year the transfer was made, the distribution is treated as if it had been made from the transferor plan. Thus, for example, if a distribution is transferred to an IRA and the employee makes a withdrawal of transferred amounts (plus income) from the IRA, the exemptions to the early distribution tax applicable to qualified plans (rather than the rules applicable to IRA withdrawals) apply. This rule is de-

signed to prevent individuals who do not want the distribution to remain in a tax-favored arrangement from being disadvantaged by the transfer.

The plan trustee is required to notify employees of the requirements of the transfer rules and of the amount of any transfer. Once the transfer is made to the transferee plan in accordance with applicable Code provisions, the employer is relieved of all responsibility for the amounts transferred.

A plan is not treated as violating the prohibition on reduction of accrued benefits (sec. 411(d)(6)) solely by reason of the transfer. For purposes of determining years of service and the buy-back rules (sec. 411(a)(7)), a transfer is treated as a distribution.

Similar rules apply to distributions from qualified annuities (sec. 403(a)) and tax-sheltered annuities (sec. 403(b)).

The provisions apply to distributions in plan years beginning after December 31, 1991.

Required distributions from qualified plans

The bill repeals the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and, therefore, generally replaces it with the rule in effect prior to the Tax Reform Act. Thus, under the bill, distributions are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70 or (2) the calendar year in which the employee retires. In the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70. Distributions from an IRA are required to begin no later that April 1 of the calendar year following the year in which the IRA owner attains age 70.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70, the bill requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70 in which the employee was not receiving benefits under the plan. Thus, under the bill, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70 does not apply, under the bill, in the case of a governmental plan or church plan.

This provision applies to years beginning after December 31, 1990.

C. Title III.—Miscellaneous Provisions

Treatment of leased employees

The bill replaces the historically performed test in the definition of leased employee with a control test. Thus, under the bill an individual is a leased employee of a service recipient if the services are

performed by the individual under the control of the recipient (and the other requirements are satisfied).

The provision is effective for taxable years beginning after December 31, 1983.

Elimination of half-year requirements

Under present law, a number of employee plan rules refer to the age of an individual at a certain time. For example, distributions under a qualified pension plan are generally required to begin no later than the April 1 following the year in which an individual attains age 70-1/2 (sec. 401(a)(9)). Similarly, an additional income tax on early withdrawals applies to certain distributions from qualified pension plans and IRAs prior to the time the participant or IRA owner attains age 59-1/2 (sec. 72(t)).

The bill changes the half-year requirements to birthdate requirements. Those rules under present law that refer to age 59-1/2 are changed to refer to age 59, and those that refer to age 70-1/2 are changed to refer to age 70.

The provision applies to distributions in years beginning after December 31, 1990.

Plans covering self-employed individuals

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA.

Under present law, certain special aggregation rules apply to plans maintained by owner-employees that do not apply to other qualified plans (sec. 401(d)(1) and (2)). The bill eliminates these special rules.

The provision applies to years beginning after December 31, 1990.

Full funding limitation of multiemployer plans

The bill provides that the 150 percent of current liability limitation does not apply to multiemployer plans. In addition, the bill repeals the present-law annual valuation requirement for multiemployer plans and applies the prior-law rule that valuations be performed at least every 3 years.

The provision applies to years beginning after December 31, 1990.

Affiliation requirements for employers jointly maintaining a VEBA

The bill provides that otherwise unrelated employers are treated as affiliated and, therefore, can maintain a tax-exempt VEBA if the employers (1) are in the same line of business, (2) act jointly to perform tasks which are integral to the activities of each of the employers, and (3) act jointly to such an extent that the joint maintenance of a VEBA is not a major part of the joint activities.

Under the bill, employers are considered affiliated, for example, under the following circumstances. The employers participating in

the VEBA are in the same line of business and belong to an association that provides to its members a significant amount of each of the following services: (1) research and development relating to the members' primary activity; (2) education and training of members' employees; and (3) public relations. In addition, the employers are sufficiently similar (e.g., subject to similar regulatory requirements) that the association's services provide material assistance to all of the employers. The employers also demonstrate the importance of their joint activities by having meetings at least annually attended by substantially all of the employers. Finally, the employers maintain a common retirement plan.

On the other hand, it is not intended that the mere existence of a trade association is a sufficient basis for the member-employers to be considered affiliated, even if they are in the same line of business. It is also not sufficient if the trade association publishes a newsletter and provides significant public relations services, but only provides nominal amounts, if any, of other services integral to the employers' primary activity.

A group of employers are also not considered affiliated under the bill by virtue of the membership of their employees in a professional association.

The bill is intended as a clarification of present law. However, it is not intended to create any inference as to whether any part of the Treasury regulations affecting VEBAs, other than the affiliated employer rule, is or is not present law.

Treatment of certain governmental plans

The bill provides that (1) section 457 does not apply to excess benefit plans maintained by a State or local government, (2) the compensation limitation on benefits under a defined benefit pension plan does not apply to plans maintained by a State or local government, and (3) the defined benefit pension plan limits do not apply to certain disability and survivor benefits provided under such plans. Excess plans maintained by a State or local government are subject to the same tax rules applicable to such plans maintained by private employers (e.g., sec. 83).

The provision is effective for taxable years beginning after December 31, 1986.

Modifications to simplified employee pensions

The bill conforms the eligibility requirements for SEP participation to the rules applicable to pension plans generally by providing that contributions to a SEP must be made with respect to each employee who has at least one year of service with the employer.

The bill modifies the rules relating to salary reduction SEPs by providing that such SEPs may be established by employers with 100 or fewer employees. The bill also repeals the requirement that at least half of eligible employees actually participate in a salary reduction SEP.

The bill also provides that an employer meets the requirements of the 125 percent deferral percentage test for salary reduction contributions if the employer makes a nonforfeitable contribution to the plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to

participate in the arrangement without regard to whether the employee makes an elective contribution under the arrangement.

The provision applies to years beginning after December 31, 1990.

Contributions on behalf of disabled employees

The bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

The provision applies to years beginning after December 31, 1990.

Distributions from rural cooperative plans

The bill provides that distributions can be made from a rural cooperative plan which includes a qualified cash or deferred arrangement upon attainment of age 59, even if the plan is not a profit-sharing or stock bonus plan.

The provision is effective as if included in the amendments made by section 1011(k)(9) of the Technical and Miscellaneous Revenue Act of 1988.

Reporting of pension and annuity payments

The bill provides that the definition of "information return" under section 6724(d) includes reports of pension and annuity payments required by section 6047(d), and any report required under subsection (i) or (l) of section 408. Similarly, the definition of "payee statement" under section 6724(d)(2) is amended to include reports of pension and annuity payments required by section 6047(d) and any report required under subsection (i) or (l) of section 408. The bill provides that section 6652(e) is amended to delete reports of designated distributions from the scope of its $25 per day penalty.

The bill provides a $10 reporting threshold for designated distributions.

The provision applies to returns and statements required to be filed after December 31, 1990.

Date for adoption of plan amendments

The bill provides that any plan amendments required by the bill are not required to be made before the first plan year beginning on or after January 1, 1992, if the plan is operated in accordance with the applicable provision and the amendment is retroactive to the effective date of the applicable provision.

IV. ISSUES AND ANALYSIS RELATING TO THE SIMPLIFICATION OF EMPLOYEE PENSION BENEFITS TAX LAWS

A. General Simplification Issues

There are three potential sources of income for an individual after retirement—social security benefits, employer-provided pension plan benefits, and personal savings. These three sources of retirement income have traditionally been referred to as the "three-legged stool" providing retirement income security. Taken together, these three sources of income ideally should provide an adequate replacement for preretirement income.

An employer's decision to establish or continue a pension plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for amounts contributed to an employer-provided pension plan to encourage the establishment and continuance of such plans.

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. Some have argued that this complexity has made it difficult, if not impossible, for employers, particularly small employers, to comply with the law. In addition, it is asserted that this complexity deters employers from establishing pension plans or forces the termination of such plans. If this assertion is accurate, then the complexity of the employee benefits laws is reducing the number of employees covered under employer-provided plans. Such a result then forces social security and personal savings to assume more of the burden of replacing preretirement income.

Others assert that the complexity of employee benefits laws and regulations is a necessary byproduct of attempts (1) to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer, (2) to provide employers, particularly large employers, with the flexibility needed to recognize the differences in the way that employers do business; and (3) to ensure that retirement benefits generally are used for retirement purposes.

A brief discussion follows of the reasons for complexity in the pension area.

Reasons for complexity in employee pension benefits laws

Volume and frequency of employee benefits legislation

Many employers and practitioners in the pension area have argued that the volume of legislation affecting pension plans enacted since 1974 has contributed to complexity. In many cases, a particular substantive area of pension law may be dealt with legislatively every year. For example, the rules relating to the form and

taxation of distributions from qualified pension plans were significantly changed by the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, and the Tax Reform Act of 1986. In many cases, changes in the rules are lobbied for by employers and practitioners.

This constant change of the law has not only contributed to complexity for the employer, plan administrator, or practitioner who must understand the rules, but has also created problems for the IRS and Department of Labor. Regulations projects are so backlogged at the IRS that employers may not know what they must do to bring their pension plans into compliance with enacted legislative changes because the IRS has been unable to publish adequate guidance for employers.

The amount of legislation in the pension area in recent years hinders the ability of the IRS and the Department of Labor to monitor compliance with the law. Significant amounts of resources are required to be expended to educate government employees with respect to changes in the law. Time that is spent reviewing pension plan documents to determine whether they qualify under the tax laws in form takes time away from the auditing of plans to ensure that they qualify in operation.

The level of legislative and regulatory activity in the pension area has also created problems because inadequate time is available to consider the possible interaction of various provisions. The IRS may issue regulations that are immediately superseded by legislation. Legislation is enacted that does not consider the potential interaction problems created with other areas of employee benefits law.

Some people argue that the rules relating to employer-provided pension plans should not be significantly altered in the context of an effort to simplify the rules. This argument assumes that additional changes in the employee benefits area will only contribute to complexity by legislating again in an area that some say has been overlegislated in the last 10 years.

On the other hand, legislative initiatives that merely repeal existing rules may not contribute to additional complexity of the rules unless the repeal of such rules leaves uncertainty as to the rule that applies in place of the repealed rule.

The structure of the workplace

Some argue that the complexity of the rules relating to pensions stems from a problem that is not unique to the employee benefits area—that is, the way in which the workplace has developed has created inherent complexities in the way that legislation is enacted. The way in which employers do business affects the complexity of pension legislation.

Large employers tend to have complex structures. These complex structures may include the division of employees among various subsidiaries that are engaged in different types of businesses. Rules are required to deal with the issues that arise because a business is operated in many tiers. For example, questions arise as to which employees are required to be taken into account in determining whether an employer is providing pension benefits on a nondiscriminatory basis. To what extent are employees of various subsidi-

aries that are engaged in completely different activities required to be aggregated? If these employees must be aggregated for testing purposes, what kind of recordkeeping burdens are imposed on the employer? How are headquarters employees treated and how does the treatment of such employees differ from the treatment of subsidiary employees? If an employer retains temporary workers, to what extent are such workers required to be taken into account? Should employees covered by collective bargaining agreements be treated differently than other employees? Employers face these issues every day because of the way in which their businesses are operated, rather than simply because the laws governing pension benefits are complex.

Flexibility and complexity

Employers and employees generally want to be able to tailor their compensation arrangements, including pension benefits, to fit their particular goals and circumstances. Present law accommodates these desires by providing for various tax-favored retirement savings vehicles, including qualified plans, individual retirement arrangements (IRAs), simplified employee pensions (SEPs), and tax-sheltered annuities. There are many different types of qualified plans, different ways of funding such plans, and different ways of providing benefits under such plans.

The number of different tax-favored retirement arrangements increases complexity in the pension rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model pension plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.

To some extent, the complexity of present law is elective. For example, employers who wish to reduce complexity can adopt a master or prototype plan. Similarly, an employer may adopt a simple profit-sharing plan for all his employees that involves a minimum of administrative work. However, many employers choose more complicated compensation arrangements.

Complexity and certainty

Although employers and practitioners often complain about the complexity of the rules relating to employer-provided pension plans, some of that complexity is, in fact, attributable to the desire of employers or the Congress to have certainty in the rules. For example, the general nondiscrimination rule relating to qualified pension plans merely requires that a plan not discriminate in either contributions or benefits in favor of highly compensated employees. This rule is easy to articulate; however, determining whether or not the rule is satisfied is not a simple task. The most obvious problem is determining what the word "discriminate" means. If it means that there can be no difference in contributions or benefits between those provided to highly compensated employees and those provided to rank-and-file employees, then the rule may be fairly straightforward. However, because the rules permit employers some flexibility to provide more contributions or benefits for highly compensated employees, then it is necessary to deter-

mine how much of a difference in the contributions or benefits is permitted.

On the other hand, rules that provide greater certainty for employers tend, on their face, to appear to be more complex. A case in point are the nondiscrimination rules for employee benefits added in the Tax Reform Act of 1986 (Code sec. 89).[11] Employers complained vigorously about the calculations and recordkeeping requirements imposed by section 89. However, these rules developed during the legislative consideration of the 1986 Act in large measure in response to employer's complaints about the uncertainty of a general rule prohibiting nondiscrimination in favor of highly compensated employees.

A more mechanical rule will often appear to be more complex, but will also provide more certainty to the employers, plan administrators, and practitioners who are required to comply with the rule. Thus, any attempts to reduce complexity of the employee benefits laws must balance the desire for simplicity against the perceived need for certainty. In addition, it should be recognized that simplicity in legislation does not preclude complexity in regulation.

Retirement policy vs. tax policy

A source of complexity in the development of pension laws and regulations occurs because the Federal Government has chosen to encourage the delivery of retirement benefits by employers through the Federal income tax system. This decision tends to create conflicts between retirement income policy and tax policy.

Retirement income policy has as its goal the delivery of adequate retirement benefits to the broadest possible class of workers. Because the decision to maintain a retirement plan for employees is voluntary, retirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan. Such a policy might also encourage the delivery of more retirement benefits to rank-and-file employees by adopting a rule that prohibits discrimination in favor of highly compensated employees, but does not otherwise limit the amount of benefits that can be provided to such employees. Thus, an employer whose principal objective was to provide large retirement benefits to highly compensated employees (e.g., management) could do so as long as the employer also provided benefits to rank-and-file employees.

On the other hand, tax policy will be concerned not only with the amount of retirement benefits being delivered to rank-and-file employees, but also with the extent to which the Federal Government is subsidizing the delivery of such benefits. Thus, Federal tax policy requires a balancing of the tax benefits provided to an employer who maintains a qualified plan in relation to all other tax subsidies provided by the Federal tax laws. This balancing has led the Congress (1) to limit the total amount of benefits that may be provided to any one employee by a qualified plan and (2) to adopt strict nondiscrimination rules to prevent highly compensated em-

[11] The rules of section 89 were repealed in 1989. (P.L. 101-140).

ployees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified pension plans.

Jurisdiction of pension legislation

When ERISA was enacted in 1974, the Congress concluded that Federal pension legislation should be developed in a manner that limited the Federal tax subsidy of employer-provided retirement benefits and that provided adequate safeguards for the rights of employees whose employers maintained pension plans. Accordingly, the rules adopted in ERISA included changes in the tax laws governing qualified plans (Title II of ERISA) and also included labor law requirements applicable to employer-provided plans (Title I of ERISA). In many cases, these labor law requirements mirrored the requirements of the tax laws and created a civil right of action for employees. Thus, ERISA ensured that compliance with the Federal employee benefits laws could be monitored by the Federal Government (through the IRS and the Department of Labor) and by employees (through their civil right of action under the labor laws).

Although many of the pension laws enacted in ERISA had mirror provisions in the labor laws and in the Internal Revenue Code, subsequent legislation has not always followed the same form. For example, the top-heavy rules that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 were only included in the Internal Revenue Code and did not contain a corresponding provision in Title I of ERISA. Some have argued that such a piecemeal approach to employee benefits legislation can lead to inconsistencies between the Federal tax law and Federal labor law and can contribute to the overall complexity of the rules governing pension plans.

In addition, the enforcement of rules relating to employer-provided pension plans is shared by the IRS and the Department of Labor. Thus, there is no single agency of the Federal Government that is charged with the development and implementation of regulations and with the operational enforcement of the rules relating to pension plans.

Although the authority of each applicable agency has been clarified, complexity can occur because of the manner in which the agencies interact. An employer must determine the agency with which it must consult on an issue and may find that the goals of each agency are different. For example, the Pension Benefit Guaranty Corporation (PBGC) views the funding of a defined benefit pension plan from its goal of assuring solvency of the plan when benefit payments are due. On the other hand, the IRS is concerned that employers should not be permitted to overfund defined benefit pension plans as a mechanism by which the employer can shelter income from taxation. Without careful coordination of the goals of these 2 Federal agencies, employers may receive inconsistent directives.

Transition rules

When the Congress enacts tax legislation altering the tax treatment of qualified pension plans or distributions from such plans, transition relief is often provided to specific employers or individ-

ual taxpayers or to a class of employers or taxpayers. Transition relief generally delays temporarily or permanently the application of the enacted rule to the applicable taxpayer. Sometimes, transition relief will apply a modified rule that is a compromise between present law and the enacted rule.

The adoption of transition rules for a taxpayer or a class of taxpayers contributes to the actual and perceived complexity of employee benefits laws.

B. Issues and Analysis Relating to S. 2901

1. Nondiscrimination provisions

Definition of highly compensated employee

Two primary issues are presented by the present-law definition of a highly compensated employee: (1) the appropriate dollar or other cut-off point for the class of highly compensated employees and (2) the extent to which family members should be aggregated.

The development of a definition of a highly compensated employee must balance the administrative complexity for an employer in identifying those employees who are highly compensated and the need for a definition that does not create inappropriate results. Some argue that the definition of a highly compensated employee should probably be employer specific. Such a rule recognizes that compensation patterns will be affected by such factors as geographic location, employer size, and industry. However, such a definition can be unjustifiably complex to apply in the case of large employers with numerous operating divisions or lines of business.

The bill adopts a definition of highly compensated employee that utilizes a dollar compensation threshold and an ownership interest threshold to identify highly compensated employees. Under this definition, the level of the compensation threshold becomes the key issue—if the compensation threshold is set either too low or too high, it may permit an employer to discriminate against rank-and-file employees. However, no single compensation threshold will be appropriate for every employer. Thus, a definition of highly compensated employee that establishes a single compensation threshold may sacrifice theoretically accurate results in favor of a more administrable rule that achieves a rough justice in most cases.

On the other hand, present law permits employers to use a single dollar level of compensation rather than determining who is in the top-20 percent of employees. Thus, the bill can be viewed as streamlining the definition of compensation to eliminate unnecessary categories of highly compensated employees. This streamlining is also evident in the elimination of officers—in most case officers will be either owners or highly compensated by virtue of their salary level so that the officer category is not necessary.

Family member aggregation also lends complexity to the definition of highly compensated employee under present law. The treatment of certain family members as a single highly compensated employee is designed to prevent income splitting to circumvent (1) the nondiscrimination rules or (2) the $200,000 limit on compensation taken into account. Theoretically, it might be argued that the family aggregation rule should apply to all highly compensated em-

ployees. However, the Congress has deemed family aggregation appropriate only in the case of employees who have sufficient control of an employer to manipulate the way in which compensation is paid. Some also argue that the present-law rules unduly restrict the provision of pension benefits in family businesses.

The bill eliminates the application of the family aggregation rule to the top 10 employees by compensation on the grounds that (1) in virtually all cases the employees who should be aggregated are 5-percent owners and (2) the additional administrative burden on employers to identify family members of the top 10 employees outweighs the small potential benefit of the rule.

Definition of compensation

Developing a definition of compensation involves a variety of factors, including the ability of the employer to administer the definition (e.g., to what extent is the definition consistent with employer payroll practices and to what extent do numerous definitions create the need to determine compensation in a variety of ways), the purposes for which the definition is being applied and the relevant policies, and the desires of employers and employees to retain flexibility in benefit design.

The Tax Reform Act of 1986 attempted to simplify the definition of compensation by creating a "uniform" definition for employee benefit purposes. This goal was not achieved, however, because a variety of definitions are used under the Code. The regulations interpreting the uniform definition permit employers a great deal of flexibility in defining compensation. This flexibility allows employers to tailor their compensation packages to suit their needs and allows employers to choose a definition that is most suited to their current administrative and payroll practices. On the other hand, the regulations arguably create additional complexity through additional options—employers will be forced to determine which choice of compensation is best for them, and this decision may change from year to year. It is particularly difficult for small employers to explore various options. In addition, the more options are provided the greater the potential for manipulation of the rules so as to undermine policy objectives.

The bill attempts to balance these factors by providing a definition of compensation that can be used for all purposes, not just some, and by permitting variations on this definition to conform to employer practices in appropriate cases. For example, the bill permits employers generally to use base pay rather than total taxable compensation. The basic definition of compensation (W-2 wages) should be relatively easy for employers to administer because it is a determination that employers are already required to make. In some cases the compensation used will be the prior year's, with the result that employers will know early in the plan year what compensation is used for that year.

The bill eliminates some of the options employers have under the temporary regulations in defining compensation for nondiscrimination testing purposes. Some employers may perceive this as a tightening of the rules and may prefer the flexibility, even if it means performing additional calculations. On the other hand, the bill takes a broader view than is possible under the regulations and

permits greater flexibility in defining compensation for purposes of the definition of highly compensated employee and the limits on contributions and benefits. The bill also should ease administration by providing comparable treatment for all these definitions, e.g., in the treatment of salary reduction contributions. The reduction in flexibility under the regulations should be balanced with the ability to use a definition of compensation for all purposes.

From a policy perspective, it is arguable that the definition of compensation should be different for different purposes. For example, for purposes of determining who is a highly compensated employee, salary reduction contributions arguably should be taken into account; such contributions are real economic income and an employee's status as a highly compensated employee should not be affected by the employee's election to defer salary. On the other hand, for purposes of the limitations on contributions and benefits, salary reduction arguably should not be counted.

Some argue that the simplicity that could be achieved by adopting a truly uniform definition outweighs the policies underlying different definitions of compensation. Moreover, the definition of compensation in the bill (W-2 wages) has relevance outside the benefits area and thus may be less susceptible of manipulation in a way that undermines the nondiscrimination rules.

Minimum participation requirement

The minimum participation rule was adopted in the Tax Reform Act of 1986 because the Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for nondiscrimination purposes are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of the highly compensated employees. The proposed Treasury regulations address many of the concerns with the prior-law comparability rules that led to the enactment of the minimum participation rule. However, the potential for discrimination is always greater if an employer maintains multiple plans; no set of rules will be able to address all the possible differences between multiple plans.

The minimum participation rule was also viewed as a means of achieving the intent of the comparability requirements with less of the inherent complexity and administrative burdens imposed by the comparability rules. Any changes that limit the scope of the minimum participation rule reintroduces some complexity for employers and imposes additional burdens on the IRS in monitoring compliance.

The bill targets the application of the minimum participation rule to the class of plans—defined benefit pension plans—in which, some argue, the greatest potential for discrimination exists. This targeting could be viewed as an appropriate attempt to balance the effect of the minimum participation rule on employers with the interests of employees who might be affected by the operation of the rule. On the other hand, some might argue that the minimum participation rule has the most significant effect on small employers and that it is difficult to understand the justification for a small

employer maintaining a multitude of plans for its employees, regardless of the type of plan.

In addition, the bill's provision may provide an incentive for employer's to maintain defined contribution plans because such plans are not subject to the minimum participation rule. Some may argue that this incentive is inappropriate at a time when fewer new defined benefit plans are being established.

Nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions

The sources of complexity generally associated with the nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests. None of these factors is new—some form of the nondiscrimination test has been in the law since 1978. Changes to these rules made by the Tax Reform Act of 1986 may have added to the complexity of the rules in operation.

The Tax Reform Act narrowed the permitted disparity between contributions by highly compensated employees and contributions by nonhighly compensated employees. Plans which previously passed the nondiscrimination tests may not meet the new rules, thereby placing more focus on the nondiscrimination rules themselves, as well as on the procedures for correcting failures to satisfy the rules. The Tax Reform Act also imposed a separate dollar limitation on annual elective deferrals of employees ($7,979 for 1990); some people believe that this dollar limitation obviates the need for nondiscrimination tests or obviates the need for nondiscrimination tests based on actual utilization of the cash or deferred arrangement. However, the dollar cap on elective deferrals limits the deferrals of highly compensated employees, but does not, by itself, ensure that there is adequate participation in the arrangement by rank-and-file employees.

The Tax Reform Act also added the special nondiscrimination rules for employer matching contributions and after-tax employee contributions. These rules added a new layer of testing and, therefore, of complexity for qualified cash or deferred arrangements (called section 401(k) plans), because an employer match is typically a part of such arrangements.

The changes made in the Tax Reform Act of 1986 were enacted because Congress was concerned that the rules relating to qualified cash or deferred arrangements encouraged employers to shift too large a portion of the share of the cost of retirement savings to employees. Congress was also concerned that the nondiscrimination rules permitted significant contributions by highly compensated employees without comparable participation by rank-and-file employees, a result which some believe is inconsistent with a basic reason for extending favorable tax treatment to employer-provided pension plans.

On the other hand, it is argued that the complexity of the nondiscrimination requirements, particularly after the Tax Reform Act changes that impose a dollar cap ($7,979 for 1990) on elective deferrals, is not justified by the marginal additional participation of

rank-and-file employees that might be achieved by the operation of these requirements. Some argue that the rate of rank-and-file employee participation in cash or deferred arrangements is more directly related to the age of the employee than to the employee's compensation and that the nondiscrimination rules do not take this factor into account. They believe that the failure of young employees, who are more likely to be nonhighly compensated, to make elective deferrals should not restrict the ability of older employees to contribute to their retirement savings. Further, the definition of a highly compensated employee may include some middle-income taxpayers for whom adequate retirement savings is essential and the operation of the nondiscrimination rules may prevent such an employee from saving.

Some people believe that the Tax Reform Act unnecessarily restricted the ability of highly compensated employees to save for retirement. The fact that the Federal Government waived the application of nondiscrimination requirements to the cash or deferred arrangement maintained for Federal employees is often cited as a justification for the repeal of the special nondiscrimination test for all employers. In addition, they argue that the result that the nondiscrimination rules is intended to produce can also be achieved by creating an incentive for employers to provide matching contributions on behalf of rank-and-file employees. Matching contributions, it is argued, create a sufficient inducement to rank-and-file employee participation.

Some practitioners have suggested that the present-law nondiscrimination tests should be eliminated or replaced with a design-based test. Under a design-based test, a plan is nondiscriminatory if it is designed in a certain way. Some people have serious tax and retirement policy concerns with a test that is not based on actual contributions and would argue that such a test permits cash or deferred arrangements to operate essentially like an individual retirement arrangement (IRA) with a much higher contribution limit ($7,979 for 1990). This type of IRA-equivalent arrangement is only available to employees whose employers offer such a plan. Thus, some would argue that the absence of nondiscrimination rules based on actual utilization would cause the Federal tax laws to treat similarly situated taxpayers differently.

Some believe that a test based on actual participation is the best way to prevent elective plans from disproportionately benefiting high-paid employees and the only way to ensure that low-paid employees actually benefit under the plan. It is argued that special nondiscrimination rules are necessary in the case of elective plans because higher income employees naturally are in a position to defer greater amounts of income than lower paid employees. Indeed, if an elective plan is the employee's only retirement plan, lower income employees may not have sufficient disposable income to provide sufficient retirement income. For this reason, some believe that elective retirement plans do not operate as efficiently as nonelective plans from a retirement policy perspective.

However, some argue that the adoption of a design-based nondiscrimination test for cash or deferred arrangements and matching contributions will promote expanded coverage for rank-and-file employees. The adoption of a nondiscrimination safe harbor that

eliminates the testing of actual contributions to the plan removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, who do not now provide any tax-favored retirement plan for their employees, to set up a plan. However, some argue that the rapid rate of establishment of cash or deferred arrangements is inconsistent with arguments that the nondiscrimination requirements act as a deterrent to employers to set up such plans.

The bill addresses concerns that rank-and-file employees may not participate by requiring a certain level of employer contributions. These contribution provide an incentive for lower-paid employees to contribute. In addition, the bill assures that lower-paid employees will be aware of the plan by requiring employers to communicate the plan to employees.

In addition, a design-based nondiscrimination test provides certainty to an employer that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year. On the other hand, some point out that there are alternative ways to achieve this result.

Under the bill, the design-based nondiscrimination tests are provided as alternatives to the present-law nondiscrimination tests. The addition of optional methods of satisfying the nondiscrimination requirements for cash or deferred arrangements may be perceived by some employers as adding, rather than reducing, the complexity of the requirements.

2. Distribution rules

In general

The pension distribution rules have been uniformly identified as a primary candidate for simplification by employers, practitioners, policy-makers, and the IRS. These rules affect nearly 16 million individual taxpayers and often require complex calculations that are difficult for the average taxpayer to perform. Many have suggested that a major part of any pension simplification proposal should be the distribution rules.

Rollovers

The present-law rules relating to rollovers of distributions from a qualified plan to an IRA or to another qualified plan represent an exception to the fundamental principle that income should be taxed when it is actually or constructively received. The rollover rules are intended to facilitate the retention of retirement savings for retirement purposes when an individual either (1) separates from service prior to retirement age or (2) receives a lump-sum distribution from a plan.

The rollover rules originally were available only in the case of certain lump-sum distributions. Because the original rollover provisions created harsh results in the case of inadvertent failures to receive a lump-sum distribution, the Congress has liberalized the rollover rules. However, the liberalizations, while eliminating most of the harsh results, have complicated the rollover rules to the point

that the average plan participant will be unable to determine in many cases whether a distribution can be rolled over. The restrictions on rollovers under present law lead to numerous inadvertent failures to satisfy the rollover requirements and contribute significantly to the complexity of the rules relating to the taxation of pension distributions.

The bill addresses the complexity of the present-law rollover rules by permitting any distribution (other than a minimum required distribution) to be rolled over to another qualified plan or an IRA. The bill does not permit the rollover of after-tax employee contributions—the concern with permitting rollovers of employee contributions is primarily administrative rather than a policy concern. Permitting the rollover of employee contributions is consistent with retirement policy; individuals should be permitted to keep all their retirement savings in a tax-favored arrangement until retirement. However, the administrative problems of keeping track of basis in an IRA should not be underestimated. Employers maintaining qualified plans to which after-tax employee contributions have been made often comment that they would like to eliminate recordkeeping burdens by cashing out employee contributions. Permitting such contributions to be rolled over to an IRA would merely shift, rather than solve, the recordkeeping problems. Indeed, such problems could be worse in an IRA because IRA funds may be freely transferred between accounts.

Lump-sum distributions

The original intent of the income averaging rules for lump-sum distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. While the income averaging rules provide a benefit to taxpayers, they also create complexity by requiring complex calculations that the average taxpayer has difficulty understanding. In addition, the existence of these rules has generated additional complexities under present law in the definitions of those distributions that qualify for the favorable treatment and in the restrictions on rollovers between tax-favored retirement arrangements that are needed to prevent taxpayers from shifting retirement assets in order to elect income averaging with respect to more assets.

The need for rules to prevent bunching of income has arguably been significantly reduced. The reduction and compression of tax rates in the Tax Reform Act of 1986 significantly reduces the adverse tax effect for a taxpayer who receives a lump-sum distribution. Moreover, the bill's liberalization of the rollover rules increases the flexibility of taxpayers in determining the timing of the income inclusion of pension distributions.

Some also argue that averaging should be eliminated from a retirement policy perspective. It can be argued that the Federal tax laws should not create an incentive for taxpayers to take pension distributions in lump sums. In fact, some studies have shown that significant percentages of lump-sum distributions are used for nonretirement purposes.

Some argue that the bill's retention of the present-law rules for net unrealized appreciation on employer securities unnecessarily

preserves some of the complexity of present law. Thus, for example, the definition of what constitutes a lump-sum distribution could be eliminated from the Code if the rule for net unrealized appreciation were repealed. Some also argue that, like the averaging rules, the need for the special unrealized appreciation rule is reduced by liberalizing the rollover rules.

The bill also does not eliminate the present-law transition rules relating to the 1986 Act repeal of capital gains treatment for certain lump-sum distributions and the continued availability of 10-year income averaging for certain individuals. The retention of these transition rules undercuts much of the simplicity attained by repeal of 5-year income averaging. On the other hand, the transition rules were added in the 1986 Act to reflect the reliance that plan participants may have had on the availability of favorable tax treatment for withdrawals and the elimination of these rules could be viewed as unfair to those individuals who are eligible for the transition rules. Of course, the reliance problem could be addressed by providing a limited period of time (such as 1 year) after the enactment of the bill during which individuals could receive distributions that are eligible for the transition rules.

Transfers to IRAs or eligible transferee plans

The provision in the bill requiring a trustee-to-trustee transfer of certain distributions from qualified plans to an IRA or a defined contribution plan that accepts such distributions is intended to promote sound retirement policy. Such a transfer requirement eliminates the adverse income tax effect that occurs when an employee receives a distribution from a qualified plan but inadvertently fails to roll the distribution over to an IRA or another qualified plan within the permitted rollover period. Further, the bill provision reduces the likelihood that retirement savings will be spent for nonretirement purposes by forcing the employee to take an affirmative action (withdrawal from the transferee plan) in order to have access to the distribution. It can be argued that such a provision may make it more likely that at least a portion of retirement savings will remain in a tax-favored arrangement and that the employee will have adequate sources of retirement income when it is needed.

On the other hand, the provision may create an additional administrative burden for the employer by requiring the plan trustee to designate a transferee plan if the employee does not designate a plan. Generally, this will mean that the plan trustee will be required to set up an IRA on behalf of the employee if the employee fails to designate an IRA. In addition, the bill requires the plan trustee to notify employees of the requirements of the transfer provision and of the amount to be transferred. Thus, the provision imposes an additional reporting requirement on employers or plan trustees. Some employers and trustees may also be concerned about continuing fiduciary liability with respect to amounts transferred.

The benefits of the transfer provision (i.e., promoting additional retirement savings) must be balanced against the administrative burdens on employers.

Required distributions from qualified plans

A uniform distribution rule for pension benefits was adopted because it reduces disparities in opportunities for tax deferral among individuals covered by different types of plans and eases administrative burdens. The minimum distribution rules are designed to ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

Some will argue that the application of the required distribution rules to all employees under present law is unnecessary because the vast majority of employees commence distributions prior to age 70. Only in the case of very highly compensated employees is the potential for deferral of receipt of benefits a problem.

The required distribution rule under present law has the effect of eliminating an incentive that employers use to get their employees to retire. Employers prefer to be able to induce employees to retire, thereby creating jobs for younger employees, by refusing to commence payments of retirement benefits. Under present law, this option is not available to employers; however, the bill will permit employers to utilize this incentive.

On the other hand, the bill also requires a plan administrator to actuarially adjust the benefits payable to an employee under a defined benefit pension plan to reflect the period during which benefits could have been paid, but were not. This provision can also serve as a disincentive to employees to retire because they will not lose the actuarial value of the retirement benefits they could have been receiving. This provision is necessary to prevent employees from being disadvantaged because payment of their benefits is delayed; however, it also adds complexity.

The return to the pre-1986 Act rules relating to required distributions also reintroduces some of the complexities the 1986 Act sought to eliminate. Thus, for example, employers will have to apply different sets of rules to two different groups of employees. Also, it may be difficult to determine when someone has retired. For example, is someone retired for purposes of the minimum distribution rules if they are working for the employer on a part-time basis?

3. Miscellaneous provisions

Treatment of leased employees

The leased employee rules are designed to prevent circumvention of the pension plan qualification rules. The coverage and nondiscrimination rules operate by comparing an employer's highly compensated employees and nonhighly compensated employees. The possibility for discriminating in favor of highly compensated employees increases to the extent that an employer can reduce the number of individuals required to be counted as nonhighly compensated employees through arrangements such as leasing. For example, one obviously abusive type of transaction that Congress was concerned about in enacting the leasing rules were cases in which a doctor would fire his staff and then rehire the same people through a leasing organization. The former employees would no

longer be considered employees of the doctor, enabling the doctor to set up a generous qualified plan that covered only himself.

Avoidance of the qualification rules through employee leasing is possible because the common-law rules for determining who is an employee are concerned primarily with who is the appropriate party from whom to collect withholding taxes and, in some cases, for determining whether or not an individual is an employee or an independent contractor. The same factors that are relevant to such a determination are not necessarily those that are most relevant in determining those situations which undermine the pension rules.

The primary concern articulated with respect to the present-law rules is that the statute, as interpreted by proposed regulations, is overly broad and counts as leased employees individuals who should not be considered such. There is also some concern that it is difficult to obtain the information necessary to determine who is a leased employee because some of the information is obtainable only from a third party and is not readily accessible by the employer.

Most would agree that the present-law rules as they now stand are overly broad; however, there is debate about the appropriate solution. Some argue that the "control" test of the bill is preferable to present law because it relies solely on information within the control of the employer. Thus, the employer may more easily make a determination of who are considered leased employees. They also argue that the "historically performed" test has no relation to the economic relationship between the recipient and the individual, and that it is the nature of that relationship that should be determinative.

On the other hand, the control test of the bill may create some confusion as employers and practitioners try to distinguish it from the control test used to determined whether an individual is a common law employee. Leased employees are by definition individuals who, under the common law test, are not employees. Use of similar terms without clarification of their meaning can create administrative problems for employers and enforcement problems for the IRS.

There is also some concern that the bill will be perceived as merging the rule with the common-law test, with the result that some individuals, such as doctor office technicians, who clearly were intended to be covered by the rules are not. Thus, the more the test appears to be like the common law test, the greater the concern that the bill's rule will not be sufficient to prevent avoidance of the nondiscrimination requirements.

Some also question whether true simplification of the rules can be achieved statutorily. The determination of whether someone should be a leased employee is inherently factual in nature. It depends on the underlying economic relationship of the parties—a factor which will vary case by case with each individual. Thus, some argue that it is the case-by-case analysis that is relevant. This case-by-case analysis approach could be implemented with minor statutory changes to the employee leasing rules with direction to the Secretary in the legislative history as to the kinds of circumstances that the Congress believes should and should not result in someone being considered a leased employee.

Elimination of half-year requirements

The change from ages 59-1/2 and 70-1/2 to 59 and 70, respectively, should result in the use of ages that are easier to calculate.

Plans covering self-employed individuals

The repeal of the remaining special rules for plans maintained by unincorporated employers should make the qualification standards easier to apply and should eliminate the need for special restrictions on rollovers between plans if one plan is a plan of an unincorporated employer.

Full funding limitation of multiemployer plans

It is argued that the application of the full funding limitation to multiemployer pension plans creates significant complexity. It is necessary to determine (1) whether the full funding limit applies on a contributing employer-by-contributing employer basis and (2) who bears the burden of the sanction if the rule is violated. In addition, given the intent of the full funding limitation, it is arguable that this limitation need not apply to multiemployer plans because the contributing employers to the plan have no interest in making excess contributions to the plan. The nature of the collective bargaining process and the fact that unrelated employers are contributing to the same pension plan should act as a sufficient deterrent without the imposition of a separate funding restriction.

On the other hand, some argue that it is difficult to understand why the arguments against the full funding limitation might not also be relevant in the case of a collectively bargained plan that is not a multiemployer plan or in the case of a multiple employer plan.

Affiliation requirements for employers jointly maintaining a VEBA

The rules relating to VEBAs under present law permit an employer and, in some cases, a group of employers to contribute to a tax-exempt trust that is established to provide benefits to employees of the employer or group of employers. By generally providing tax exemption for the earnings on amounts contributed to a VEBA, present law reduces the cost to an employer or a group of employers of providing certain benefits.

To the extent that the VEBA rules provide more favorable income tax treatment than is provided to an insurance company, use of a VEBA may encourage an employer or group of employers to self insure benefits rather than purchasing insurance from a commercial insurance company. Thus, any proposal that recommends the liberalization of restrictions applicable to VEBAs should be viewed in light of their potential interaction with the insurance company tax rules. In fact, some people argue that the present-law VEBA rules, which permit employers in the same line of business operating within the same State to establish a VEBA, permits a group of employers to establish what is, in effect, a tax-exempt insurance company for the funding of health and life benefits for employees. Thus, it could be argued that the justification for permitting unrelated employers to establish a VEBA should be reexamined.

However, some may conclude that the liberalization of the VEBA rules is justified because VEBAs serve the public policy of ensuring that employers have set aside sufficient funds to provide benefits to their employees. In addition, it may be argued that it is inappropriate to try to compare VEBAs with commercial insurance companies because there are inherent differences in the way that VEBAs operate. For example, a VEBA is established by an employer or a group of employers who have a significant nexus whereas an insurance company will typically serve a diverse clientele. Similarly, a VEBA exists for the funding of a statutorily limited class of benefits; a commercial insurance company will typically have many diverse products for sale to the general public.

The bill provides that employers will be deemed to be affiliated if certain requirements are satisfied. Although historically the notion of affiliated employers has been linked to some kind of common ownership, the bill permits unrelated employers to be treated as affiliated. In connection with this provision, it is appropriate to consider whether the concept of affiliation adopted in the bill should be extended to other areas in the tax laws, or at least to the employee benefits area. For example, such a concept could be extended to apply to the group of employers that is tested together for nondiscrimination purposes under the qualification rules for pension plans.

Distributions from rural cooperative plans

In general, a qualified cash or deferred arrangement is required to be a profit-sharing or stock bonus plan. Under either type of plan, present law normally permits in-service withdrawals. In fact, the withdrawal rules relating to a qualified cash or deferred arrangement are generally more restrictive than the withdrawal rules applicable to other profit-sharing or stock bonus plans.

Certain pre-ERISA money purchase pension plans and pension plans maintained by rural cooperatives can also be qualified cash or deferred arrangements. Because these plans are pension plans, no in-service withdrawals are permitted, notwithstanding the fact that certain in-service withdrawals are permitted from qualified cash or deferred arrangements. In the case of a plan maintained by a rural cooperative, it can be argued that this is an unnecessary restriction on withdrawals since a rural cooperative plan is structured as a pension plan only because rural cooperatives do not have profits within the general meaning of the Code so that, at the time the plans were established, they could not be profit-sharing plans.

On the other hand, some might argue that the liberalization of the withdrawal rules to permit in-service distributions is inconsistent with sound retirement policy in that it creates an incentive for plan participants to dissipate retirement savings for nonretirement purposes. In addition, such a rule creates a class of pension plans that are subject to more favorable withdrawal rules, which might be perceived as unfair to other employers not eligible for the special rules.

Date for adoption of plan amendments

The provision that delays the time by which plan amendments are required in order to bring the plan into compliance with the changes made by the bill benefits the employer in 2 ways. First, the provision gives the employer additional time to make the necessary changes in the plan document. Second, it provides time during which the IRS can issue additional guidance with respect to the requirements and such guidance can then be incorporated into the plan document, which will reduce the need for subsequent plan amendments.

On the other hand, the operation of the provision means that plan administrators and participants will not be able to rely on the language of the plan document in determining what their rights might be under the plan. In addition, the plan document represents the contract between the employer and its employees and such contract should be kept as current as possible. The benefit of the additional time for employers should be balanced against the importance of employees being able to determine their rights and of plan administrators being able to administer the plan properly.

SIMPLIFICATION OF TAX RULES RELATING TO EMPLOYEE BENEFIT PROGRAMS MAINTAINED BY CHURCHES

(S. 2902, The Church Retirement Benefits Simplification Act, Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, August 3, 1990, JCX-24-90)

INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on August 3, 1990, to review the Internal Revenue Code rules relating to private pension plans and possible options for simplification of on S. 2901,[1] the 50 plan rules. The hearing will focus employee Benefits Simplification Act, introduced by Senator Pryor and others on July 25, 1990, and S. 2902, the Church Retirement Benefits Simplification Act, also introduced by Senator Pryor on July 25, 1990.

This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a discussion of S. 2902 and the issues relating to modification of the Federal income tax rules relating to church-maintained retirement and employee benefit plans. Part I is a summary. This is followed by a discussion of the present-law Federal tax rules regarding tax-qualified plans, and, in particular, plans maintained by churches (Part II), a description of S. 2902 (Part III), and a discussion of issues relating to church plans (Part IV).

I. SUMMARY

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Similar tax treatment is accorded to tax-sheltered annuity programs.

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[1] For a description of S. 2901, see Joint Committee on Taxation, *Simplification of Present-Law Tax Rules Relating to Qualified Pension Plans (S. 2901, the Employee Benefits Simplification Act* (JCS-24-90), August 3, 1990.

[2] This document may be cited as follows: *Joint Committee on Taxation, Simplification of Tax Rules Relating to Employee Benefit Programs Maintained by Churches (S. 2902, the Church Retirement Benefits Simplification (JCX-24-90), August 3, 1990.*

The employer maintaining the plan is entitled to a deduction (within limits) for contributions to a plan even though an employee is not required to include the benefit in income until it is distributed.

The rules relating to qualified plans and tax-sheltered annuities are generally designed to encourage employers to establish such plans (particularly for their rank-and-file employees) and to protect employees' rights under the plans.

Unless a church elects otherwise, plans maintained by churches or church-related organizations are exempted from the coverage, vesting, funding, and certain other requirements contained in the Employee Retirement Income Security Act of 1974 (ERISA). With respect to non-electing church plans, such rules in effect before the enactment of ERISA apply. In addition, several special rules apply to such plans. With respect to welfare benefit plans, church plans generally are subject to the same rules that apply to plans maintained by other employers.

S. 2902 would consolidate and modify rules relating to church-maintained qualified retirement plans, tax-sheltered annuity plans, and welfare benefit plans. In general, the bill would expand the existing church plan exemption in the qualified plan area. Issues exist with respect to whether the present-law exemption is warranted and, if warranted, whether the exemption should be expanded in the manner contemplated by the bill.

II. PRESENT-LAW TAX RULES [3]

A. Overview of Qualified Plans

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred. Contributions to a qualified plan are held in a tax-exempt trust.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limit on the tax benefits for qualified plans.

Qualified plans are broadly classified into two categories, based on the nature of the benefits provided: defined contribution plans and defined benefit pension plans.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan also may be specified as a flat or step-rate percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.[4]

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

B. Tax-Sheltered Annuity Programs

Certain eligible employers may maintain tax-deferred annuity plans (sec. 403(b)). These plans provide tax-sheltered retirement savings for employees of public education institutions and employees of certain tax-exempt organizations (including

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[3] This document generally is limited to a discussion of the Internal Revenue Code rules relating to tax-qualified retirement plans. In addition to the rules in the Internal Revenue Code, the labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain extensive rules regarding employee benefit plans. For a more detailed discussion of the qualification rules, see Joint Committee on Taxation, *Present-Law Income Tax Rules Relating to Qualified Pension Plans (JCS-9-90), March 22, 1990.*

[4] Individual accounts may be maintained for after-tax employee contributions made to a defined benefit pension plan.

churches and certain organizations associated with churches) that are described in section 501(c)(3). In addition to tax-deferred annuities, alternative funding mechanisms under section 403(b) include custodial accounts invested in mutual fund shares (sec. 403(b)(7)) and church-maintained retirement income accounts (sec. 403(b)(9)).

Tax-sheltered annuity programs may be funded through either employer contributions or salary reduction amounts. Employer contributions are excluded from the employee's income for the taxable year to the extent they do not exceed the employee's exclusion allowance. The amount of salary reduction is limited to an annual maximum (sec. 402(g)). In addition, the total amount of contributions is subject to the limitations on contributions generally applicable to defined contribution plans (sec. 415(c)).

Tax-sheltered annuity programs must meet certain nondiscrimination rules (sec. 403(b)(12)). Plans with nonelective employer contributions must meet the minimum participation requirements (sec. 401(a)(26)), minimum coverage requirements (sec. 410), and the nondiscrimination requirements relating to contributions and benefits (secs. 401(a) (4) and (5)). In addition, if employer contributions are used to match employee contributions, the program must meet the requirements generally applicable to matching plans (sec. 401(m)). Tax-sheltered annuity programs must also meet the requirements relating to the limitation on the amount of compensation upon which contributions and benefits may be based (sec. 401(a)(17)).

A tax-sheltered annuity program is required to meet an eligibility test that is met if all nonexcludable employees of the organization may elect to have the employer make contributions of more than $200 pursuant to a salary reduction agreement if any employee of the organization may elect to have the organization make contributions for such contracts pursuant to such agreement.

C. Sanction for Failure to Meet Qualification Rules

If a plan fails to meet the qualification standards, then the special tax benefits for qualified plans do not apply, and benefits and contributions are taxed under normal income tax rules. Similar rules apply in the case of an employer who fails to meet the rules relating to tax-sheltered annuities. In general, if a plan fails to meet the qualification standards, then contributions to the plan are includable in employees' gross income when such contributions are no longer subject to a substantial risk of forfeiture (secs. 402(b) and 83). Amounts actually distributed or made available to an employee are generally includable in income in the year distributed or made available under the rules applicable to taxation of annuities (sec. 72). Special sanctions apply in the case of failure to meet certain nondiscrimination rules (e.g., sec. 410).

An employer is generally not entitled to a deduction for contributions to a nonqualified plan until the contributions are includable in an employee's gross income.

D. Special Rules Applicable to Church Plans

In general

A church plan is a plan established and maintained for employees (or their beneficiaries) by the church or by a convention or association of churches that is exempt from tax under section 501 (sec. 414(e)). Church plans include plans maintained by an organization, whether a corporation or otherwise, that has as its principal purpose or function the administration or funding of a plan or program for providing retirement or welfare benefits for the employees of the church or convention or association of churches (sec. 414(e)(3)(A)).[5]

Certain church plans are exempt from the coverage, vesting, funding and fiduciary requirements of ERISA. Church plans may waive this exemption by election (sec. 410(d)). Electing plans become subject to all section 401(a) qualification requirements, Title I of ERISA, the excise tax on prohibited transactions (sec. 4975), and participate in the termination insurance program administered by the Pension Benefit Guaranty Corporation.

Qualification retirements

Minimum coverage and participation rules.—Church plans are subject to the minimum participation rule that requires each plan to cover the lesser of 50 employees or 40 percent of all employees. However, non-electing plans are not subject to the

[5] With respect to certain provisions (e.g., the exemption for church plans from nondiscrimination rules applicable for tax-sheltered annuities), the more limited definition of church under the employment-tax rules applies (secs. 3121(w)(3) (A) and (B)).

minimum participation and coverage requirements contained in section 410. Instead these plans must meet pre-ERISA coverage requirements (sec 401(a)(3) asthat section was in effect on September 1, 1974).[6]

Nondiscrimination in contributions and benefits.—Church plans are subject to rules that require that a plan not discriminate in favor of highly compensated employees (sec. 401(a) (4) and (5)). In addition, such plans are subject to the rules relating to the integration of benefits with social security (sec. 401(l)) and to the rules relating to top-heavy plans (sec. 416).

Vesting.—Non-electing church plans are not subject to the vesting rules of section 411. However, such plans must meet pre-ERISA vesting rules (secs. 401(a) (4) and (7) as in effect on September 1, 1974). In general, under pre-ERISA law, participants must have become fully vested upon attainment of normal retirement age, or upon the termination of the plan (to the extent funded) whether the termination was partial or otherwise.

Maximum limitation on contributions and benefits.—The limitation on contributions and benefits that apply to qualified plans also apply to church plans (sec. 415). However, the rules in effect prior to the Tax Reform Act of 1986 relating to early or late commencement of benefits apply. In addition, church plans are subject to the requirements relating to the limitation on the amount of compensation upon which contributions and benefits may be based (sec. 401(a)(17)).

Deductions.—The limitations on an employer's deduction for contributions to a qualified plan are, in large part, irrelevant in the case of a church plan because churches are tax-exempt organizations.

Funding.—Non-electing church plans are exempt from the minimum funding requirements (sec. 412(h)(4)). However, such plans must meet certain pre-ERISA requirements (sec. 401(a)(7) as in effect on September 1, 1974). These requirements do not require a particular funding method.

Distributions.—In general, distributions from church plans are subject to the present-law distribution rules applicable to plans maintained by nonchurch employers. However, an exception applies with respect to the definition of a qualified domestic relations order (sec. 414(p)(11)). In addition, certain church plans (described in sec. 3121(w)(3) (A) or (B)) are not required to begin benefits by April 1 of the year following the year in which an employee attains 70½, if the employee has not retired.

Tax-sheltered annuities.—Tax-sheltered annuity programs maintained by churches generally are not subject to the nondiscrimination rules applicable to such programs (sec. 403(b)(1)(D)). For purposes of this exemption, a church is defined as a church or church controlled organization as defined for certain employment tax purposes. For these purposes, a church includes a convention or association of churches, or an elementary or secondary school that is controlled, operated or principally supported by a church or by a convention or association of churches (sec. 3121(w)(3)(A)). A church controlled organization is defined as a tax-exempt organization described in section 501(c)(3), other than one that (1) offers goods, services or facilities for sale (except incidentally) to the general public, unless such sale is at a nominal charge substantially less than cost, and (2) normally receives more than 25 percent of its support from either governmental sources or from receipts from admissions or sales of goods, services or facilities (sec. 3121(w)(3)(B)).

Rules relating to welfare benefit plans

The exclusions from income related to employer-provided welfare benefits are available to employees of churches (e.g., sec. 106). In addition, the requirements relating to the particular exclusion (including applicable nondiscrimination requirements) generally apply to welfare benefit plans maintained by churches. Thus, for example, a plan maintained by a church must meet the nondiscrimination rules relating to self-insured medical plans (sec. 105(h)), group legal services plans (sec. 120), cafeteria plans (sec. 125), education assistance plans (sec. 127), and dependent care assistance programs (sec. 129). The nondiscrimination rules (sec. 505) that apply to

[6] Prior to ERISA, section 401(a)(3) required that a plan benefit either (1) 70 percent or more of all employees, or 80 percent or more of all eligible employees if at least 70 percent or more of all the employees were eligible for the plan, or (2) such employees as qualify under a reasonable nondiscriminatory classification as determined by the Secretary. For purposes of this pre-ERISA coverage test, the following employees could be excluded from consideration: (1) employees who have not been employed for at least 5 years, (2) employees whose customary employment is not more than 20 hours in any one week, and (3) employees whose customary employment is not more than 5 months in any calendar year.

voluntary employees' beneficiary associations (VEBAs) also apply to VEBAs maintained by churches.

Church plans generally are not subject to the health care continuation rules (sec. 4980B). In addition, certain church plans are not subject to the nondiscrimination requirements applicable to group-term life insurance (sec. 79(d)). For purposes of the group-term life insurance rules, a church plan is defined as a plan maintained by a church organization described in section 501(c)(3) other than educational organizations above the secondary school level, hospitals, and other medical care related organizations.

III. DESCRIPTION OF S. 2902 [7]

S. 2902 provides a general revision of the rules relating to church-maintained qualified retirement and welfare benefit plans. In addition, rules relating to employee annuity contracts and retirement income accounts maintained for the benefit of church employees are modified.

A. Consolidation and Modification of Rules Relating to Church-Maintained Qualified Retirement Plans

In general

The bill adds a new section 401A to the Code that defines a qualified church plan. If the requirements of new section 401A are met then the qualified church plan is treated as satisfying section 401(a) as well as all sections referred to therein.

Definition of qualified church plan

In general

In order to meet the requirements of section 401A, the plan must meet the definition of a church plan as set forth in section 414(e). In addition, the church that maintains the plan may not have elected (pursuant to section 410(d)) to waive the exemption from certain qualification requirements available to church plans (e.g., participation, vesting and funding rules).

Employee contributions and vesting

An employee's rights in his or her accrued benefit derived from his or her own contributions must be nonforfeitable. In addition, the vesting schedule of a qualified church plan must meet either a 10-year vesting schedule or a 5- to 15-year vesting schedule. A plan satisfies the 10-year vesting requirement if an employee who has at least 10 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions. A plan meets the 5- to 15-year schedule if the vesting schedule meets the following:

Years of service	Nonforfeitable percentage
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15 or more	100

Funding requirements

As under present law, a qualified church plan must meet the requirements of section 401(a)(7) as that section was in effect on September 1, 1974.

[7] S. 2902, the Church Benefits Simplification Act of 1990, was introduced by Senator Pryor on July 25, 1990.

Additional requirements

A qualified church plan must meet the requirements of sections 401(a) (1), (2), (8), (9), (16), (17), (25), (27) and (30). In addition, the requirements of sections 401(b), 401(c), and 401(h) apply to such plans.

If the plan includes employees of an organization that is not a church, then either the plan or such organization (at the option of the plan) shall meet the requirements of sections 401 (a)(3) and (a)(6) (as in effect on September 1, 1974), as well as sections 401(a)(4), 401(a)(5) and 401(m).

Definitions and special rules

Definition of church.—For purposes of section 401A, a church is defined as a church or a convention or association of churches, including organizations whose principal function is to fund or maintain a plan for churches (as described in sec. 414(e)(3)(A)). The definition of church also includes certain organizations described in section 414(e)(3)(B)(ii) (relating to certain tax-exempt organizations) other than (1) schools above the secondary level (other than those for religious training) or (2) health care organizations (including hospitals) that provide community service for inpatient care and where not more than 50 percent of total patient days are customarily assignable to certain categories of medical treatment.

Satisfaction of trust requirements.—A plan does not fail to meet section 401A merely because such plan is funded through an organization described in section 414(e)(3)(A) rather than through a trust.

Failure of one organization to qualify.—If one or more organizations maintaining a church plan fails to satisfy the requirements of section 401A, the plan is not disqualified with respect to the other organizations maintaining the plan that meet such requirements.

Special rules relating to highly compensated and excludable employees.—For purposes of section 401A, no employee is considered an officer, shareholder or person whose principal duties consist of supervising the' work of other employees if such employee during the year or the preceding year received compensation of less than $50,000 (indexed). In addition, certain employees covered by collective bargaining agreements (as described in section 410(b)(3)(A)) are excluded for purposes of section 401A.

Effective date

The provision of the bill that adds section 401A generally is effective for years beginning after December 31, 1989. The vesting provision is effective for years beginning after December 31, 1992.

No regulation or ruling under section 401(a) issued after December 31, 1989, shall apply to a qualified church plan unless such regulation or ruling is specifically made applicable to such plans.

A church plan (within the meaning of section 414(e)) shall not be deemed to have failed to satisfy the applicable requirements of section 401(a) for any year beginning prior to January 1, 1990.

B. Retirement Income Accounts of Churches

Under present law, retirement income accounts (described in sec. 403(b)(9)) maintained by certain churches are treated as tax-deferred annuities. The bill modifies certain rules relating to such accounts. First, the bill allows certain controlled organizations (described in sec. 414(e)(3)(B)(ii)) that are exempt under section 501 to maintain such accounts. Second, the bill provides that certain ministers (including self-employed ministers) are treated as employees for purposes of the rules relating to retirement income accounts.

Effective date.—The provision is generally effective for years beginning after December 31, 1989. A church plan (within the meaning of sec. 414(e)) shall not be deemed to have failed to satisfy the applicable requirements of section 403(b) for any year beginning prior to January 1, 1990.

C. Tax-Sheltered Contracts Purchased by Churches

The bill modifies several rules relating to tax-deferred annuity contracts purchased by churches. The first modification relates to the nondiscrimination rules. Under the bill, if a contract is purchased under a church plan by (1) schools above the secondary level (other than those for religious training) or (2) health care organizations (including hospitals and medical research organizations) which provide community service for inpatient care and not more than 50 percent of total patient days are customarily assignable to certain categories of medical treatment, either

the plan or such organization (at the option of the plan) must meet the requirements of sections 401 (a)(3) and (a)(6) as in effect on September 1, 1974, 401(a)(4), (5), (17) and 401(m).

The bill defines a contract purchased by a church to include an annuity (sec. 403(b)(1)), a custodial account (sec. 403(b)(7)), and a retirement income account (sec. 403(b)(9) as amended by the bill). A church is defined as a church or a convention or association of churches, including certain organizations described in sections 414(e)(3)(A) and 414(e)(3)(B)(ii).

The vesting requirements that apply for purposes of new section 401A apply for purposes of church plans under section 403(b). Thus, the present-law vesting rules relating to tax-sheltered annuities do not apply (secs. 403(b)(1)(C) and 403(b)(6)). In addition, salary reduction amounts must be nonforfeitable. The rules relating to the failure of one organization to meet the requirements of section 403(b) and the rules relating to highly compensated and excludable employees are similar to the rules applicable under new section 401A.

The bill treats as an employee for section 403(b) purposes certain self-employed (within the meaning of sec. 401(c)(1)(B)) ministers and any other duly ordained, commissioned or licensed minister that is employed by an organization other than an organization described in section 501(c)(3). Thus, these individuals may participate in tax-sheltered annuity programs.

For purposes of applying the exclusion allowance (sec. 403(b)(2)) and the limitations on contributions and benefits (sec. 415), any nonvested contribution which is forfeitable is treated as an amount contributed to the contract in the year for which such contribution is made and not in the year the contribution becomes nonforfeitable.

Effective date.—The modifications relating to the purchase of contracts by churches generally are effective for years beginning after December 31, 1989. The vesting standards are effective for years beginning after December 31, 1992.

No regulation or ruling under section 401(a) or 403(b) issued after December 31, 1989, shall apply to a contract purchased by a church unless such regulation or ruling is specifically made applicable to such contracts.

D. Modification of Distribution Requirements

Under present law, an annuity contract is not described in section 403(b) unless distributions do not begin before age 59½, separation from service, death, disability (within the meaning of sec. 72(m)) or (with respect to principal under the contract) in the case of hardship. The bill modifies the definition of disability for purposes of retirement income accounts to conform to the definition used for purposes of the rules relating to cash or deferred arrangements (sec. 401(k)(2)).

Effective date.—The modification is effective for years beginning after December 31, 1988.

E. Modification of Required Beginning Date for Distributions

Under present law, distributions are required for certain retirement programs no later than April 1 of the year following the year in which a participant turns 70½ (sec. 401(a)(9)). With respect to church plans, the required beginning date is the later of the date described in the preceding sentence and April 1 of the year after the year in which the employee retires. Under the bill, the special rule for church plans applies to all church plans described in section 414(e) instead of the present law rule that allows relief only to those churches treated as such for employment tax purposes (secs. 3121(w)(3) (A) and (B)).

Effective date.—The provision is effective as if included in the Tax Reform Act of 1986.

F. Exclusion of Ministers from Nondiscrimination Requirements

The bill adds a new section 414(u) that excludes ministers from being considered when an employer applies the following sections: 401(a) (3), (4) and (5) as those sections were in effect on September 1, 1974, 401(a)(4), 401(a)(5), 401(a)(26), 401(k)(3), 401(m), 403(b)(1)(D) 410, 79(d), 105(h), 120(c) (1), (2), and (3), 125(b), 127(b)(2), and 129(d) (2), (3), and (8).

The church plan in which such minister participates shall be treated as a plan or contract meeting the requirements of section 401(a), 401A, or 403(b) with respect to such minister's participation.

Effective date.—This provision is effective for years beginning before, on, or after December 31, 1989.

G. Aggregation Rules Not to Apply to Churches

The bill adds a new section 414(v) that exempts churches from certain aggregation rules (secs. 414(b), (c), (m), (o) and (t)) that must be applied in order to determine who is the employer for certain nondiscrimination rules and for certain other purposes (secs. 401(a) (3), (4), and (5) as those sections were in effect on September 1, 1974, 401(a)(4), (a)(5), (a)(17), (a)(26), 401(h), 401(m), 410(b), 411(d)(1) and 416).

The exemption is available to church-related organizations except in the case of such organizations that are not exempt from tax under section 501(a) and which have a common, immediate parent.

A church-related organization may make an election to use this provision for itself and other related organizations on or before the last day of the plan year beginning on or after January 1, 1993.

Effective date.—The provision is effective as if included in the provision of P.L. 93-406, P.L. 98-369, or P.L. 99-514 to which the amendment relates.

H. Qualified Retirement Contributions to Include Voluntary Contributions Pursuant to Church Plans

The bill amends the rules relating to individual retirement accounts (Sec. 219) to allow ministers to make or to have made on their behalf qualified retirement contributions in a manner similar to the rules relating to qualified voluntary employee contributions that applied under prior law. Amendments are also made to the distribution rules relating to such contributions.

Effective date.—The provision is effective for taxable years beginning after December 31, 1989.

I. Self-Employed Ministers Treated as Employees for Purposes of Certain Welfare Benefit Plans

Under the bill, the special rule (sec. 7701(a)(20)) treating certain life insurance salesmen as employees for the purpose of certain welfare benefit and qualified plan rules is expanded to include self-employed ministers.

Effective date.—The provision is effective for years beginning before, on, or after December 31, 1989.

J. Deductions for Contributions by Certain Ministers to Retirement Income Accounts

Under the bill, if a minister (as defined below) makes a contribution to a retirement income account, such contribution is treated as though it were made to a tax-exempt pension trust and is deductible to the extent it does not exceed the exclusion allowance applicable to tax-sheltered annuities (sec. 403(b)(2)). Ministers for whom this provision is available include self-employed ministers and certain ministers employed by an organization that is not described in section 501(c)(3).

Effective date.—The provision is effective for years beginning after December 31, 1989.

K. Modification of Rules for Plans Maintained by More than One Employer

Under the bill, a church plan is not treated as a single plan merely because employers commingle assets solely for purposes of investment and pooling of mortality experience.

L. Expansion of Definition of Church for Purposes of Rules Relating to Certain Deferred Compensation Plans

Under present law, eligible deferred compensation plans under section 457 may only be maintained by eligible employers. Churches (as defined in sec. 3121(w)(3)(A)) and certain church-controlled organizations (as defined in sec. 3121(w)(3)(B)) are not eligible employers. The bill expands the definition of churches under this rule to include all churches as defined under new section 401A.

Effective date.—The provision is effective for years beginning after December 31, 1978.

M. Modification to Health Benefits Accounts in Church Plans

Under present law, a pension or annuity plan may provide for the payment of medical expenses through a segregated account (sec. 401(h)). In the case of a key employee, a separate account must be maintained and any additions to the account

with respect to such employee are treated as annual additions for purposes of the rules relating to limitations on contributions and benefits (sec. 415). Under the bill, with respect to a church plan maintained by more than one employer, a separate account is not required for an employee who is a key employee solely by reason of being an officer with annual compensation greater than $45,000. The bill also modifies the amount of the annual addition under section 415 with respect to participants of church plans.

Effective date.—The provision is effective for years beginning after March 31, 1984.

N. Modification of Rule Relating to Investment in Contract

The bill grants foreign missionaries the exception to the special riles for computing employees' contributions (sec. 72(f)) currently available only with respect to certain contributions relating to credits for service performed prior to January 1, 1963.

Effective date.—The provision is effective for taxable years beginning after December 31, 1989.

O. Modification of Rule Relating to Elective Deferral Catch-Up Limitation for Retirement Income Accounts

The bill modifies the elective catch-up provisions relating to retirement income accounts by repealing one of the limitations on the amount of such catch-up contribution (sec. 402(g)(8)(A)(iii)).

Effective date.—The provision is effective as if included in the Tax Reform Act of 1986.

P. Church Plans May Annuitize Benefits

Under the bill, a retirement income account, a church plan, or an account comprised of qualified voluntary employee contributions does not fail to meet qualification requirements merely because it pays benefits to participants and their beneficiaries from a pool of assets administered or funded through an organization whose principal purpose is to provide such benefits (described in sec. 414(e)(3)(A)), rather than through the purchase of annuities from an insurance company.

Effective date.—The provision is effective for years beginning before, on, or after December 31, 1989.

Q. Church Plans May Increase Benefits

Under the bill, a retirement income account, a church plan, or an account comprised of qualified voluntary employee contributions does not fail to meet applicable qualification requirements merely because it increases benefit payments to participants and their beneficiaries pursuant to a method not described in section 401(a)(9) or the accompanying regulations.

Effective date.—The provision is effective for years beginning before, on, or after December 31, 1989.

R. Exemption for Church Plans from Nondiscrimination Rules Applicable to Self-Insured Medical Accounts

The bill exempts plans maintained by churches (as described in new sec. 401A) from the nondiscrimination rules relating to self-insured medical plans (sec. 105(h)).

Effective date.—The provision is effective for years beginning before, on, or after December 31, 1989.

IV. ISSUES RELATED TO S. 2902

In general

S. 2902 generally consolidates and modifies rules relating to the regulation of retirement and benefit programs maintained by churches and church-related organizations. The bill may be characterized as generally expanding the present-law exemption available to church plans with respect to these rules. The key issue is whether such an expansion is warranted.

Rationale for Present-Law Qualification Requirements

The qualification standards and related rules governing retirement and employee benefit programs are designed to ensure that such programs benefit an employer's

rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and limit the amount of tax benefits accorded to the plan and its benefits. Several of the rules serve to ensure that funds are in fact available at the time they are payable to participants (e.g., funding requirements and fiduciary rules).

Church plans generally are not subject to several qualification rules that were enacted under ERISA (e.g., the minimum coverage rules and the minimum funding rules). However, this exemption generally has not been granted to churches in the area of welfare benefit plans

Some argue that the rationale behind the present-law exemption is Congressional deference to the First Amendment requirement of separation of church and state. Arguably, this rationale would support the expansion of the existing exemption to other church-related entities and to other areas (e.g., the rules relating to welfare benefit plans).

Others argue that the need to protect participants exists without regard to whether the plan is maintained by a church or church-related entity.

These persons would also argue that in many instances church-related entities are in direct competition with for-profit entities that must meet ERISA restrictions. In such a case, there is a competitive advantage conferred on the church-related organization. The Congress has used this rationale in several areas to limit the exemption for church plans to certain types of church entities. For example, the exemption related to group-term life insurance (sec. 79) is available only with respect to certain organizations (other than hospitals and colleges) described in section 501(c)(3).

Statement of Secretary Elizabeth Dole to the Association of Private Pension and Welfare Plans, May 16, 1990

Thank you all for that warm welcome, and thank you, Don, for your kind words of introduction. It is always a pleasure to be introduced by a fellow Tar Heel.

It's a privilege to be able to launch this important two-day conference on health care and retirement planning—issues of great interest and concern to me as Secretary of Labor.

It was the passage of ERISA in 1974, which gave the Labor Department the responsibility for ensuring the basic fairness and integrity of the private pension system.

What is the state of this system sixteen years after ERISA? I believe that it is one of the great success stories of our economy. Today, more than 55 million Americans are participating in or receiving benefits from some type of pension plan. And the assets in these plans have grown almost 600% since 1974, reaching approximately two trillion dollars. And as the plans have grown, they have also become more secure. In 1974, only 35% of all defined benefit plans were fully funded. Today, that number is over 80%.

And, as you know, private pension funds have become, far and away, one of the most significant players in the financial market, controlling 18% of the equity and 27% of the outstanding corporate bonds in the United States. They are also the largest single component of national savings.

The increased importance of pensions in the financial future of millions of individuals and of America herself, means that we must take every step possible to ensure the system remains healthy.

That is why the PBGC, of which I am Chairman, released last week, for the first time, a list of the 50 companies with the largest plan underfunding. Let me make it absolutely clear that all of these plans may meet the minimum legal requirements for funding. Indeed, there is no correlation between underfunded plans and illegal activity. Of the 1,500 underfunded plan terminations handled by the PBGC in its 15 year history, there was evidence of fraud, embezzlement, or abuse in fewer than 10 plans.

Minimum requirements notwithstanding, and realizing as I do that corporate officers, such as yourselves, have to make tough resource allocation decisions, I believe that protecting your workers' futures through fully funded pensions should be one of your highest priorities.

Indeed, the challenge that the Department of Labor faces, and that you face as pension professionals, is to build upon our record of success . . . and to continue to ensure that investments in our pension and health care systems are not "risky business."

We aim to meet this challenge by following three principles: One: Pensions must be relevant to the needs of a changing workforce. Two: They must be secure. Three: They must be voluntary.

PENSION PORTABILITY

The days of working for one employer for thirty to forty years are now the exception, and not the rule. Each year, one in five working Americans changes jobs, and one in ten changes careers. Some experts predict that the average worker will soon hold up to ten jobs during his career.

In light of that fact, last year, I indicated my intention to carefully study the issue of pension portability. Since that time, we have pursued the issue in depth with pension experts from government, business and labor.

Today, I would like to offer a status report on the Department's activities, sharing with you what we have learned to date.

The single largest source of portability losses appears to be the simple fact that people are spending their pensions before retirement. Our best preliminary estimates, based on Department of Labor and U.S. Census Bureau data, indicate that the current consumption of savings set aside for retirement may represent up to two-thirds of the total portability loss. This occurs when workers who change jobs take their retirement savings in a lump sum—and roughly 80% of these lump-sum distributions are being spent, rather than being saved through a new retirement plan.

These savings have been granted tax-favored status on the condition that they be used for retirement income. Adequate retirement income is an important national objective and justifies the generous tax benefits that have been accorded private pension plans. Spending these savings before retirement frustrates this objective. I couldn't agree more with the concerns raised by Treasury Secretary Brady that we, as a nation, consume too much and save too little.

Stated quite simply, portability, to the greatest extent possible, should ideally allow a worker to maintain a single retirement account for all of his or her savings.

Therefore, we should encourage employees to keep retirement savings in tax-favored retirement vehicles. One method, which I'm looking at closely, is facilitating the roll-over of pre-retirement lump sum distribution of benefits based on *employer contributions*, into an IRA or a subsequent employer's defined contribution plan.

In addition, an effective portability policy should allow employees to direct the transfer of their *employee contributions*, to an IRA or a defined contribution plan of another employer.

Our discussions. have envisioned that unlike the current limits, these transfers would also include employee contributions on which taxes had already been paid. This change would ensure that workers can continue to achieve tax-free buildup on more of their retirement savings.

Enhanced portability is meaningless for the half of America's workforce which is not covered by private pension plans. Accordingly, during our discussions, we have considered ways to expand pension coverage.

One natural idea would be to increase the number of pensions offered by America's small businesses, which will provide the most new job opportunities in the future. Smaller businesses are often unable to institute complicated and expensive pension plans, and, as a result, are at a disadvantage in recruiting and retaining quality workers.

Current law partially addresses these concerns with simplified employee pensions (SEPs), for plans which cover twenty-five or fewer employees, allowing them to defer up to nearly $8,000 of their salary by contributing it to IRA's.

Many believe that these plans are an ideal savings vehicle for smaller firms to sponsor, because they are not subject to portability losses from plan design or delayed vesting, and because they are easier for employers to administer, as ERISA provides simplified reporting and disclosure requirements.

Therefore, our discussions have included options such as making tax-deductible contributions available to SEPS which cover up to fifty employees. Under this change, SEPS would be available to nearly 95% of America's businesses, and would allow an additional five and a half million workers to accumulate savings through pre-tax payroll deductions.

We are also concerned about the discrepancy between single-employer and multi-employer vesting. As you know, single-employer plans now generally require only five years of service before vesting, while multi-employer plans generally require ten.

Extending the five-year vesting schedule to multi-employer plans, would immediately benefit an estimated 1.1 million participants who already have five or more

years of service, but who are not vested under existing rules. Such a proposal also has the effect of simplifying the law by creating a uniform standard for all plans and all workers.

That, ladies and gentlemen, is a sketch of our work in progress—what the Department of Labor has under consideration. We have made considerable headway, but there is still work to be done, and revenue effects to consider. Obviously, in the current budget climate, any portability package we would propose would have to be deficit neutral. I look forward to the active contributions of APPWP as I finalize a pension policy which will take America into the next century.

ENFORCEMENT

While portability is an idea to meet the needs of a new and changing workforce, our second principle in setting pension policy—security—is one that will never change.

The pledge I have made on this issue is very straightforward: We will strive to ensure that every participant receives the benefits to which he or she is entitled. I believe this can only be accomplished by renewed commitment to vigorous enforcement of our pension laws. And I have, indeed, made this commitment through several initiatives.

The large increase in the number of pension plans and assets has occurred without a significant increase in the number of employees who monitor them. Therefore, I requested an additional 133 enforcement positions—100 in the Pension and Welfare Benefits Administration, 33 in the Solicitor's office—in hopes of improving this situation. These additions should allow us to pursue approximately 1,000 additional enforcement cases, and should result in approximately an additional $45-50 million in restored pension assets.

I am also considering whether or not we have the appropriate mix of civil and criminal enforcement cases. This is part of my department-wide review of all our enforcement authority.

Within weeks, I will also send up to Congress a package of legislative proposals to increase both the scope and quality of ERISA audits performed by outside public accountants. This package includes eliminating the "limited scope" exemption, and imposing a peer review requirement every three years for independent public accountants who wish to remain qualified to conduct ERISA audits.

We have been working closely with the American Institute of Certified Public Accountants on all audit related issues, including compliance testing. As you know, compliance testing would require the plans' auditor to review transactions to ensure they comply with ERISA's requirements.

As part of this procedure, if an accountant discovered a serious violation that posed an immediate threat to the plan, the plan's sponsor would be required to report it directly to the Department. I am pleased to report that our negotiations with the AICPA on this matter are progressing constructively.

Our commitment to retirement security can also be seen in the proposals we have made to increase the penalties for those who violate ERISA, and to enhance an individual's ability to enforce their rights under the law. These proposals include: Requiring the awarding of attorney and expert witness fees to successful plaintiffs in private ERISA civil actions; Paying a "bounty" from recovered assets to those who report significant ERISA fraud to the Department; and increasing the existing excise tax penalty and civil penalties for prohibited transactions from 5% to 10%; requiring de novo review in benefit claims cases where conflict of interest exists; and requiring plan fiduciaries to disclose records regarding proxy voting of stock they hold.

My enforcement provisions go beyond pension plans alone, to include Multiple Employee Welfare Arrangements, or MEWA's as they are more commonly known. Investigations conducted by the Department of Labor have disclosed that a significant number of self-funded MEWAS are fraudulent schemes. These schemes create tragic consequences for subscribing employers and participants by leaving them liable for unpaid medical bills, and sometimes with pre-existing conditions for which they will never be insured in the future.

The Texas State Board of Insurance has estimated that MEWA plan participants in Texas have been left with known unpaid claims of over 19 million dollars, and unpaid claims not yet reported, are estimated to total at least this much.

We cannot yet accurately determine the full extent of this problem, or the number of fraudulent MEWA's in operation. However, interest in this area is growing. Representatives from 34 states recently attended a conference on this subject sponsored by the Department of Labor and the U.S. Attorney in Atlanta.

The Department of Labor believes that the states have an important role to plan in MEWA enforcement, since state insurance laws contain reserve and capital requirements for entities providing health insurance.

However, some promoters of MEWA's have attempted to raise Federal preemption under ERISA as a defense against state actions to enforce these requirements. Any confusion in this area should have been cleared up in 1983, when Congress explicitly amended ERISA to grant states the authority to regulate MEWA's regardless of their status under ERISA.

To leave no doubt on this subject, I have written a personal letter to each state insurance commissioner, detailing this program, emphasizing their authority to take action against MEWA's, and underscoring our commitment to effective, coordinated enforcement between the Department and the states.

We recognize, however, that if states can not easily locate the promoters of MEWAs, then it is extremely difficult to enforce their insurance laws. Therefore, we have proposed legislation which would require MEWAs to file registration statements with the Department of Labor. Willful failure to file such a statement would be subject to the criminal sanctions of Section 501 of ERISA.

Also, as PWBA's outstanding Assistant Secretary David Ball, who has done yeoman's work on these initiatives, testified yesterday on Capitol Hill, we have developed a six-point program for aiding the states in their efforts with respect to MEWAs. This program includes legal assistance, training sessions, cooperative investigative arrangements, and access to our computer data base.

And within the last year, PWBA and our Inspector General have opened up over 60 criminal and civil MEWA investigations. In January, indictments were handed down in Atlanta, charging four individuals and two corporations with embezzlement and with making and receiving kickbacks in a fraudulent MEWA operation, which purported to provide health benefits to approximately 9,000 employees and dependents of nearly 300 companies located in 16 states. We will continue to vigorously enforce these laws and regulations, and we expect similar indictments in other states in the near future.

PRESERVATION OF VOLUNTARY, MARKET-DRIVEN SYSTEM

Finally, let me turn to our third principle—the preservation of the voluntary nature of our pension system. To encourage the continued growth of private pensions, we must discourage the tendency to replace a system driven by the market to one driven by mandates.

One example of this tendency is the "reversion" proposal currently in the Senate. Government policy should encourage employers to fully fund pension plans. This legislation, however, does precisely the opposite, providing disincentives for creation and full funding of plans, and resulting in less security and greater risk for millions of Americans.

Another example is the "Visclosky Bill," currently pending in the House. There are many compelling reasons why the President and I oppose mandating joint labor-management trusteeship for single employer plans. Chief among them is the fact that the primary goal of our voluntary employee benefit system is to encourage the adoption and maintenance of employee benefit plans. Under this proposal, sponsors would have a strong disincentive to maintain their plans because they would bear the risk of plan investment performance without being able to determine investment strategies. I appreciated APPWP's help in defeating this proposal last year on the floor of the House, and I look forward to your continued support.

Our pension system has succeeded because it is driven by the market, and not by government mandates. I am committed to doing all I can to ensure that it stays that way.

Finally, I couldn't leave a discussion about employee benefits without mentioning this past December 31st—which became my most joyous New Year's Eve ever when at 10:00 p.m., the Pittston Coal Company and the United Mine Workers reached an agreement to end their bitter nine month labor dispute.

During the negotiations, it became quite clear that the overriding issue of concern was the long-term security of the pension and health benefits of the miners, retirees, and their families. And when I announced the settlement, I also announced I would be appointing a blue-ribbon commission to review the pension and health care issues, and their impact on the coal industry as a whole.

The Commission, under the Chairmanship of former Secretary of Labor Bill Usery was appointed in March, and is due to report back to me within six months. I hope that the knowledge we gain through this Commission may shed some light on the means of solving the broader problems of health plans and health care coverage—a pivotal issue for the 1990's.

It has been a pleasure to be with you today, and let me thank you again for allowing me the opportunity to share our thoughts on meeting the needs of our changing workforce.

America owes much to our working men and women. Their dreams and hard work have built our nation, made her great, and kept her strong. And as they worked for America's future, they also took our word that the investments securing their future would be safe. Our word must now be as good as their work. Let us work together to ensure that retirement income security is anything but a "risky business."

Thank you and God bless you.

Prepared Statement of Arthur M. Ryan

I. Introduction

The Church Alliance is a coalition of church pension board executives acting on behalf of church pension and welfare benefit programs. These programs are among the oldest employee benefit programs in our country. Several date from the 1700s, with the median age of the retirement programs represented through the Church Alliance being in excess of 50 years. These programs provide retirement and welfare benefits for approximately 261,000 ministers and 114,000 lay workers employed by thousands of churches and church ministry organizations. The 27 historic, mainline denominations served by these pension boards minister to the spiritual needs of over 66 million members of Protestant and Jewish faiths.

Since the enactment of the Tax Reform Act of 1986 (the "1986 Act") representatives of the Church Alliance have met on a regular basis to identify and address the problems, some new and some not so new, that church retirement and welfare benefit plans face under the Internal Revenue Code of 1986, as amended (the "Code") [1]. These discussions led to the development of the Church Retirement Benefits Simplification Act of 1990 (S. 2902 and H.R. 5373) (the "Act"). The Act is designed to accomplish three primary goals:

1. As the cornerstone, to recodify the rules applicable to church retirement plans and church retirement programs so that all such rules are identified, simplified and brought together, separately, in the Code. Retirement plan issues unique to churches would thus be off-the-table and not inadvertently impacted when Congress is considering future Code changes which are applicable to secular employers but not appropriate for churches, and vice versa;
2. To bring workable consistency to the coverage and related rules that apply to church retirement programs; and
3. To resolve several other significant problems churches face in administering their retirement and welfare benefit programs under current law.

II. Church Retirement Employee Benefit Plans—Background

Church retirement benefit programs began in recognition of a religious denomination's mission to care for church workers in their advanced years. Several church retirement and welfare benefit programs were initially formed to provide relief and benefits for retired, disabled or impoverished ministers and families as particular cases of need were identified. As time passed, these and other denominations began to provide for the retirement needs of their ministers and lay workers on a current and systematic basis. Today, church retirement and welfare benefit programs provide benefits for ministers and lay workers employed in all forms of pastoral, healing, teaching, preaching, and evangelistic ministries and missions, including, among others, local churches, seminaries, old-age homes, orphanages, mission societies, hospitals, universities, church camps and day care centers.

The provision of retirement and welfare benefits for ministers and many lay workers in recognition of their denominational service is administered and funded in most denominations through a denomination-wide church pension board. A church pension board is an integral part of the denomination it serves, and is engaged in the functions of the denomination, even though separately incorporated. A church pension board is controlled by or associated with the denomination with which it is affiliated. Retirement programs now maintained by church pension boards generally involve a program of section 403(b) retirement income accounts,

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

pension plans, primarily of the defined benefit variety, that are described in section 401(a), or other arrangements that meet the unique needs of persons carrying out the missions and ministries of the church.

Over the years, church denominations have organized themselves in a variety of ways reflecting their own theological beliefs and forms of church polity. It is these diverse sets of church polities that make compliance with some employee benefit requirements of the Code most difficult. Some denominations are organized in a "hierarchical" polity, in which a "parent" church organization sets the policy for the entire denomination. Other denominations have organized themselves in a "presbyterian" structure under which policy-making is carried out primarily through local presbyteries consisting of representatives drawn from the various churches within the geographic area served by a particular presbytery. Several other denominations, composed of autonomous churches, or conventions or associations of churches, cooperate in "congregational" or "connectional" forms of governance in which churches and church ministry organizations are associated by voluntary and cooperative participation.

To add to the variety and complexity of church polities, church denominations are often national or, in many cases, international in scope. A single denomination may consist of thousands of local churches and church ministry organizations, along with foreign ministry organizations. Church pension boards thus typically provide retirement and welfare benefits to thousands of ministers and lay workers.

The extent to which control is exercised over churches and church ministry organizations within a denomination depends in part on the form of church governance the denomination has taken. In many churches, especially those that are congregational or connectional in nature, centralized control is minimal or nonexistent. Churches and church ministry organizations in congregational and connectional denominations, while sharing common religious bonds and convictions, are autonomous units that have associated by voluntary and cooperative participation in church conventions or annual conferences, rather than being controlled by a "parent" church organization.

The church community thus reflects several different forms of polity, with each of the 27 denominations in the Church Alliance having its own unique methods and traditions for relating to its individual churches, church ministry organizations and the ministers and lay workers serving that particular denomination. Because of the diversity in the tenets, beliefs, customs, polities and traditions of the churches and church ministry organizations represented through the Church Alliance, it is difficult, and at times impossible, to apply rules crafted with a secular organizational form in mind to the employee benefit programs they maintain. Surely there should be no Procrustean bed indiscriminately imposed on these programs.

III. OVERVIEW OF THE ACT

The Act will be discussed in two parts. Part One contains the cornerstone of the Act, a recodification of the rules applicable to church retirement plans so that all such rules are identified, simplified and brought together~~, separately, in the Code~~ so that issues unique to churches will be off-the-table and not inadvertently impacted when Congress is considering future changes to the Code which are applicable to secular employers but not appropriate for churches, and vice versa.

Part One also describes modifications to and clarification of certain of the coverage and related rules that currently apply to church retirement programs. These modifications and clarifications to these coverage and related rules are:

1. Modification of the provision in section 403(b)(1)(D) (relieving section 403(b) annuity plans of churches and certain church-controlled organizations from certain coverage and related rules) by extending such relief to all churches and church-controlled or associated organizations described in section 414(e) other than church hospitals, colleges and universities, and, as so modified, extending such relief to church retirement plans described in section 401(a).

2. Clarification that the coverage requirements of section 403(b)(12) to be imposed on certain section 403(b) church plans are pre-ERISA coverage requirements.

3. A provision that would exclude ministers engaged in the exercise of their ministry from being considered in testing their employer's plan or program, or the church plan in which they participate, for compliance with certain coverage and related rules applicable to retirement plans described in section 401(a), annuity plans described in section 403(b) (including section 403(b)(9) retirement income account programs), and certain welfare benefit plans or programs for which an income tax exclusion is provided;

4. A provision that would impose ten year "cliff" or "5 to 15" year vesting schedules on church retirement plans (such plans are not now subject to specific schedules) and permit such schedules to be incorporated into section 403(b) annuity programs;

5. Clarification that certain self-employed ministers and ministers employed in the exercise of their ministry by government and secular employers may participate in their denomination's section 403(b) annuity plans and certain welfare benefit plans on the same tax-favored basis as other church common law employees;

6. Clarification that a church pension board that holds the assets of a retirement plan described in section 401(a) will be treated as satisfying the trust requirement of such subsection.

Part Two of the discussion of the Act presents proposed solutions to several other significant problems church employee benefit programs face under current law. Part Two considers the following provisions:

A. Restoration of the provision which permitted "qualified voluntary employee contribution" accounts under church plans;

B. Clarification that the aggregation rules of sections 414 (b), (c), (m), (o) and (t) do not apply to churches and church ministry organizations for purposes of certain coverage and related rules;

C. Clarification that a church retirement plan maintained by more than one employer and which commingles assets solely for purposes of investment and pooling mortality experience for participants in pay status will not be subject to section 413(c);

D. A modification of the rules applicable to section 401(h) accounts maintained by multiple employer church retirement plans to replace the requirement to establish separate accounts for post-retirement, medical, or life insurance benefits payable to "key employees" under such plans with a requirement to take into account the actuarially-determined value of their pre-funded post-retirement medical coverage for purposes of section 415(c).

E. A provision designed to enable foreign missionaries to secure an "investment in the contract" for purposes of section 72 as a result of their employer's contribution to a church retirement plan;

F. Modification of the provisions of section 401(a)(9) by relieving church plans described in section 414(e) from the requirement of beginning plan distributions to participants at age 70½, by clarifying that such church plans can annuitize benefits without the need for purchasing annuities from a commercial insurance company, and by clarifying that such church plans can provide for increasing annuities for their participants (even if such increases are not provided pursuant to a method described in the regulations promulgated under section 401(a)(9)).

G. Modification of the special catch-up contribution rules of section 402(g)(8)(A) to make such rules workable for church section 403(b) programs;

H. Modification of the provision in section 457(a)(13) (added by the Technical and Miscellaneous Revenue Act of 1988 and relieving certain deferred compensation plans of churches and certain church-controlled organizations from the requirements of section 457) by extending such relief to all church-controlled or associated organizations (other than church hospitals, colleges and universities); and

I. Modification of section 105(h) to extend what is basically the same relief from coverage rules provided for church group-term life insurance plans under section 79 to church self-insured health care plans described in section 105(h).

An issue-by-issue examination of each of these provisions follows.

IV. PART ONE: RECODIFICATION OF CHURCH PLAN RULES AND MODIFICATIONS TO CERTAIN COVERAGE AND OTHER RULES

A. Recodification of Church Plan Rules

Over the years, church pension boards administering employee benefit plans have grappled with the complexity resulting from the many changes that have occurred in the laws governing the provision of retirement and welfare benefits. Furthermore, church pension boards have had to administer their programs within an environment that is, as described above, significantly different from the environment in which secular employers operate. Unfortunately, retirement and employee benefit tax laws have not always taken this difference into account, with the result that churches have had to divert a significant amount of time and resources from their religious missions and ministries in attempting to identify and comply with rules that in many instances are unworkable or simply not needed for church retirement plans.

Over the last decade, staff members of the tax-writing committees of Congress and aides of several concerned Members of Congress have discussed with representatives of the Church Alliance the need for the rules that apply to church plans to take into account the unique needs and characteristics of church retirement and welfare benefit programs. The need for such a set of workable rules was discussed again during deliberations on the 1986 Act.

Needed modifications to the rules that currently apply to church retirement and welfare benefit plans are discussed in Section B of Part One and Part Two, below. However, as has also been suggested by Congressional staff and others, establishing workable rules for church retirement and welfare benefit plans is not enough. These rules must also be recodified in a fashion that will both identify and simplify such rules and separately locate them in the Code.

Recodification of church retirement plan rules in this manner will permit Congress to address the rules applicable to secular employers without the need to focus on the potential impact of such changes on church retirement plans, and vice versa. In addition, recodification of church retirement plan rules will also make it easier for unsophisticated church ministry organizations to identify and understand the rules that apply to their retirement programs. The Act provides for this recodification by creating a new section 401A and by modifying section 403(b). The Act also provides that a determination as to whether a section 401A plan or a church section 403(b) annuity program meets the requirements of such sections is to be made based on the provisions of the Code in effect on the date of the legislation's enactment, and that regulations or rulings issued by the Internal Revenue Service under section 401(a) or 403(b) shall not apply to section 401A plans or church section 403(b) annuity programs unless specifically made applicable thereto. Section 403(b), as modified, clarifies that section 403(b)(9) retirement income accounts can be designed on either a defined contribution or defined benefit basis, and that the definition of the term "disability" (as used for purposes of the section 403(b) distribution rules) shall have the same meaning as that term is used in connection with the section 401(k) distribution rules.

B. Modifications to Certain Coverage and Related Rules

1. General Coverage and Related Requirements

Congress has from time to time made the determination for policy reasons that churches and church ministry organizations should be treated differently under the Code from secular organizations. For example, in the 1986 Act, Congress determined it appropriate to exempt churches and qualified church-controlled organizations described in section 3121(w)(3) from the new coverage and related rules to be imposed on section 403(b) annuity plans. In TAMRA, Congress exempted the accident or health plans and group-term life insurance plans maintained by these same church organizations from the coverage requirements of section 89 (now repealed) Most recently, in the Omnibus Budget Reconciliation Act of 1989 (H.R. 3299), Congress expanded the former section 89 exemption to relieve all church group-term life insurance plans described in section 414(e) from the return to the requirements of section 79, other than group-term life insurance plans maintained by church hospitals, universities, colleges, or organizations whose basis for exemption is similar to that of church hospitals. In contrast, however, all churches and church ministry organizations that maintain retirement plans described in section 401(a) remain subject to certain coverage and related rules.[2]

Consistent with its testimony filed with the Senate Finance Committee during deliberations on the 1986 Act, the Church Alliance continues to believe that it is appropriate to relieve section 403(b) annuity plans maintained by churches and all church-controlled or associated organizations described in section 414(e) (other than church hospitals, colleges and universities) from the coverage and related rules of section 403(b)(12). Under current law, the exemption from section 403(b)(12) coverage and related rules only applies to churches and "qualified church-controlled organizations." A qualified church-controlled organization is generally defined in section

[2] During the Senate Finance Committee's deliberations on the 1986 Act, the Church Alliance filed testimony with that committee expressing its view that no nondiscrimination rules should be imposed on any church section 403(b) annuity plan described in section 414(e). The Church Alliance continues to hold this view. However, given the expenditure of time and resources that would be required to develop comprehensive data to support its assertion, at this time the Church Alliance has determined only to seek to broaden the exception from coverage testing under section 403(b)(1)(D) in a manner similar to that adopted by the Senate in H.R. 3299, although Church Alliance members continue to believe that a coverage testing exception based on section 414(e) status is the correct approach.

3121(w)(3)(B) (a Social Security provision) as a church-related organization which offers goods and services to the general public but derives no more than 25% of its funds from the provision of such services.

This approach to the section 403(b)(12) exemption creates several difficulties. First, basing the exemption on section 3121(w)(3)(B) status means that some church-related organizations could fluctuate from year to year between being within and without the exemption depending on varying levels of support. Second, because the test is a complicated determination based on levels of support, many small church organizations may inadvertently fall outside the exemption. Moreover, the definition of "qualified church-controlled organization" is far too complex for small church organizations to understand. Third, under this approach to the exemption, some church-related organizations, such as orphanages, day care centers, retirement homes and old age homes, would not be qualified church-controlled organizations. These organizations all maintain close ties to the church and receive substantial support (financial, spiritual and otherwise) from the denomination with which they are associated. In addition, the constituency served by these organizations is typically drawn from the denomination with which they share common religious bonds.

Church ministry organizations should be governed by the same rules that apply to churches for the following reasons:

(a) Churches and church-related or associated organizations operate in an environment far different from corporate America. Churches rely to a very large extent on contributions, including tithes and offerings, to support their operations, including the compensation of their ministers and lay workers. Unlike secular business entities and government employers, churches cannot pass operating costs on to customers or meet such costs by raising taxes. This means, in short, that decisions must be made as to priorities in allocating resources between the church's mission and charitable work, on the one hand, and other costs such as employee compensation and benefits, on the other hand.

Churches are also much more loosely structured than most secular business organizations which have a centralized management that can impose restrictions on constituent parts of the organization. In addition, many church employees view their work primarily as serving the church in what could be termed a quasi-volunteer relationship. Many of those employees have chosen their work out of a sense of mission and service for the church and do not look to the church for high salaries or rich retirement and welfare benefits.

In addition, churches are tax-exempt and, unlike secular business organizations, have no need for tax deductions. Churches and church ministry organizations therefore lack the incentive present in the case of secular employers to maximize either the amount of the employer's tax deduction or the amount of income the highly-compensated employees who control a secular business can shelter from current taxation through plan contributions and tax-free fringe or welfare benefits. Thus, retirement and welfare benefits provided to the ministers and lay workers of a denomination are provided out of a sense of moral responsibility rather than as a way to maximize tax benefits for both the employer and a highly-paid executive.

(b) The administrative burdens and related costs imposed on churches and church ministry organizations, if coverage and related rules are applied, outweigh any possible gain from an employee benefit policy perspective. Ministers and lay workers are relatively low paid, so that the highly compensated group (as such term is generally defined under the Code) is minimal among clergy and lay workers of denominations represented by the Church Alliance. In addition, most work units in the church setting are relatively small or otherwise ill-equipped to understand and apply complex rules because they do not have the resources (both in terms of personnel and finances) to redirect away from the churches' mission and ministries.

Compliance is further complicated by the fact that retirement and welfare benefits have historically been provided for ministers through a denomination-wide plan. This approach has been used historically because both the minister and the church often view the ministry as service for the denomination itself, although any one minister may serve many individual churches throughout his or her career. Lay workers, however, do not generally move among denominational employers as frequently as ministers and tend to view an individual church as their employer. Thus, benefits for lay workers are more likely to be provided at a local level, with the denomination itself having little control (particularly in the case of congregational and connectional denominations) over the type or amount of benefits that are provided. Church denominational structures also involve complex relationships that sometimes make identification of a minister's or lay worker's employer a difficult task.

(c) Church retirement and welfare benefit programs have been developed over the years within the confines of the polity, theology and needs of the church denomination served. Denominational polities and theologies were developed, in many cases, decades ago, and differ greatly among denominations. Moreover, most church polities prevent or do not permit ready adherence to the rules and regulations of the Code which have been developed in the context of secular business organizations. For example, the governing document of one major, mainline denomination requires, as a condition of a minister's call to a congregation, that the minister participate in the denomination-wide retirement and welfare benefit program. The denomination in question, however, is not a strict hierarchical denomination, and thus does not have sufficient control over any individual local church or church ministry organization to require participation for lay workers in the denomination-wide program or even to require comparable programs to be adopted at the local church level. Both the denomination's control over the terms of call of its ordained ministers, and the independence of the local churches and ministry organizations, are so firmly rooted in the constitution and polity of the denomination that neither could be easily changed. Both these factors, however, make it difficult, if not impossible, to comply with the coverage and related requirements imposed by the Code which were designed with secular, profit-motivated corporations and other business entities in mind. Other denominations face similar problems in attempting to balance restrictions imposed by the church with those imposed by the Code. Given the diversity of church polities, however, it is a difficult if not impossible task to design a set of coverage and related rules that work uniformly for all denominations.

The Act modifies the current exemption in section 403(b)(1)(D) by expanding it to include all churches and church-related organizations described in section 414(e) (other than church hospitals, colleges and universities).[3] The Act would also extend the exception from coverage and related rules provided in section 403(b)(1)(D), as so modified, to the coverage and related rules that now apply to retirement plans described in section 401(a).

2. Uniform Application of Pre-ERISA Coverage Rules

Section 403(b)(12) provides that a section 403(b) program must meet the requirements of section 410(b) "in the same manner as if such plan were described in section 401(a)." By virtue of the provisions found in section 410(c)(2), the quoted language should require compliance with section 401(a)(3) as in effect on September 1, 1974, rather than section 410(b). It has been suggested, however, that the quoted language in section 403(b)(12) could be interpreted to mean that post-ERISA coverage rules apply to certain church section 403(b) retirement programs.[4] This interpretation would give rise to an incongruous result—church retirement plans described in section 401(a) would be governed by the pre-ERISA coverage rules contained in section 401(a)(3) (as in effect on September 1, 1974), while other church retirement plans described in section 403(b) maintained by the same types of church employers would be governed by the post-ERISA coverage rules of section 410(b).

The Act clarifies that the coverage rules applicable to church section 403(b) annuity plans are based on pre-ERISA law.

3. Exclusion of Ministers from Coverage Testing

The provisions of Part One, Section B(1), would provide a uniform exemption from coverage testing for churches and most church-controlled organizations. However, some ministers exercise their ministry in ways other than as the minister of a local church. For example, ministers serve as chaplains in secular, government or church hospitals, universities, nursing homes, half-way houses, prisons, drug counseling centers, and orphanages, or as instructors of religion in colleges. In some cases, the governing rules of a denomination may require these ministers' participation in the denomination's retirement and welfare benefit program. Even if such participation is not required, in career terms chaplains and similarly situated ministers may consider the denomination their employer, rather than the institution they serve. In addition, these chaplains and ministers move in and out of specialized ministries of the denomination, and the denomination's plan therefore offers consistency and portability of plan benefits for these individuals.

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[3] This modification is more specifically described as follows: If employees of a hospital or university do not participate in a section 414(e) church plan, then no coverage or related rules would apply. If such employees do participate in such a plan, then either the plan as a whole or the plan as maintained by the hospital or university must satisfy the requirements of section 401(a)(3) as in effect on September 1, 1974, section 401(a) (4), (5), (17) and section 401(m).

[4] This position is taken in the section 410(b) proposed regulations, promulgated by the Internal Revenue Service on May 18, 1989.

Chaplains and ministers working for other organizations under similar employment arrangements typically are not "highly compensated employees," either as that term is commonly understood or within the meaning of section 414(q). However, it is unclear as to whether such individuals are to be treated as members of the "prohibited group" (as such term is defined under retirement plans subject to section 401(a)(4) and section 410(b) under current (*i.e.*, post-ERISA) law, or under section 401(a)(3) as it existed on September 1, 1974). This uncertainty, coupled with the minister's participation in the separate retirement and welfare benefit plan of his or her denomination, complicates coverage testing for the institutional employer the minister serves.

For example, a Lutheran chaplain may serve at a Catholic hospital. For tax purposes, the chaplain would in all likelihood be treated as employed by the Catholic hospital, but the chaplain typically would participate in the Lutheran denomination's retirement and welfare benefit programs. If the Catholic hospital has not made the election available to it under section 410(d) to have post-ERISA law apply to its retirement program, the chaplain might be considered to be a member of the pre-ERISA prohibited group (if the chaplain had supervisory duties or was considered to be "highly compensated" under the subjective "facts and circumstances" test used prior to the addition of section 414(q) to the Code in 1986). If the Catholic hospital contributed a greater percentage of the chaplain's compensation to the Lutheran retirement program than to its separate retirement program in behalf of its rank and file employees, the hospital's plan could perhaps be found to be discriminatory and thus not qualified.

The Act provides that ministers employed in the exercise of their ministry are to be excluded from consideration in testing the church plan in which they participate and the retirement or welfare benefit plans of their employer for compliance with certain coverage and related rules applicable to the following: retirement plans described in section 401(a) annuity plans described in section 403(b) (including retirement income accounts described in section 403(b)(9)), or welfare benefit plans described in sections 79, 105, 120, 125, 127 and 129.

4. Vesting Schedules Under Church Retirement Plans

Although section 403(b)(1)(C) requires that the rights of employees under an annuity contract described in that subsection be nonforfeitable, section 403(b)(6) recognizes that sponsors of section 403(b) annuity plans will often associate a vesting feature with their plans with respect to nonelective employer contributions. In this manner, employees can be required to complete some minimum period of service before they become fully vested in their right to receive promised retirement benefit payments. Section 403(b)(6) effectively states that if an annuity contract is forfeitable, it is not described in section 403(b) until it becomes nonforfeitable, at which time the full amount that becomes nonforfeitable is treated as an amount contributed by the employer in that year for such annuity contract.

The interpretation placed on the relationship between section 403(b)(6) and section 415(c) can significantly affect the utility of section 403(b)(6). As interpreted by the Internal Revenue Service, section 415(c) limits the "annual addition" (as defined in section 415(c)(2)) to an employee's section 403(b) retirement income account generally to the lesser of $30,000 or 25% of the employee's compensation. Because section 403(b)(6) suggests that an employer's contribution under a section 403(b) annuity plan containing a vesting feature does not occur until the amount subject to forfeiture becomes nonforfeitable, it is possible that even under a fairly liberal vesting schedule, the section 415(c) annual addition limits would be exceeded in the year when the forfeitable-to-nonforfeitable change occurs (if a similar interpretation is carried over to section 415).

The operation of section 403(b)(6) also raises questions in carrying out the exclusion allowance computation under section 403(b)(2) and in applying the new coverage and related rules of section 403(b)(12). Although the exclusion allowance computation of section 403(b)(2) contains a prior service concept, under which greater contributions can be made for participants in whose behalf contributions have not been made in prior years, this prior service contribution inflator is tied to what is essentially the participant's compensation at the time prior nonelective contributions change from being forfeitable to nonforfeitable. If the participant's compensation has decreased at that time, when compared to compensation paid during the period when nonelective contributions were forfeitable, the exclusion allowance computation could result in some portion of the contributions being treated as taxable income. This same result could occur if forfeitures (and income allocated to forfeitable contributions) are taken into account at the time the forfeitable-to-nonforfeitable change occurs. These same factors (*i.e.*, decreasing compensation and allocation

of forfeitures and income) could also bring about disparities in contribution levels that could run afoul of the new coverage requirements of section 403(b)(12).

The legislative history surrounding the introduction of section 403(b)(6) into the Code in 1958 indicates that section 403(b)(6) was added to help rather than hinder section 403(b) program participants. A 1958 change in the law that was intended to help section 403(b) annuity plan participants should not cause benefits to become taxable to participants through the operation of other rules added in later years (specifically, section 415 and section 403(b)(12)).

Under current law, church retirement plans described in section 401(a) and which have not made a section 410(d) election are subject to the vesting requirements of section 401(a)(4) and section 401(a)(7) as in effect on September 1, 1974 (*i.e.*, pre-ERISA vesting requirements) The Act would change that rule and impose a ten year "cliff" or "5 to 15" year vesting schedule on church plans described in proposed section 401A and would permit such schedules to be incorporated into church section 403(b) annuity programs. In connection with this change, the Act would also, in the case of church section 403(b) annuity plans, eliminate the nonforfeitability requirement of section 403(b)(1)(C) and the application of section 403(b)(6).

5. Self-Employed Ministers and Ministers Employed Outside Their Denomination Treated as Employees

Many ministers consider themselves to be self-employed individuals for income tax purposes, and the ministers' tax returns (and their churches' tax information returns) are prepared accordingly. This treatment may be due to individual or denominational theological belief, or due to the function served (*i.e.*, a family counselor) and perhaps in many instances stems from the fact that the Code specifically treats ministers as self-employed individuals for purposes of FICA taxes.

The legal standards used to determine whether a minister is to be treated as self-employed or as an employee for income tax purposes are based on a consideration of a number of factors to be applied to the particular "facts and circumstances" of a minister's employment relationship with his or her denomination. While no one factor is said to be determinative in this analysis, the question as to whether a church or church ministry organization "controls" the minister with respect to both the "means" and "end" of the employment relationship is one of the more significant factors to be taken into consideration. The difficulty of applying this standard to a particular minister in view of the many different forms of church government, polity, beliefs, and traditions is a rationale that supports the treatment of a minister as a self-employed individual for purposes of FICA taxes.

Retirement plans described in section 401(a) permit self-employed individuals to participate in such plans. However, there is a question as to whether participation is available for a self-employed minister whose denomination or church provides retir5ement benefits in the form of a section 403(b) annuity plan.[5]

Questions also exist concerning whether some ministers; although not self-employed, are prevented from participating in their denomination's retirement programs because they technically may not be considered to be employed by a church employer that participates in such programs. Chaplains employed by state or Federal prisons or hospitals, by secular hospitals, or hospitals related to other denominations face this problem.

The Act would clarify the status of these ministers and permit self-employed ministers and ministers employed by secular or government employers to be treated as employees of a participating church employer for purposes of contributions to a denominational section 403(b) retirement program and to welfare benefit plans described in sections 79, 104, 105, 106, and 125.

6. Satisfaction of Section 401(a) Trust Requirement by Certain Retirement Plans

Section 401(a) requires that assets of a retirement plan described in that section be held in trust. As interpreted by the Internal Revenue Service, this trust requirement contemplates a valid, existing trust, evidenced by a written document setting forth the terms of the trust, and recognized as such under local law. As noted above, some church pension boards maintain retirement plans described in section 401(a), and these plans are typically operated through a separately incorporated, tax-exempt church pension board without the intervention of any separate trust document naming the church pension board as trustee. In some jurisdictions, these sepa-

[5] Letter Ruling 8950086 dated September 24, 1989, the Internal Revenue Service determined that a self-employed minister is eligible to participate in a section 403(b) annuity plan.

rately incorporated pension boards may be treated as establishing a trust arrangement; in other jurisdictions, this result may not be as clear.

Although church pension boards may be considered to be holding assets in trust under local law, and might qualify as "custodial account" arrangements described in section 401(f) (if they vent to the time and expense involved in such a determination), it is appropriate, far simpler and will promote uniformity to provide in new section 401A that the trust requirement of section 401(a) is satisfied in the case of a church pension board that holds the assets of a retirement plan described in such subsection.

V. PART TWO: OTHER ISSUES RELATING TO CHURCH EMPLOYEE BENEFIT PLANS

A. Qualified Voluntary Employee Contributions

The 1986 Act repealed the provision in section 219 that allowed deductible employee contributions to be made to certain employer retirement arrangements in lieu of deductible contributions to individual retirement accounts ("IRAs"). The rationale behind this repeal was apparently the fact that if an employee is an "active participant" in an employer's retirement plan, deductible IRA contributions may not be available.

Church retirement programs made extensive use of "qualified voluntary employee contributions" ("QVECs") under prior law. However, the Church Alliance is not aware of other large employer groups that made extensive use of QVECs in the past or that continue to want to use them.

Due to employee confidence in and familiarity with church retirement plans and church pension board administration, along with the ease of making contributions to such plans, many ministers and lay workers would prefer to supplement their retirement savings through the use of QVECs, rather than through contributions to IRAs. The availability of a vehicle through which such individuals will supplement retirement savings is of great importance in the church environment because salaries and pensions of ministers and lay workers are historically low.

The restoration of QVECs would restore to churches a useful retirement planning technique that is already available in another form. The Church Alliance is aware that there may be concerns that the QVEC rules were so complicated that compliance was always in issue. If this concern is present, the Church Alliance believes that the QVEC rules should be simplified rather than eliminating a useful retirement planning tool.

The Act provides for the restoration of QVECs (that are subject to post-1986 tax rules that govern IRAs) to the Code for purposes of contributions to church retirement programs.

B. Special Rule Relating to Aggregation of Employees

Sections 414 (b) and (c) provide rules under which all employees of all entities that are members of a controlled group of corporations or under common control are to be treated as employed by a single employer for purposes of certain rules applicable to retirement plans. Similar concepts apply under sections 414 (m), (n) and (o), and in the welfare plan area, under section 414(t). Until 1986, practitioners generally believed that sections 414 (b) and (c) do not require aggregation of tax-exempt organizations that have no stock ownership or control (as defined in sections 414 (b) and (c)). However, in 1986 the Internal Revenue Service indicated that it believes that a concept of control does exist for the tax-exempt sector under sections 414 (b) and (c).[6] These aggregation rules were also said to be applicable to tax-exempt employers in the legislative history surrounding the addition of new coverage and related rules to section 403(b). These pronouncements have caused a great deal of confusion and concern within the church retirement and welfare benefit plan community, particularly when a control concept is applied to different church denominational structures and arrangements and organizations within it.

The group of organizations related to a particular denomination tends to be extremely large, often consisting of thousands of employers located not only around the nation, but around the world. However, due to differences in focus, function, location, or other factors, the level of benefits provided may not be the same from employer to employer. If the aggregation rules identified above require all church organizations within a given denomination to be aggregated, it will be virtually impossible for church pension boards and other church organizations to administer benefit programs and determine the impact of Code requirements on such programs.

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[6] *See* Letter Ruling 8702063 (October 16, 1986) and related General Counsel Memorandum ("GCM") 39616 (June 27, 1986).

Imposition of these aggregation rules under a control concept could also result in aggregation requirements for some denominations and none for others—aggregation could be required in a hierarchically structured denomination but not required in a congregationally organized faith.

An additional problem will result if aggregation results in a controlled group containing churches and church-related organizations which are *not* subject to coverage and related rules and church-related organizations which are subject to such rules. How do the organizations which are exempt from such rules enter into testing? If an organization which is subject to such rules fails to comply with one or more of them, what are the consequences to the other churches and organizations? Aggregation simply does not work well in this situation.

Another similar type of aggregation problem results if the rules of section 401(a)(26) and sections 414 (b), (c), (m), or (o) are applied to a group of church related organizations Containing both tax-exempt and taxable employers. As currently applicable, section 401(a)(26) would require that a qualified plan benefit the lesser of (i) 50 employees of the employer, or (ii) 40 percent or more of the employees of the employer. If an organization with less than 50 employees is under common control with organizations having more than 1½ times the number of employees of the first organization, it is impossible for that organization to maintain a plan solely for its own employees. When the group under common control is composed of both tax-exempt and taxable employers, other Code sections make it impossible to cover all employees of the group under common control in a single plan permitting elective deferrals. On the one hand, section 401(k)(4)(B) prohibits tax-exempt organizations from maintaining plans with section 401(k) cash or deferred arrangements. On the other hand, section 403(b)(1)(A) permits section 403(b) salary reduction contributions only on behalf of employees of certain tax-exempt organizations. As a consequence, section 401(a)(26) precludes the small employer in such a group under common control from offering its employees an elective deferral arrangement. This result is inequitable and apparently unintentional.

The Act would give church organizations described in section 414(e) an irrevocable election not to apply the aggregation rules of sections 414 (b), (c), (m), (o) and (t) to a church or a convention or association of churches, including an organization described in section 414(e)(3)(A) or an organization described in section 414(e)(3)(B), for purposes of the following coverage and related rules: sections 401(a)(3), 401(a)(4) and 401(a)(5) as in effect on September 1, 1974, sections 401(a)(4), 401(a)(5), 401(a)(17), 401(a)(26), 401(h), 401(m), 410(b), 411(d)(1), 416 and the various welfare benefit coverage rules described in the sections listed in section 414(t). The Act further provides that for purposes of such rules such organizations shall not be considered as controlling or controlled by any other organization. However, the Act would require aggregating for-profit subsidiaries controlled by the same non-profit corporation. The election not to have the aggregation rules apply must be made by the last day of the plan year commencing or after January 1, 1993, and once made is irrevocable.

C. Issues Concerning Section 413(c)

Section 413(c) addresses the manner in which certain rules will be applied to a plan maintained by more than one employer. Treasury Regulations $1.413-2(a)(3)(iv) states that the qualification of a section 413(c) plan under sections 401(a) or 403(a), as modified by section 413(c), is determined with respect to all employers maintaining the section 413(c) plan. This regulation also states that the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the section 413(c) plan for *all* employers maintaining the plan. The legislative history of TAMRA indicates that the principles of section 413(c) are to be applicable to section 403(b) annuity plans.

Treasury Regulations §1.413-2(a)(2) defines a "section 413(c) plan" as a plan that is a "single plan" (within the meaning of section 413(a) and Treasury Regulations §1.413-1(a)(2)) and which is maintained by more than one employer. Treasury Regulations §1.413-2(a)(2) states that the mere fact that a plan utilizes a common trust fund or otherwise pools plan assets for investment purposes does not, by itself, result in a particular plan being treated as a section 413(c) plan. However, Treasury Regulations §1.413-1(a)(2) cross references the definition of a "single plan" under section 414(l) and Treasury Regulations §1.414(l)-1(b)(1). The definition of the term "single plan" in the regulations under section 414(l) states that a single plan exists if and only if all of the plan assets are available, on an ongoing basis, to pay benefits to employees who are covered by the plan and their beneficiaries. The regulations state that if this situation exists, the plan will be a "single plan" regardless of whether the plan has different benefit structures, whether it is structured with several plan documents, whether several employers contribute to the plan, whether the

assets of the plan are invested in several trusts or annuity contracts, or whether separate accounting is maintained for purposes of cost allocation but not for purposes of providing benefits under the plan.

The general structure of the retirement plans maintained by a number of denominations represented through the Church Alliance provides for separate account balances on behalf of different employees, with each employer making contributions to the plan for its own employees. However, at the point in time when pension payments will be made from the plan, the plan "self-annuitizes" and provides its own stream of annuity payments by pooling all of the assets of the retired individuals for mortality purposes. Self-annuitizing benefits enables church pension boards to avoid the costs associated with the purchase of commercial insurance contracts and permits the church pension boards to control the types of investments that are made with church plan funds. Thus, while separate accounts and separate contributions are made to the plan, when it is time for benefit payments to be made, all of the "annuitized" assets of the plan are available to pay benefits to each individual covered under the plan Thus, such arrangement could perhaps be treated as a single plan for purposes of section 413(c).

As noted above, one of the consequences of the applicability of section 413(c) is that the failure of one contributing employer to meet the applicable coverage requirements could disqualify the entire plan. Because the plans maintained by church denominations often involve thousands of employers, there is no practical means for a denomination to ensure that each employer has satisfied the coverage requirements. In addition, as noted above, churches and most church-controlled organizations will be exempt under the proposed legislation from coverage and related rules, but the rules will continue to apply to certain other church ministry organizations (*e.g.*, hospitals, colleges and universities). Historically, some denominations have maintained a single plan for *all* of the various church-affiliated employers. Thus, the question also arises here as to whether the failure of one church-controlled organization to meet applicable coverage requirements could cause the disqualification of the plan for the churches and church-controlled organizations which have been specifically exempted from these requirements.

The Act amends section 413(c) to provide that such subsection shall not apply to a church retirement plan maintained by more than one church employer which commingles assets for purposes of investment and pooling mortality for participants in pay status.[7]

D. The Separate Account Requirement of Section 401(h)(6)

Section 401(h) permits pension and annuity plans to pay sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents only if certain conditions are satisfied. One of these conditions, set forth in section 401(h)(6), is that separate accounts must be maintained for such benefits payable to each key employee and his or her spouse and dependents. Further, such benefits (to the extent attributable to plan years beginning after March 31, 1984 for which the employee is a key employee) can only be payable to such employee (and the employee's spouse and dependents) from such separate account. In addition, section 415(1) provides that contributions allocated to any such separate account shall be treated as an annual addition to a defined contribution plan for purposes of the dollar limit prescribed by section 415(c) on contributions to such plans.

The clear purpose of the Code sections cited above was to curb tax-motivated, excessive pre-funding of certain types of post-retirement benefits to increase an employer's current tax deductions. The Senate and House Reports, as well as the Joint Committee on Taxation's "Blue Book" on the revenue provisions of the Deficit Reduction Act of 1984 ("DEFA"), state that these provisions were enacted because Congress "believed that the favorable tax treatment accorded these contributions may be subject to abuse unless they are taken into account under the limits on contributions and benefits." *S. Rep. No.* 169 (Vol. I), 98th Cong., 2d Sess. 327 (Comm. Print 1984); *H.R. Rep. No.* 432 (Part 2) 98th Cong., 2d Sess. 1295 (1984); Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 833 (Comm. Print 1984).

Application of these provisions to a multiple employer church plan is inappropriate. Apart from the fact that church plans are maintained by tax-exempt organizations that do not engage in tax-motivated pre-funding, the combination of lack of

[7] A church pension board whose chief executive officer is a member of the Church Alliance pursued an administrative remedy to the section 413(c) issue with the Internal Revenue Service. The Internal Revenue Service has indicated informally that the requested administrative relief cannot be granted.

centralized control over denominational employers and the sheer number of employers and employees participating in church retirement plans makes it difficult for the administrators of multiple employer church arrangements to obtain and keep current information on the identity of the relatively few key employees among all of the employees participating in such arrangements. In such plans, it is probable that administrators, due to incomplete or out-of-date data, will make mistakes in determining which employees are subject to the separate account requirement. This could lead to disqualification of the retirement plan.

In addition, if separate accounts must be set up to provide post-retirement medical benefits for key employees, and if benefits for such employees can be paid only from such accounts, church plans may be forced to commercially insure the benefits of key employees. Otherwise, plans may be prevented from paying the medical expenses of a key employee who, because of serious injury or illness, incurs expenses in excess of the amount allocated to his or her account. In the multiple employer context, it is often not feasible to provide retiree health care on a pay-as-you-go basis. To require churches to commercially insure these benefits would increase the cost of providing them.

In addition, in the case of a tax-exempt employer, the term "key employee" can only refer to an officer having annual compensation greater than $45,000 for any plan year. very few employees are highly compensated in the church setting, and benefits provided under church plans tend to be quite modest. Accordingly, even if a multiple employer church plan administrator could easily identify all key employees of all participating employers and allocate their benefits to separate accounts, only a small percentage of the plan participants would be key employees, and it is extremely unlikely that many of these employees would have benefits that, when combined with amounts allocated to such separate accounts, would exceed the section 415 annual addition limits.

A particularly onerous and unfair aspect of the section 401(h) separate account requirement results from the effective date of a technical correction made in the 1986 Act. As enacted in 1984, these provisions applied only to five percent owners and were effective for years beginning after March 31, 1984. DEFRA §528(b). Because employers contributing to church plans typically have no owners, the provisions had no effect on church plans. However, a technical correction made in 1986 extended the application of these provisions to all "key employees," effective for years beginning after March 31, 1984. As noted above, church plan participants may include a few officers who are "key employees." Thus, in 1986, church plans suddenly became subject to the section 401(h) separate account rules, retroactive to as early as 1984. It is impossible for such plans to maintain separate accounts, and make payments only from such separate accounts, retroactively, for years during which no such separate accounts were in fact maintained or required.

The Act would replace the separate account requirement, in the case of a multiple employer church plan, as described in section 414(e), with a requirement to take into account the actuarially-determined value of pre-funded post-retirement medical coverage of a key employee for purposes of the section 415(c)(1)(A) dollar limitation on annual additions to a defined contribution plan. This change will allow a multiple employer church plan to avoid identifying its key employees and testing with respect to them if: (1) none of the employees covered by the section 401(h) arrangement are also covered by another defined contribution plan; and (2) the maximum actuarially-determined amount that is set aside each year over the working life of an employee covered under the section 401(h) arrangement would not exceed $7,500 (twenty-five percent of the section 415(c) limit), as adjusted for changes in the cost of living. As discussed above, for this purpose, the definition of "employer" should be applied without regard to sections 414 (b), (c), (m), (n) or (o).

E. Special Rule for Foreign Missionaries Participating in Church Provided Annuity Plans

Most denominations represented through the Church Alliance have ministers and lay workers serving their respective denomination abroad as missionaries. Under current law, foreign denominational employers can contribute to the denomination's section 403(b) retirement program or to the denomination's retirement plan described in section 401(a) in behalf of these foreign missionaries.

However, some denominations are having difficulty in encouraging foreign church organizations (*e.g.*, foreign missionary societies and boards and foreign churches) to contribute to the denominational retirement program. This is due to the fact that the employer's contribution does not create any "investment in the contract," or basis, within the meaning of section 72(c)(1) due to the operation of a special rule set out in section 72(f).

Stated very generally, section 72(f) provides that for purposes of determining an employee's "investment in the contract" amounts contributed by the employer shall be included in the investment in the contract, but only to the extent that such amounts were includable in the gross income of the employee, or, if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includable in the gross income of the employee under the law applicable at the time of such contribution. However, amounts distributed by an employer and which, if they had been paid directly to the employee, would have been excludable from income under section 911 (*i.e.*, foreign source income) are specifically excepted from creating basis under section 72(f).

Foreign mission boards or missionary societies are generally aware of the fact that, from a tax planning perspective, it is preferable to pay the foreign service minister or lay worker their entire compensation in cash and encourage the minister or lay worker to purchase a retirement annuity, rather than contribute to the denominational retirement plan on their behalf. This is because individual contributions by foreign missionaries will create basis for purposes of section 72—employer contributions in their behalf will not. However, in practice these missionaries often do not make a contribution on their own to build adequate retirement savings, and when they eventually return to live out their retirement years in the United States, their inadequate retirement income may need to be supplemented, either through the form of additional denominational contributions or through application for government assistance.

Section 72(f) was amended in 1962 to provide that income that is excluded from tax by virtue of the exclusion provided in section 911 would not create any "investment in the contract" for purposes of section 72. However, the operation of the rule hinders, rather than furthers, the provision of retirement savings for employees by employers.

The Act therefore would amend section 72(f) to enable foreign missionaries to be credited with an "investment in the contract" under section 72 for their employer's contribution to their denomination's retirement program. A similar change would also seem to be appropriate for other foreign service workers and their employers.

F. Modifications to Section 401(a)(29)

Section 401(a)(9)(C) provides that distributions from section 401(a) and section 403(b) retirement plans must begin by April 1 of the calendar year following the calendar year in which an employee-participant attains age 70s. However, there is an exception from this distribution requirement for governmental plans or church plans maintained by churches and qualified church-controlled organizations (as defined in section 3121(w)(3)). For these plans, distributions must begin by the later of the date just described or April 1 of the calendar year following the calendar year in which the employee-participant retires.

The limited exception provided for church plans is in many cases unworkable. As noted, it is common for ministers to move from church employer to church employer during denominational service, and some of these employers may not be organizations described in section 3121(w)(3). For example, a minister may work for a period of time serving a local congregation, then may transfer to work as a chaplain at a church hospital, and then return to serving another local congregation. If the minister attains age 70½ while the minister is working for the church hospital, presumably distributions from the denominational church retirement plan would need to begin at that time. However, if the minister is working for the local congregation upon attaining age 70½, presumalbly plan distributions would not be required to begin at age 70½.

The current section 401(a)(9) distribution exception thus creates obvious administrative problems for church pension boards. In addition, because ministers view their services on a denomination-wide basis within the denomination rather than on an employer-by-employer basis, it makes more sense for the distribution exception to be worded in terms of a denomination-wide church plan.

The Act therefore amends section 401(a)(9)(C) to provide that distributions for a participant in a church plan (as defined in section 414(e)) are not required to begin until the later of the date determined under the general rule of section 401(a)(9)(C) or April 1 of the calendar year following the calendar year in which the participant retires. This is essentially the same rule granted to governmental plans.

The Act also would deal with two problems created by the proposed regulations under section 401(a)(9). These proposed regulations suggest that in a situation in which a defined contribution plan provides an annuity for a participant, such annuity must be purchased from a commercial insurance company. Church pension boards typically are organized in a manner that permits the pension board to pro-

vide funding of retirement benefits as well as plan administration. Thus, when an individual participates in a defined contribution retirement plan sponsored by a church pension board, the participant typically is assigned an account balance to which contributions and earnings thereon are credited during the individual's active working life. At the time of the individual's retirement, the benefits in the account are typically transferred to a pool of assets which is used to fund benefits for participants who are in pay status. This pooling arrangement takes certain mortality risks into account and is otherwise maintained on a sound actuarial basis. The requirement of the proposed regulations that a defined contribution plan purchase an annuity from a commercial insurance company would eliminate the ability of church pension boards to carry out their traditional functions and duties, and would also create potential problems for denominations concerned with the manner in which plan assets are invested. The Act therefore would provide that this requirement of the proposed section 401(a)(9) regulations would not be applicable to a church retirement plan described in section 414(e).

The proposed regulations also contain a number of exclusive options for paying out plan benefits over time. Church pension boards in some instances have developed a tradition of providing annuitants with an additional benefit at year-end based on favorable administrative and investment experience of the plan. However, this additional benefit, commonly known in the church community as a "13th check," would not be permitted under the proposed section 401(a)(9) regulations. The Act also provides that church pension boards would be permitted to preserve this "13th check" option.[8]

G. Modification to Section 403(b) "Catch-Up" Contribution Rule

Section 402(g)(8) provides for a limited increase in the $9,500 limit on elective contributions to section 403(b) retirement plans. This increase is only available to an employee who has completed 15 years of service with an employer that is an educational organization, hospital, home health service agency, health and welfare service agency, or church or convention or association of churches (including church ministry organizations described in section 414(e)(3)(B)(ii)).

The increased "catch-up" contribution amount is determined under section 402(g)(8)(A) by increasing the $9,500 limit by the least of the following amounts:

(1) $3,000 (the "First Cumulative Test"),

(2) $15,000 reduced by amounts not included in gross income for prior taxable years by virtue of making a special "catch-up" contribution (the "Second Cumulative Test"), and

(3) The excess of $5,000 multiplied by the number of years of service of the employee with the qualified organization over the total amount of salary reduction contributions made on behalf of such employee for prior taxable years (the "Third Cumulative Test").

Church pension boards are capable of administering the First and Second Cumulative Tests, but the Third Cumulative Test will be impossible to administer. This is true because the Third Cumulative Test assumes that records have been maintained by church pension boards in prior taxable years that differentiate between salary reduction contributions and nonelective employer contributions. Such records were not required to be kept prior to the 1986 Act. Thus, these records are often not available or could only be created through an enormous expenditure of employee hours.

Section 1011(c)(5)(A) of TAMRA, and the description of such act prepared by the Joint Committee on Taxation, indicates that the Secretary of the Treasury is to promulgate, by regulation, "administrable methods" for dealing with this problem.

The Church Alliance believes the Third Cumulative Test is simply unnecessary. The special "catch-up" contribution amount of section 402(g)(8) is subject to (and not in addition to) the section 415 contribution limits, and the amount of additional elective deferrals cannot exceed $3,000 in any one year, with a lifetime limit of an additional $15,000 in contributions. The Act eliminates the Third Cumulative Test from section 402(g)(8)(A) for church section 403(b) annuity programs.

H. Modification to Section 457

As noted above, one of the primary goals of the proposed legislation is to bring workable consistency to the rules that govern church retirement benefit plans. The Act would modify the relief granted the retirement benefit plans of churches and

[8] The Church Alliance has filed comments with the Internal Revenue Service concerning both problems raised by the section 401(a)(9) proposed regulations.

certain church-controlled organizations under various employee benefit rules by extending such relief to church-controlled organizations described in section 414(e) (other than church hospitals, colleges and universities). To promote desired consistency, the Act would extend the section 457 relief provided under current law to these same organizations.[9]

I. Modification to Section 105(h)

Prior to the repeal of section 89, group-term life insurance plans and accident or health plans (whether insured or self-insured) maintained by churches and qualified church controlled organizations were not subject to the coverage requirements of section 89. When Congress repealed section 89 in 1989, the coverage requirements that applied prior to the enactment of section 89 were restored for group-term life insurance plans and self-insured accident or health plans, except that Congress relieved the group-term life insurance plans of basically all church organizations other than church hospitals and universities from the application of the coverage requirements of section 79(d). However, similar relief was not provided under section 105(h) for self-insured church accident or health plans.

As a result of the failure to include relief for church accident or health plans under section 105(h), church employers became the only group of employers in America that were *worse off* as a result of the repeal of section 89. This is true because the coverage requirements of section 105(h) present problems for many churches and church related ministry organizations. For example, in the case of one denomination which maintains a self-insured accident or health plan, the denomination is able to control the provision of health care benefits for its ministers. However, under the form of government taken by this denomination, the denomination cannot control the provision of health care benefits to lay workers, and the local church is thus free to establish a different health care plan for these other church employees. In some cases, the plan may be as good as or better than the plan provided for the minister. However, if it is not, the coverage rules of section 105(h) may be violated, and as a result the minister will in all likelihood be required to include the reimbursements received under the health care plan in his or her income.

The Act would modify section 105(h) to provide that the coverage rules of such subsection do not apply to accident or health plans maintained by churches and church-controlled organizations described in section 414(e) (other than church hospitals, colleges and universities).

VI. REVENUE IMPACT AND RETROACTIVE EFFECT OF PROPOSAL IN PARTS ONE AND TWO

The Church Alliance is aware that any legislation that is introduced in the Congress in our country's economic environment must address the issue of cost. Although the Church Alliance does not have the revenue estimating capabilities available to Congress, the Church Alliance is strongly of the view that the Act involves virtually no revenue loss, while at the same time reflecting sound employee benefit policy as applied to churches.

The Act contains proposed effective dates for each change. In some cases, certain of these provisions are to be made retroactively effective on a "before, on, or after" basis. In addition, the Act contains a provision which states that what are now church retirement plans described in section 401(a) and church section 403(b) plans are deemed to satisfy the requirements of current law for years prior to January 1, 1990. Church pension boards have attempted to operate their retirement and welfare benefit programs in compliance with applicable Code requirements over the years. However, given the large number of church employers and employees involved in these programs, the complexity of many of these requirements (particularly as applied to diverse theological polities), and the lack of sophistication and resources of many if not most church employers, there has been a concern over the years that some church organizations may have inadvertently failed to comply with some aspect of these rules as they apply to churches. Giving certain provisions retroactive effect, and giving church retirement plans a "fresh start" under new, simpler rules, will eliminate this concern.

VII. CONCLUSION

The Church Alliance believes that the provisions in the Act strike a balance between the perspective and needs of the church retirement and welfare benefits com-

[9] The Church Alliance continues to believe that any exception to section 457 should be extended to all church organizations described in section 414(e), and that section 457 should not be applied to the nonelective deferred compensation plans of any tax-exempt organization.

munity and the interests of government in a sound pension policy. The Act's all important cornerstone is a recodification of church retirement plan rules so that all such rules are identified, simplified and brought together separately in the Code. Issues which are unique to churches will thus be off-the-table and not inadvertently impacted when Congress is considering future changes which are applicable to secular employers but not appropriate for churches, and vice versa. This recodification, along with the other modifications and clarifications described herein, is of vital importance to churches and church ministry organizations and will be of benefit to legislative and regulatory bodies in providing workable, uniform rules applicable in the church setting.

PREPARED STATEMENT OF HAROLD A. SCHAITBERGER

Good morning, Mr. Chairman. My name is Harold A. Schaitberger, Executive Assistant to the President, International Association of Fire Fighters, AFL-CIO, a union representing over 180,000 professional fire fighters.

I am here this morning representing the views of public sector unions and employer organizations concerned about and affected by laws impacting pension funds of state and local government employees. The following organizations support the statement that follows regarding provisions in your bill affecting state and local pension funds: American Federation of State, County and Municipal Employees; International Association of Fire Fighters; National League of Cities; National Conference of State Legislatures; National Association of Counties; Government Finance Officers Association; National Association of State Retirement Administrators; National Association of Government Deferred Compensation Administrators; National Conference on Public Employee Retirement Systems; and National Council on Teacher Retirement.

Mr. Chairman, on behalf of these 10 organizations, we would like to personally thank you for introducing S. 2901, the Employee Benefits Simplification Act. We would especially like to thank you for including in this comprehensive bill provisions addressing the problems of state and local government pension plans caused by the Internal Revenue Code section 415 limitations.

Public Pension Plans and Concerns. As you know, state and local government pension plans differ from private sector pension plans in several ways. Because of these differences, the application of the IRC section 415 pension limits adversely affects the pensions of government employees. The greatest problem facing the plans is the fact that if just one retiree's pension benefit exceeds the section 415 limits, the entire pension plan is exposed to disqualification, thus placing an unfair burden on both plan participants and the plan itself. Such action would result in both current and future employees being taxed annually on the value of benefits earned each year and the earnings of the trust would be subject to Federal taxation.

Government plans are also different from private sector plans in that most plans are contributory on the part of employees. Historically, government workers have had more generous plans than the private sector because of low pay of government employees and the fact they contribute to their plans. Government plans also provide for some type of regular cost-of-living adjustments distinguishing them from their private sector counterparts. Many government employees are not covered by social security and thus rely solely on their state and local government pensions for retirement income. Another practice common to public plans, but not the private sector, is that disability and survivor benefits are paid out of the retirement system thereby making them subject to Sec. 415 limitations. Because of these unique characteristics, state and local government pension plans need some adjustments in the application of the IRC section 415 limits in order to avoid exposure to disqualification.

The proposed changes in your bill to the existing section 415 requirements will simplify compliance for state and local government pension plans and enable them to pay the level of benefits promised without jeopardizing the tax status of the trust.

State and local governments employ over 14 million full-time workers. These employers offer comprehensive employee benefit packages which include retirement benefits. Most of those covered are participants in a defined benefit plan. Defined benefit plans provide a specific benefit to vested individuals, without regard to investment earnings experience. Therefore, the employee bears little risk but the employer is bound, often through constitutional guarantees or local statutes, to meet its pension benefit obligations. Over the years, maintaining a defined benefit plan has become increasingly complex and administratively burdensome for employers.

Federal regulation of state and local government pension benefits is an area of continuing change and concern to state and local governments as well as organizations representing those employees. Although public plans are exempt from ERISA, most plans operate as "qualified" plans under the Internal Revenue Code for the purpose of maintaining preferred tax treatment of the pension trust and employee contributions. As a result, the maximum benefit and contribution limits of IRC section 415 present special problems for these plans.

Impact of Section 415 on Public Pension Plans. Section 415 limits the annual pension contribution or benefit level a public (and private) employer may fund. The maximum annual benefit payable from a governmental defined benefit plan is the less of (1) 100 percent of the participant's average compensation for the highest three consecutive years, or (2) $90,000. If the $90,000 limit is employed, the limit must be reduced actuarially if benefit payments commence prior to age 62; may not go below $75,000 if benefit payments commence at or after age 55; and may not go below $50,000 for police officers and fire fighters credited with at least 15 years of service. The $90,000 and $50,000 limits are indexed for inflation. The limits for 1990 are $102,582 and $56,990 respectively. The $75,000 limit is not indexed.

The 415 limits were enacted to cap the Federal revenue loss associated with the employers' tax-deductible contributions to the employees' pensions funds. Since state and local governments are tax-exempt entities and do not take such deductions, an exemption from the 415 limits does not affect Federal revenues.

Many public pension plans are constitutionally or statutorily required to pay benefits in excess of the section 415 limits. The major problem is cause by the "100 percent rule" because public employers calculate benefit levels on the basis of total compensation, whereas the section 415 limits are based on income as reported on W-2 forms, which does not include certain salary reductions. Therefore, the allowable benefits under the 100 percent limit is lower than the benefit provided under state and local government pension benefit formulas. he result is that employees are denied pension benefits under Federal legislation that they are legally entitled to receive under state and local law. Similar problems arise when 415 limits are applied to disability retirements and survivor benefits.

To clarify this point further, I would like to give a simple example of how a typical fire fighter, with 35 years of service, could be entitled to a pension benefit that currently exceeds the section 415 pension limits.

SECTION 415 RETIREMENT EXAMPLE

Captain: 35 years service; 56 years of age
Retirement: 2.5% times number of years of service based on average highest three consecutive years

	Year 33	Year 34	Year 35
Salary	$48,000	$52,000	$56,000
Employer pickup of employee contributions (11%)	−5,280	−5,720	−6,160
457 deferred compensation	−4,500	−6,000	7,500
Taxable W-2 Earnings	$38,220	$40,280	$42,340

Retirement Benefit Formula:

2.5% x years of service x average of highest three consecutive years

$$.025 \times 35 \times \frac{\$48.000 + \$52,000 + \$56,000}{3}$$

$$.025 \times 35 \times \frac{\$156.000}{3}$$

.025x35x$52,000 = **$45,500 annual pension**

Section 415 Limit test: Lesser of

•100% of average highest three consecutive years of taxable earnings=$40,280

OR

•Dollar limit at age 56=$75,000

••Benefit provided under plan exceeds Section 415 limit by $5,220.••

RETIREMENT EXAMPLE

This example demonstrates what happens with a captain who has 35 years service and has elected to take advantage of deferring salary through 457 deferred compensation plan. Because of the employer pickup and the 457 plan, this captain's taxable W-2 earnings have been reduced in each of the last three years of employment. From a tax advantage, this is good. However, will have an impact on the Section 415 limits.

In this example, the captain's plan retirement benefit *before* the limit is tested will be 2.5% times 35 years of service times the average of the highest three consecutive years salary: ($48,000 + $52,000 + $56,000 divided by 3) = **$45,5000 annual pension benefit.**

For the pension to comply with IRC 415 limits, it must not exceed the lesser of the dollar limit or percentage limit.

The dollar limit is based ~~on the~~ retiree's age. In this example, the dollar limit at age 56 is $75,000.

The percentage limit is 100% of the average highest three consecutive years of taxable earnings. In this example, 100% would be $38,220 + $40,280 + $42,340 divided by 3 = $40,280.

Since the actual pension benefit ($45,500) exceeds the lesser of the percentage limit ($40,280) or the dollar limit ($75,000), the pension of the captain exceeds the IRC Section 415 limits on pension benefits by $5,220 and would therefore expose the entire pension plan to disqualification.

Likewise, if the pension benefit had been based on the highest year's salary or final year's salary, this pension benefit would have exceeded the Section 415 limits by $8,720 (2.5% times 35 times $56,000 = $49,000).

Section 415 Remedy. Mr. Chairman, because of your efforts and that of other members of this Committee, the problems associated with the 415 limits and state and local government pension plans have been successfully addressed in your legislation. I would like to discuss each in turn.

First, under section 102, you have addressed the problem of a standardized definition of compensation for 415 purposes. Your bill modifies the employer election to take salary reduction contributions into account by permitting deferrals under sections 457 and 414(h)(2) to be taken into account and providing that an election to take salary reduction into account is to apply for all purposes, to all employees, and to all salary reductions. This provision alone will correct many of the problems associated with applying the 415 limits to government pension plans. It will certainly correct the previously cited example.

Second, under section 306, the compensation limitation under 415 on benefits under a defined benefit pension plan does not apply to plans maintained by a state or local government. This provision will be especially helpful to many low income employees who find themselves receiving a very small pension that actually exceeds the 100 percent compensation limits. As discussed earlier, this will also be helpful to the many long-tenured employees who are eligible to receive benefits in excess of their average compensation as a result of regular cost-of-living adjustments.

Third, under this same section, the defined benefit pension plan limits do not apply to disability and survivor benefits provided under such plans. This point is critical because so many of the state and local government employees are engaged in dangerous and hazardous professions and disability retirement benefits are more likely to be provided than workers compensation. This is especially true of fire fighters and law enforcement officers.

Fourth, under this same section, excess plans maintained by state or local governments to provide benefits in excess of the compensation limitation on benefits under a defined benefit pension plan will be subject to the same tax rules applicable to such plans maintained by private employers. The section 457 limitations on unfunded deferred compensations plans will not apply to these excess plans.

Mr. Chairman, these provision will certainly simplify the administration of state and local government pension plans. Most importantly, these changes will allow plans to pay benefits to retirees—benefits that have been promised to them—and not cause any adverse impact on the tax status qualification of the plans. These

technical changes will ensure that state and local government employees' pensions, and disability and survivor benefits will be protected for those who have served the public and earned these benefits.

The organizations listed above enthusiastically endorse these provisions and hope that you can expedite their passage to prevent any further confusion or problems in this area.

I would be happy to answer any questions you or other members of the Committee might have.

Prepared Statement of Kenneth D. Simonson

INTRODUCTION AND SUMMARY

My name is Kenneth D. Simonson. I am vice president and chief economist of the American Trucking Associations, the national trade association of the trucking industry. ATA's membership includes more than 4000 carriers and suppliers of all sizes and types. ATA is a federation; membership in our 51 state associations and 10 conferences representing different industry segments, combined with ATA's direct membership, totals roughly 30,000 businesses. To transport shipments, the carriers engage approximately 100-150 million owner-operators who have the financial responsibility for providing hauling equipment and incurring other substantial operating expenses. Employee leasing tax rules are a significant concern to many of them.

Senator David Pryor (D-Ark.) has performed a valuable service by introducing and holding a prompt hearing on S. 2901, the "Employee Benefits Simplification Act." Many of its provisions are of broad applicability and will be the subject of comment by benefits specialists and general business groups. Thus, the comments that follow concentrate on one aspect of benefit simplification that has particular ramifications for trucking: employee leasing.

S. 2901 helps simplify and clarify the intended scope of employee leasing by substituting a control test for "historically performed" language. We would not be concerned about an "historically performed" test if the language were reasonably interpreted as applied to our industry. Historically, there has always been a distinct difference between the services of an employed driver and those of an owner-operator who, at risk of fain or opportunity for profit, provides valuable equipment, bears significant expenses and also drives or provides drivers. Doing no more than driving an employee's truck for pay has historically been provided by employees, but this is only a part of the total obligation of the owner-operator.

We are satisfied that historically an employed truck driver and an owner-operator perform two distinctly different functions. However, we fear that an excessively broad construction of "historically performed" could Introduce much confusion into the contractual relationship of carriers and owner-operators. Clarifying language in the statute or a clear exclusion in the Committee reports of the carrier and owner-operator relationship would be helpful. In addition, we recommend adoption of several other pieces of statutory or report language. More fundamentally, we believe Congress should reconsider whether the concept of employee leasing prevents abuse or discourages employers from offering benefits.

BACKGROUND

Congress added employee leasing tax rules to the Internal Revenue Code in 1982 after learning of professionals in private practice who pretended to fire their staffs and then "leased" them back from companies that paid their wages. This ruse enabled them to claim they had no employees in their own practice other than themselves and they could thus pay retirement benefits to themselves without running afoul of the existing rules on pension discrimination.

Code section 414(n) was added to stop this abuse by requiring "recipients" of services to count individuals performing those services ("leased employees") along with the recipient's actual employees in determining whether the recipient met certain pension rules. In 1986, the list of provisions for which leased employees had to be considered was broadened to cover other types of benefits, so that now the term applies to 22 provisions of the tax code.

Under section 414(n)(2),

> . . . the term "leased employee" means any person who is not an employee of the recipient and who provides services to the recipient if—
>
> (A) such services are provided pursuant to an agreement between the recipient and any other person (in this subsection referred to as the "leasing organization"),

(B) such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year (6 months in the case of core health benefits), and

(C) such services are of a type historically performed, in the business field of the recipient, by employees.

This definition appeared to be reasonably straightforward. Nothing in the law or the legislative history suggests that this definition would generally apply to independent small businesses that happen to perform the bulk of their services for one recipient. For instance, an independent owner-operator of a tractor or tractor-semitrailer, who has the opportunity for profit and the risk of loss on equipment, operating expenses and services, is not an employee for employment tax purposes and should not logically be a leased employee for benefits purposes.

However, proposed IRS regulations issued in August 1987 ignored the seemingly plain Congressional intent in several respects (discussed below). We feared that, if adopted, the rules could have made thousands of owner-operators into leased employees, even though they are independent contractors providing a service requiring the utilization of substantial operating equipment and bearing substantial operating expenses. Thousands of trucking company employees could also have become leased employees of shippers. We do not believe that Congress intended either of these results when it enacted the employee leasing standards in Internal Revenue Code section 414(n).

Even though Treasury and IRS officials have since said that they recognize the proposed rules were too sweeping, they have given no hint as to how they would narrow the scope of the rules. Therefore, we think further legislation to specify Congressional intent is in order.

Last year, the Senate Finance Committee reported out a bill and accompanying report language that significantly clarified Congressional intent. The bill is now in conference as part of the Senate version of H.R. 3, which deals mainly with child care. If the employee leasing language is stripped from H.R. 3, we believe it should be added to a benefits simplification bill.

At the moment, only one piece of that language is in S. 2901: a replacement for the troublesome "historically performed" test of section 414(n)(2)(C). The substitute, requiring that a person perform services under the control of the recipient, should remove some, but not all, of the uncertainty regarding the treatment of truck drivers who are not employees of the carrier or shipper receiving their services. Fairness, simplicity and certainty could be enhanced by adding some language to the statute or at least the committee report. Here are some specific suggestions.

SUGGESTED CLARIFICATIONS

Control

The concept of "control" is fairly well understood with reference to owner-operators in the context of employment tax classifications. Owner-operators either own or have financial responsibility for substantial operating assets (often costing $50,000 or more) and significant operating expenses for which they bear a real risk of loss and opportunity for profit. They *control* their own businesses, whether they contract (directly or indirectly) with a single carrier (or shipper) or several over the course of a year. *If* the IRS interprets "control" for employee leasing purposes in the same way that it does for employment tax audits, I believe most trucking companies and shippers will be able to tell if an owner-operator is a leased employee or not.

However, the House Ways and Means Committee staff has recently suggested that an individual would be a leased employee if he or she is "directly or indirectly under the direction or control of the recipient." Because this language has no recognized meaning in tax law, it would add greatly to uncertainty and could give rise to many inequitable situations in which an independent contractor would be sufficiently beyond a recipient's control to be an independent contractor for tax purposes and yet, because of indirect controls or directions, might be claimed to be a leased employee for benefits purposes. For example, almost every shipper or carrier necessarily gives some directions in arranging for services by an owner-operator.

It would be helpful to have the bill (or Committee report) specify that "control" is not meant to apply more broadly for employee leasing purposes than for employment tax purposes and provide examples of what is and is not indirect control or direction. In particular, an owner-operator may offer services directly to a shipper, to a carrier that assigns him or her to a single shipper or various shippers, or to a fleet operator or broker who contracts with one carrier (or shipper) or several. In all of these arrangements, the owner-operator meets the employment tax standards for

being an independent contractor to the same degree. The result should be identical in all such cases for employee leasing purposes as well.

Incidental services

The Senate version of H.R. 3 includes meritorious clarifying language that services "incidental to the sale of goods or equipment" do not constitute employee leasing. We believe this language should be retained and strengthened by adding the words "or transportation" following "sale."

Under the proposed regulations, either an independent or an employee driver of a trucking company who is assigned to haul freight from a particular shipper for more than a minimum number of hours could be claimed to be the leased employee of the shipper. The language passed by the Senate should preclude that unintended result where the shipper is sending goods to an unrelated customer, since the shipment is incidental to a sale. Adding the words "or transportation' makes it clear that neither owner-operators nor trucking company employees would be leased employees of shippers merely because they regularly haul freight between two facilities of the same shipper, for instance a factory and a warehouse.

Third-party requirement

The proposed regulations ignored what appeared to be clear statutory language by stating that a self-employed individual could be both a leasing organization and a leased employee. We believe the only possible correct interpretation of Code section 414(n)(2)(A), "such services are performed pursuant to an agreement between the recipient and any other person (in this subsection referred to as the 'leasing organization')," is that a leasing organization is separate from both the recipient and the service provider. Nevertheless, either report language or statutory language should clarify that this is what the law means. An independent owner-operator providing his or her own services directly to a recipient should not be considered a leasing organization selling his own services.

At least 1 year

The proposed regulations also distorted seemingly clear language in Code section 414(n)(2)(B), "such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year (6 months in the case of core health benefits)," by using a standard of 1500 "hours of service" (or less in some cases). A long-haul truck driver who sleeps in his or her rig (and thereby guards a recipient's freight or equipment) may be accumulating 24 hours of service per day; even if only "on-duty" hours are counted, the 1500-hour limit can be reached in well under a year. It would be useful to have report language restating that "at least 1 year" means service extending over 12 calendar months or more.

6 months in the case of core health benefits

This phrase was added in 1986, when employee leasing requirements were expanded to include the infamous section 89, which used (but did not define) the term "core health benefits." A 6-month standard vastly expands the number of workers who may inadvertently become leased employees. Also, having workers who are leased employees for one purpose but not for another will make already difficult rules virtually unadministrable. Deleting "(6 months in the case of core health benefits)" from section 414(n)(2)(B) would be a valuable operational simplification. In any case, now that section 89 has been repealed, there is no justification (if there ever was one) for a 6-month rule for this limited purpose.

Record-keeping

Section 414(n)(3) lists over 20 parts of the Internal Revenue Code for which leased employees must be taken into account. The data-gathering and record-keeping requirements of these provisions are extremely broad and often very intrusive: service providers or leasing organizations must provide customers confidential information about pay, benefits hours, length of service, age and other details, depending on the applicable benefit. To the extent possible, these burdens should be limited.

The difficulty, as well as the unfairness, of requiring independent contractor drivers to provide confidential financial information to fleet operators, carriers or shippers with whom they have an arm's-length relationship cannot be overstated. Conversely, it is unreasonable to expect carriers to divulge to their customers information on driver pay and benefits when the customers can use that information to bargain with competitors, to deal with owner-operators directly, or to set up their own private trucking operations.

Furthermore, this record-keeping by and large serves no purpose. Few nonemployee truck drivers perform services for one company long enough to qualify for pensions. And even ones who do generally have chosen to be independent owner-operators rather than employees precisely because they wanted to make decisions themselves over what to do with their gross compensation. At the IRS hearing on its proposed regulations in February 1988, several owner-operators took time off to testify that they do not want to be considered employees for *any* purpose, be it employment taxes or benefits.

Related provisions

We urge the adoption of more reasonable requirements for employee leasing, for "affiliated service groups" defined in section 414(m)(5) and for "other arrangements" covered under section 414(o). As it stands, workers or organizations that do not fall under the ambit of 414(n) can still be caught up in the broad net of proposed regulations covering 414(m)(5) and (o). Yet none of these Code sections should interfere with long-standing, arm's-length business relationships such as those in the trucking and moving industries that have long existed for reasons having nothing to do with benefits evasion.

On the contrary, the existence of these rules will deter firms from offering benefits to their actual employees for fear they will have to extend coverage, or at least extensive recordkeeping, to a multitude of nonemployees.

CONCLUSION

We applaud Senator Pryor and his cosponsors for bringing some much-needed simplification and clarity to employee benefits tax provisions. S. 2901 makes a good start on the employee leasing portion of this task by substituting a potentially clearer control test for the murky "historically performed" language. We have recommended several other specific changes to make the law or Congressional intent clearer.

We remain troubled by the prospect that even with a tighter definition of who is a leased employee, companies will be forced to ask for information from service providers that historically has been confidential. Although the intent behind section 414(n) was to prevent abuse, the reality is likely to be that companies will either (1) drop benefits they would otherwise provide to actual employees so they do not have to cover nonemployees or (2) collect sensitive data from firms and individuals with which they should maintain an arm's-length relationship. Either of these outcomes would be the opposite of what Congress hoped for in 1982, when it enacted section 414(n), and of what S. 2901 is meant to achieve.

We support enactment of S. 2901 along with other changes listed above to encourage the spread of employee benefits without unduly burdening companies, independent contractors, or employees.

PREPARED STATEMENT OF ALEXANDER D. STEWART

What a privilege to testify on behalf of the Church Retirement Benefits Simplification Act of 1990. As Executive Vice President of The Church Pension Fund, since 1917 a pioneer in church plans, I assure you that this *landmark legislation* is whole heartedly endorsed by 27 major Christian communions and groups of Jewish Rabbis representing 66 million church and synagogue members.

This *legislation* eliminates for Church pension plans requirements particularly appropriate for corporate conglomerates. To conform to existing rules requires of us additional accounting personnel each year, legal expertise, and in-house auditors to make certain that every section of every statute is fulfilled. In all but 3 years since ERISA was enacted there have been changes in the regulations imposed on pension funds. This places a heavy burden financially and administratively on all church pension funds and churches, with their simple, straight-forward record systems. Our accounts have always had a certified public audit; our books are open to all communicants—try to close them. Full disclosure has always been required; we have nothing to hide or evade.

Excellent but expensive law firms whom we and other church pension funds have engaged have oft times concluded that the particular section did not even apply to us, but we could not take that chance. Perhaps a section applied generally to a secular rollover plan for highly compensated employees. Frankly, the rules for pensions over $200,000 have not presented any problem for churches. The CEO of a Fortune 500 corporation is not a Methodist minister! Nor is his wife likely to qualify for an Episcopal clergy widow's pension.

At this very moment, we here at Church Pension Fund are encouraging our churches to make pensions available for those clergy and lay employees who serve 1,000 hours a year or more. However, increasing technical complications lead some congregations to say, "Oh, let's give a generous Christmas Bonus in place of a pension—it's simpler." You know, I know, that money doesn't end up in an IRA or an annuity. In contrast, our clergy and lay pensions are provided through defined benefit plans. The money cannot be withdrawn. The retirement pension is assured.

We are not revenue estimators, but it is our view that this *legislation* is tax neutral, and no income would be lost to the Federal budget. It may even free up tax auditors to hunt for big game with the hope of significant recovery.

The Act provides a CORNERSTONE—I trust using that truly biblical word does not violate separation of church and state—a CORNERSTONE, that for plans such as ours carves out a special niche in the Code, especially the proposed new section 401A, with simple rules for qualified church retirement plans so that if and when Congress enacts legislation peculiarly appropriate for the retirement plans of secular employers it will not necessarily apply the same rules to church retirement plans. *This Act, and 401A, are of great importance to us here.* The Act also provides a level playing field with consistency for all the pension plans of all churches regardless of when they started. Currently, the coverage rules applicable under 403(b)(9) to retirement income accounts are significantly different from the rules applicable under 401(a) to plans such as our Clergy Plan. For some church bodies, this means present law is a PROCRUSTEAN bed. For example, clergy may not be technically eligible for the pension plan of their denomination and in which they have been a participant and to which they will later return if they are serving full-time as a chaplain in a hospital, university or prison that is not 'church controlled'. And we have no desire to control the prisons.

As I see it, this legislation will benefit as many as 260,000 clergy—that's enough air power to turn several windmills and solve the energy crisis. And 114,000 dedicated church or synagogue lay workers will likewise praise your name. Would you believe? If one of our own churches in a certain urban blighted area receives more than ¼ of its income from non-church sources for feeding the homeless, providing child care, teen-age drop in centers and family counseling, it could, under tight interpretation, be declared a non-church organization, and therefore its clergy not eligible for our church clergy pension plans.

Yet another church of ours down the street with substantial endowment funds carrying out the same identical programs, would have no trouble with its staff, clergy and laity being covered under our plan. This Act, implementing 401A, addresses a major concern of my church.

For simplification, the pension funds will thank you, for simplification, the volunteer church treasurers will certainly thank you; for simplification, the beneficiaries will thank you. Each month over 6,000 Episcopal beneficiaries receive their pension from us—675 are over the age of 85. Would you believe it? One widow has been a recipient since 1917, for 73 years! She must have a boyfriend named Ponce de Leon! Senator Pryor, your initiative in sponsoring this Church Retirement Benefits Simplification Act will not merely simplify the administrative machinery of The Church's Pensions Funds, the act will result in savings which benefit the retirees, who now are living longer, their widows and their dependent children. God Bless You for your efforts! And He will!

Prepared Statement of Thomas D. Terry

Mr. Chairman and Members of the Subcommittee: I am pleased to be here today to present the views of the Administration on S. 2901, the Employee Benefits Simplification Act and on S. 2902, the Church Retirement Benefits Simplification Act.

At the outset, I must note that in the current budgetary environment, simplification proposals are constrained by the realities of the Federal budget. We believe, however, that simplification of the employee benefit provisions of the Internal Revenue Code is needed—and that significant simplification is possible within budgetary constraints. We commend the Chairman and Representative Chandler for making a promising beginning by the introduction of S. 2901 and H.R. 5362, respectively.

We anticipate that S. 2901 in its current form could lose significant revenue, although we have not completed a comprehensive revenue estimate of its provisions. Accordingly, the Administration cannot support the bill in its current form. Some provisions of the bill will both achieve desirable simplification of the law and raise revenue, however. It should, therefore, be possible to fashion a revenue-neutral

package of simplifying provisions. We will be pleased to work with the Subcommittee to achieve meaningful and affordable simplification.

The Internal Revenue Code provisions relating to employee benefits have become increasingly complex in recent years. This complexity reflects both the wide variety of plans and their increasing sophistication. Given this environment, the tax laws relating to employee benefits in general, and the tax qualification requirements of section 401 of the Internal Revenue Code in particular, will never be "simple." But they clearly can be simpler than they are now; many provisions of existing law are more complex than they need be. Eliminating such unneeded complexity will benefit both the taxpayer and the tax administrator and offers the prospect of improved compliance.

The remainder of my written statement consists of our substantive comments on the provisions of S. 2901 and a brief discussion of S. 2902.

S. 2901 "Employee Benefits Simplification Act"

TITLE I—NONDISCRIMINATION PROVISIONS

Section 101. Definition of Highly Compensated Employees

Current Law

The Internal Revenue Code (the "Code") defines the term "highly compensated employee" to include any employee who during the current or preceding year (1) was a 5-percent owner, (2) earned over $75,000 (indexed) in compensation, (3) earned over $50,000 (indexed) in compensation and was in the top 20 percent of the employer's workforce by compensation, or (4) was an officer earning compensation over $45,000 (indexed) or was the highest paid officer, if no officer earned more than the stated amount. For purposes of defining highly compensated employees, the term "compensation" generally has the same meaning as for purposes of the limits on contributions and benefits under qualified plans (section 415), except that salary reduction amounts are taken into account. Current law permits certain employers to treat, on an elective basis, all employees earning over $50,000 (indexed) as highly compensated employees regardless of whether they are in the top 20 percent of the employer's workforce by compensation. In addition, certain family aggregation rules apply in the case of 5-percent owners and other highly compensated employees who are among the top 10 employees by compensation.

Proposal

The proposal would redefine the term highly compensated employee to include only 5-percent owners and employees who earn over $50,000 (indexed) in compensation. If an employer had no highly compensated employees under this definition, then the one employee with the highest compensation would be treated as highly compensated (the "one-employee rule"). The one-employee rule would not apply, however, for purposes of sections 401 (k) and (m) of the Code (relating to elective deferrals, matching contributions and employee contributions). As under current law, 5-percent ownership would be determined as of any time in the current or preceding year. For purposes of the $50,000 rule, however, an employee's compensation generally would be determined under the new uniform definition of compensation under the proposal described below for the preceding calendar year, except that the election to use base pay could not be made. Application of the family aggregation rules would be limited to 5-percent owners.

Administration Position

We generally support the proposal to simplify the definition of highly compensated employees. The elimination of the rules regarding officers and the top 20 percent of employees by compensation simplifies current law without sacrificing important policy objectives.

An important adjunct to this simplified definition, however, is the general rule that an employer is always deemed to have at least one highly compensated employee. Thus, we oppose the exception contained in the proposal to the one-employee rule for purposes of sections 401 (k) and (m).

We generally support the proposal to determine compensation based on prior periods for purposes of applying the $50,000 rule. This rule would enable an employer to know at the beginning of the year who its highly compensated employees are. We are concerned, however, that a rule looking only at prior period compensation will result in unintended gaps in the highly compensated group, primarily in the case of new hires and employees with substantial pay increases. Accordingly, the proposal should be modified to address these gaps.

We oppose the use of the proposal's new uniform definition of compensation under section 414(s) for purposes of determining an employer's highly compensated employees. As a general proposition, we believe the definition of compensation for this purpose should be defined as closely as possible to total taxable compensation plus salary reduction amounts. In particular, we believe the proposal should require, and not merely permit, the add-back of salary reduction amounts, as provided under current law. It is inappropriate for the determination of an employer's highly compensated employees to be influenced by individual employee decisions to make salary reduction contributions or, for that matter, by the employer's own decision whether to offer salary reduction arrangements of one type or another to its employees.

Section 102. Definition of Compensation

Current Law

Current law contains several definitions of compensation for purposes of applying the employee benefit provisions of the Code. One definition applies for purposes of determining the limits on contributions and benefits under qualified plans; a second definition applies for purposes of determining whether employees are highly compensated; a third definition applies generally for purposes of applying the nondiscrimination rules to qualified retirement arrangements.

The basic definition of compensation under current law is used to determine the limits on contributions and benefits under qualified plans (section 415). Compensation for this purpose is defined to conform as closely as possible to total taxable income received from the employer. Thus, salary reduction amounts excluded from an employee's gross income are not taken into account in determining compensation for this purpose. Recently issued temporary and proposed Treasury regulations provide employers with two alternative safe harbor definitions of compensation for purposes of section 415. These definitions are wages subject to income tax withholding and wages subject to social security taxes (determined without regard to the wage base limitation).

A different definition of compensation applies under current law for purposes of determining which employees of an employer are highly compensated (section 414(q)). The definition of compensation used for this purpose is identical to that used to determine the limits on contributions and benefits under qualified plans (including the safe harbor alternatives), except that salary reduction amounts are added back into an employee's otherwise taxable compensation.

A third definition of compensation is provided under current law for the principal purpose of applying the nondiscrimination rules applicable to qualified retirement arrangements (section 414(s)). Like the definition of compensation used to determine an employer's highly-compensated employees, this definition specifically incorporates by reference the definition of compensation used to determine the limits on contributions and benefits under qualified plans (including the safe harbor alternatives). However, because the definition is crucial to determining satisfaction of the nondiscrimination rules with respect to a wide variety of qualified retirement arrangements, considerably more flexibility is provided than under either of the other two definitions of compensation discussed above. Thus, the current statute permits an employer to elect to include in compensation for this purpose all salary reduction amounts under certain enumerated provisions of the Code. The recently issued Treasury regulations implement this portion of the statute and, in addition, permit employers to include salary reduction amounts under certain other provisions of the Code. The current statute also grants the Secretary authority to prescribe alternative definitions of compensation under section 414(s) as long as such alternative definitions do not result in discrimination in favor of highly compensated employees. The regulations implement this authority in two ways, most significantly by permitting employers to elect to use any other reasonable definition of compensation subject to satisfaction of a nondiscrimination test.

Proposal

The proposal would amend all three definitions of compensation under current law. For purposes of determining the limits on contributions and benefits under qualified plans, the proposal would define compensation as wages shown on the W-2 form (defined for this purpose as wages subject to income tax withholding). Alternatively, an employer could elect to define compensation solely by reference to the base pay of employees. Under either alternative, an employer could elect to include certain salary reduction amounts in compensation. Either of the foregoing elections would have to be made on a consistent basis for all plans, with respect to all em-

ployees, and for all purposes (except as noted below). Neither election could be revoked without the Commissioner's consent.

The same definition of compensation would apply for purposes of determining the employer's highly compensated employees. Two exceptions would apply, however. First, as mentioned earlier, compensation for this purpose generally would be determined on the basis of the prior year rather than the current year. And, second, an employer could not elect to define compensation by reference to base pays even if such election were made for purposes other than determining the employer's highly compensated employees.

The same definition of compensation would apply under section 414(s) as applies for purposes of determining the limits on contributions and benefits under qualified plans. In addition, the proposal specifically repeals the Secretary's authority under that section to prescribe alternative definitions of compensation.

Administration Position

We oppose the proposal to amend the current law definitions of compensation. We believe that the current definitions are more consistent than the proposal with the policies underlying each of the affected provisions of the Code. In addition, we believe the temporary and proposed regulations issued last May under sections 414(s) and 415 of the Code are more workable than the proposal. Legislation in this area is unnecessary.

In particular, we oppose the election permitted under the proposal to include salary reduction amounts in compensation for purposes of determining the limits on contributions and benefits under qualified plans. The election is inconsistent with the general policy that amounts excluded from gross income not be taken into account for this purpose.

We also oppose the proposal's failure to require that salary reduction amounts be added back to an employee's otherwise taxable compensation for purposes of determining the employer's highly compensated employees for the reasons explained earlier in our testimony.

In addition, we believe the reduction in the number of options employers have under the proposal to define compensation for purposes of section 414(s) is unwarranted. In developing the regulations, the IRS surveyed large numbers of employers in order to tailor the section 414(s) definition of compensation to existing payroll and compensation practices as well as to the needs of widely-used plan designs. Based on the survey, the IRS found little consistency in payroll and compensation practices. Accordingly, we do not believe the proposal provides the necessary flexibility to make it workable. Moreover, that flexibility could no longer be provided through regulations as the proposal would repeal the Secretary's authority to prescribe alternative definitions of compensation.

Finally, we oppose the proposal's failure to impose a statutory requirement that any definition of compensation elected by an employer by reference to base pay must be nondiscriminatory.

Section 103. Modifications of Cost-of-Living Adjustments

Current Law

Cost-of-living adjustments to various dollar limitations are currently made under adjustment procedures similar to those used for adjusting benefits under the Social Security Act, generally using the last calendar quarter of a year and a base period of the last calendar quarter of 1986. Under the Social Security Act procedures, cost-of-living adjustments to benefits are announced after the beginning of the year in which they are effective.

Proposal

The proposal would require the cost-of-living adjustments to be based on increases in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year. The proposal would also require that dollar amounts, as adjusted, be rounded to the nearest $1,000 (or to the nearest $100 in the case of the limitations on elective deferrals and in the case of the minimum and maximum compensation amounts applicable to simplified employee pensions ("SEPs")).

Administration Position

We believe this provision would be simplifying and is worth further investigation. Use of an earlier calendar quarter would permit cost-of-living adjustments to be announced before the beginning of a calendar year, and the use of rounding would ease administration and employee communications.

Section 104. Modification of Additional Participation Requirements

Current Law

Qualified plans, including both defined benefit and defined contribution plans, are generally required to benefit the lesser of 50 employees or 40 percent of the employer's workforce. New proposed regulations issued in May of this year substantially simplified the application of the minimum participation requirements.

Proposal

The proposal would exempt defined contribution plans from the minimum participation requirements. In addition, the proposal generally would reduce the numerical thresholds under the minimum participation requirements to require a defined benefit plan to cover only the lesser of 25 employees or 40 percent of the employer's workforce (but in no case less than 2 employees unless the employer had only one employee). The proposal would also permit employers to elect to have the new rules apply as if they had been included in the Tax Reform Act of 1986.

Administration Position

We are willing to investigate with the Congress the merits of modifying the current law minimum participation requirements along the lines set forth in the proposal. Because the proposal would permit employers to maintain a greater number of qualified plans with a smaller number of participants in each plan, a full assessment is needed of the additional administrative burden the proposal would place on the Internal Revenue Service.

We also question the desirability of an exemption for defined contribution plans from the minimum participation requirements. By providing that exemption, the proposal draws a fundamental distinction between defined benefit and defined contribution plans when, in practice, hybrid plans such as target benefit plans share characteristics of both types of plans. We believe more study is needed of this issue before a major category of plans is exempted from the minimum participation requirements altogether.

We oppose the portion of the proposal that permits employers to elect a retroactive effective date.

Section 105. Nondiscrimination Rules for Qualified Cash or Deferred Arrangements and Matching Contributions

Current Law

Elective salary deferral contributions to a qualified cash or deferred arrangement are generally required to meet a special average deferral percentage ADP test. To satisfy the ADP test, the average of the deferral rates (expressed as a percentage of compensation) for each highly compensated employee eligible to participate in the plan generally may not exceed the greater of (1) 125 percent of the average of the deferral rates of all nonhighly compensated employees eligible to participate in the plan or (2) the lesser of (a) 200 percent of the average of the deferral rates of all nonhighly compensated employees eligible to participate in the plan, or (b) such average plus 2 percentage points. If a plan does not satisfy the ADP test for a year, excess deferrals by highly compensated employees must be either redistributed to them or recharacterized as after-tax contributions in order to retain the qualified status of the cash or deferred arrangement. The distributions are made on the basis of the respective portions of excess contributions attributable to each highly compensated employee.

If a plan permits after-tax employee contributions, or provides for employer contributions that are contingent on a participant's elective deferrals or after-tax employee contributions ("matching contributions"), the amount of such contributions generally must satisfy a special average contribution percentage ACP test. The ACP test is generally the same as the ADP test described above, except that it applies to matching and after-tax employee contributions rather than to elective deferrals. Rules analogous to the distribution rules under the ADP test must also be followed if the ACP test is not satisfied.

Proposal

The proposal would create certain safe harbors that would, in effect, deem either the ADP test or the ACP test, or both, to have been satisfied with respect to elective deferrals and matching contributions if the plan meets certain design and notice criteria. The ADP test would be deemed to have been satisfied if (1) the plan either (a) provided matching contributions with respect to all nonhighly compensated employees equal to 100 percent of elective deferrals up to 3 percent of compensation, and 50 percent of elective deferrals between 3 and 5 percent of compensation, or (b) pro-

vided nonelective contributions equal to at least 3 percent of compensation to all nonhighly compensated employees eligible to participate in the plan, and (2) provided notice within a reasonable period before the beginning of a year to all employees eligible to participate of their rights and obligations under the plan. Certain alternative matching formulas would be allowed, subject to nondiscrimination requirements.

The ACP test would be deemed to have been satisfied with respect to matching contributions if the design and notice criteria relating to the ADP test were met and, in addition, (1) matching contributions were not made with respect employee contributions or elective deferrals in excess of 6 percent of an employee's compensation, (2) the level of matching contributions did not increase with the level of employee or matching contributions, and (3) the rate of matching contributions at each level of compensation was no higher for highly compensated than nonhighly compensated employees.

Employer matching and nonelective contributions used to meet the safe harbor requirements would be required to be nonforfeitable and subject to restrictions on withdrawals.

The proposal would also modify the standards for determining which excess deferrals and matching contributions to distribute first in the event the ADP or ACP tests are not passed and require any distributions to be made to highly compensated employees on the basis of the respective amount of contributions made on their behalf.

Administration Position

We oppose the proposed modifications to the nondiscrimination tests under sections 401(k) and 401(m) which would eliminate current law testing based on actual contributions. The proposals represent a significant change in policy, not merely a simplification. We believe they would seriously erode current policies against discrimination in retirement plans. We believe that the principal sources of complexity in this area are not the basic ADP and ACP tests but rather the rules applicable to the distribution and recharacterization of excess deferrals and contributions. Thus, we believe that simplification of these rules—not abandonment of the fundamental policy underlying these nondiscrimination rules—should be the simplification objective in this area.

In the case of plans which permit employees to elect the amount to be contributed on their behalf, existing law takes into account the fact that higher-paid employees will normally choose to defer a higher percentage of their income than lower-paid employees. Thus, the ADP and ACP tests permit deferral percentages for the high-paid and low-paid employees to be separately averaged and build in a disparity in favor of the higher-paid. In effect, the elective deferrals on behalf of highly compensated employees are leveraged off of the contributions which lower-paid employees actually make to the plan.

Cash or deferred plans are extremely popular today. In fact, as illustrated in Table I below, IRS data indicates that an increasingly large number of employers continue to establish and maintain these plans even though ADP and ACP testing is required, and even though the Tax Reform Act of 1986 substantially tightened the statutory requirements.

Table I.—NUMBER OF 401(K) PLANS

[Based on Form 5500 filings]

	1985	1986	1987	1988
Form 5500	6,942	8,842	10,486	10,645
Form 5500-C	17,499	17,228	22,088	26,341
Form 5500-R (Estimated)	22,203	21,859	21,947	26,756
Total	46,644	47,929	54,521	63,742

SOURCE: Internal Revenue Service, Employee Plans & Exempt Organizations, July 31, 1990

It is not at all clear what effect substituting a design-based qualification system for the ADP and ACP tests will have on the participation of nonhighly compensated employees in cash or deferred arrangements. The present-law ADP and ACP tests provide an clear incentive for employers to design a plan that is attractive to rank-and-file employees and to make every effort to communicate the plan to those employees, since the actual level of participation by those employees directly affects the permitted level of deferrals by highly compensated employees. By contrast,

while the proposal does require notice of the plan to be given to eligible employees, a design-based test provides *no incentive* to provide benefits in excess of the statutory minimum. In fact, such a test *discourages* employers from encouraging rank-and-file employees to participate since, once the design-based criteria have been met, any additional participation by the nonhighly compensated generally increases the cost of a plan.

Of the various sources of complaint about the ADP and ACP tests, we believe that the rules for correcting excess contributions are the most significant. Ways to simplify those rules while retaining the present-law ADP and ACP tests should be explored.

We also believe that one way to simplify the current rules would be to base the ADP and ACP tests on the prior year's average deferral and average contribution percentages for nonhighly compensated employees. This approach would make the results of the tests more predictable and would significantly reduce the likelihood of excess contributions because an employer would need to monitor currently only the elections of highly compensated employees. Indeed, excess contributions might be avoided altogether under such an approach if each highly compensated employee were permitted to defer no more than the prior year's average deferral percentage for nonhighly compensated employees plus the disparity otherwise permitted under those tests. This rule would be similar to the present-law rule for elective deferrals under simplified employee pensions.

TITLE II—DISTRIBUTIONS

Section 201. Taxability of Beneficiary of Employees' Trust

Present Law

Distributions from qualified plans and other tax-preferred retirement programs are generally subject to income tax upon receipt. Premature distributions, generally those made before age 59½, may also be subject to a 10-percent additional tax. A number of special rules may alter the general rule if applicable.

Rollovers

Current income tax and, if applicable, the additional tax on a distribution can be avoided if the taxable portion of an eligible distribution is "rolled over" to another qualified plan or Individual Retirement Account ("IRA"). Only certain distributions (generally distributions that are either "qualified total distributions" or "partial distributions) are eligible for rollover treatment. As only the taxable portion of a distribution is eligible for rollover treatment, after-tax employee contributions may not be rolled over.

Lump Sum Distributions

Capital Gains and Forward Averaging

Certain lump sum distributions are eligible to be taxed under special rules. Generally, these rules result in a lower rate of tax than would otherwise apply to a distribution, but may only be used with respect to one distribution in an employee's lifetime.

A participant or beneficiary may be able to elect to use the 5-year forward averaging rules with respect to a lump sum distribution if certain requirements are met. If a lump sum distribution is received before 1992, the recipient may also be able to elect to have the portion of the distribution attributable to pre-1974 plan participation taxed at capital gains rates.

Participants who attained age 50 before January 1, 1986, have three additional options which may reduce the rate of tax on a distribution. First, instead of using the 5-year forward averaging rules, they may continue to use the 10-year forward averaging rules available before the Tax Reform Act of 1986. Second, they may use the 5-year and 10-year forward averaging rules even if they are younger than the currently prescribed age requirement when they receive a distribution, if all of the other requirements for using those rules are met. Finally, they may elect to have the entire portion of a lump sum distribution attributable to pre-1974 participation taxed at a 20 percent rate.

Net Unrealized Appreciation

If a lump sum distribution includes securities of the employer corporation, the "net unrealized appreciation" ("NUA") in the employer securities is generally not subject to tax until the securities are sold, unless the recipient elects to have the normal distribution rules apply. When the securities are sold, the NUA is treated as long-term capital gain. If a distribution is not a lump-sum distribution, only the

NUA attributable to the employee's own contributions may be excluded from income under these special rules.

Proposal

The proposal would eliminate most of the restrictions on the types of distributions eligible for rollover treatment, and would eliminate 5-year forward averaging for lump sum distributions. It would, however, continue to prohibit the rollover of employee contributions. It would also retain the current law treatment of NUA, and the special capital gains and forward averaging rules available to participants who attained age 50 before January 1, 1986.

Administration Position

We believe that the qualified plan distribution rules are an excellent candidate for simplification. The tax treatment of qualified plan distributions is unnecessarily complex. The statutory rules for determining when a distribution can be rolled over into another qualified plan or IRA run well over 2000 words, and present innumerable interpretive issues. The steady accumulation of special rules and tax preferences over time has resulted in a statutory scheme with no clear structure or underlying rationale. Moreover, the burden of this complexity falls primarily on plan participants and beneficiaries, who must understand the rules (or hire an attorney or accountant to help them) to make use of them. By way of example, the forward averaging and other tax preferences applicable to lump sum distributions were added at a time when marginal tax rates were much higher than they are today and taxpayers faced a multitiered rate structure. Given the 1986 changes in the basic structure of the individual rates and brackets, these highly complex provisions are no longer needed. This would be particularly true if rollovers were liberalized as contemplated by the bill.

We could support this portion of the bill if the proposal were modified in several ways. First, no true simplification of the tax treatment of distributions is possible without eliminating the NUA exclusion. Retention of the exclusion requires the retention of the concept of a lump sum distribution, which is one of the principal sources of complexity under current law. The exclusion is no longer necessary to protect participants from possible inability to pay tax on a distribution, because, under the proposal, lump sum distributions would always be able to be rolled over into a qualified plan or IRA. Also, the computation of NUA on employer securities needed to apply to apply existing law creates significant recordkeeping and basis determination requirements for taxpayers. The determination of the qualified trust's cost basis for employer securities purchased at various times and for various prices is a burden even for computerized recordkeepers.

Second, we believe that the special transition rules making certain preferential treatment available to taxpayers who attained age 50 before January 1, 1986, should be eliminated. Most taxpayers who are now currently eligible to use 5-year forward averaging are also eligible to use these grandfather rules (because any individual who is now over 59½ was also 50 years or older in 1986). Furthermore, the 10-year forward averaging rules are generally more advantageous for them unless the size of their lump sum distribution is very large. For most taxpayers, then, the repeal of 5-year forward averaging alone will have little effect in short-term, and will not appreciably simplify the determination of their tax liabilities.

Section 202. Qualified Plans Must Provide for Transfers of Certain Distributions to Other Plans

Current Law

Current law places various restrictions on pre-retirement distributions of benefits from qualified plans. When a permissible distribution is made from a plan, it generally is made directly to the participant or beneficiary and is subject to income tax and, in the case of a premature distribution, a 10-percent additional tax. Under certain circumstances, the recipient of a qualified plan distribution can avoid current income taxation and any 10-percent additional tax by rolling the distribution over into another qualified plan or IRA. Similar rules apply to tax-sheltered annuities. The circumstances under which such rollovers are permitted under current law are limited, however, and the rules applicable to them are very complex.

Proposal

The proposal would require qualified plans to make "applicable distributions" in the form of direct trustee-to-trustee transfers to "eligible transferee plans." Applicable distributions would generally include any distributions over $500 permitted to be made by a plan that would have been subject to the 10 percent additional tax on early distributions if they had been distributed directly to the participant or benefi-

ciary. Exceptions to the required transfer provisions would be provided for certain distributions, including any distribution after the employee attains age 55, and distributions of employee contributions.

Eligible transferee plans would include IRAs and qualified defined contribution plans that accepted such transfers. Under the proposal, however, qualified plans would not be required to accept such transfers.

Administration Position

The Administration is continuing to study the issues which are addressed in the proposal. Figures indicate employees are spending a significant portion of their retirement savings before retirement by virtue of failing to roll over distributions received on change of employment. The Department of Labor has serious concerns about the implications of the losses of retirement savings. Finding an effective and affordable way to reduce those losses is clearly important. We have been working with the Department in evaluating possible solutions, we will continue to cooperate with efforts to address this important concern. However, we do not endorse the proposal today because of tax policy concerns, not the least of which is revenue.

Section 203. Required Distributions

Current Law

Under current law, distributions under most tax-favored retirement arrangements must begin by no later than April 1st of the calendar year following the calendar year in which the participant attains age 70½, regardless of when the participant retires. This requirement generally applies to all qualified plans, IRAs, tax-sheltered retirement annuities and custodial accounts, and eligible deferred compensation plans of certain governmental and tax-exempt employers.

Proposal

The proposal would amend current law to return to the law in effect prior to the changes made by the Tax Reform Act of 1986. Thus, distributions would generally be required to begin by no later than April 1st of the calendar year following the later of (1) the calendar year in which the participant attains age 70, or (2), except in the case of distributions from an IRA or to a 5-percent owner of the employer, the calendar year in which the participant retires. In the case of an employee who is permitted to delay required distributions until after retirement, the proposal would require the employee's accrued benefit to be actuarially increased to take into account the period after age 70 during which the employee does not receive distributions under the plan.

Administration Position

We do not oppose allowing a delay in required distributions until actual retirement except with respect to 5-percent owners, provided that the actuarial adjustment required in the case of delayed distributions is fair and realistic.

TITLE III—MISCELLANEOUS

Section 301. Treatment of Leased Employees

Current Law

Section 414(n) of the Code provides that, for purposes of certain retirement and welfare benefit provisions of the Code, a leased employee is treated as an employee of the recipient of the leased employee's services. In order to be treated as a leased employee, a person must not be a common-law employee of the recipient and, in addition, must meet three requirements. First, the person must provide services to the recipient pursuant to an agreement between the recipient and a third-party leasing organization. Second, the person must provide the services to the recipient on a substantially full-time basis for at least one year. And, third, the services must be of a type historically performed by common-law employees in the business field of the recipient.

Proposal

The proposal would eliminate the third requirement that the services be of a type historically performed by common-law employees in the business field of the recipient. In place of the "historically performed" standard, the proposal would substitute a new requirement that the services be performed under the control of the recipient.

Administration Position

We do not oppose the proposal because we understand its intent is to limit section 414(n) to the abuses Congress originally sought to target when it enacted the section in 1983. The proposal aims to overturn the expansive reading of the "historically performed" standard adopted in proposed regulations issued under that section in August 1987. From an administrative perspective, we intend to withdraw those portions of the proposed regulations relating to the "historically performed" standard under section 414(n) and to reissue them in substantially modified form in order to achieve much the same objective as the proposal. Future administrative guidance, of course, will be influenced by the proposal now under consideration.

We believe that any new standard adopted by Congress should be clear in its application to specific cases. In this regard, we suggest that detailed examples be provided to demonstrate the intended application of the standard. In particular, it should be made clear that the term "control" in this context is not to be determined by reference to employment tax concepts. Furthermore, control should be determined based on the substance and not merely the form of the arrangement adopted by the parties. The new standard should also be crafted so that it unambiguously covers cases of abuse without at the same time burdening employers with unnecessary testing under the statute. We are willing to work with the Congress to develop the proposal further along the lines we have suggested.

Section 302. Elimination of Half-Year Requirements

Current Law

A number of employee benefit provisions, such as those relating to permissible and required distributions from tax-qualified retirement plans, are based on the attainment of age 59½ or age 70½.

Proposal

Under the proposal, the half-year requirements would be eliminated so that each reference to age 59½ would become one to age 59 and each reference to age 70½ would become one to age 70.

Administration Position

We do not support this proposal. We do not believe it appreciably simplifies current law.

Section 303. Plans Covering Self-Employed Individuals

Current Law

Special employer aggregation rules apply to certain self-employed owner-employees participating in a tax-qualified retirement plan and controlling more than one business. The control group rules applicable to all employers under section 414 (b) and (c) also apply to businesses controlled by self-employed owner-employees.

Proposal

The proposal would eliminate the special employer aggregation rules for self-employed owner-employees and would leave the generally applicable control group rules in place.

Administration Position

We do not oppose the proposal. The generally applicable control group rules should be sufficient to ensure against possible abuses with respect to plans maintained by businesses controlled by self-employed owner-employees.

Section 304. Full-Funding Limitation of Multiemployer Plans

Current Law

Deductible contributions may not be made to a tax-qualified pension plan that is fully funded. The full funding limitation is defined generally to mean the excess, if any, of the lesser of (i) 150 percent of current liability or (ii) the accrued liability (including normal cost) under the plan over the lesser of (i) the fair market value of the plan's assets or (ii) the value of the plan's assets determined under section 412(c)(2). Valuations of plan assets are required at least annually.

Proposal

The proposal would eliminate the 150-percent-of-current-liability prong in the calculation of the numerator of the full funding definition with respect to multiemployer plans. The proposal would also require valuations of multiemployer plans only every three years.

Administration Position

We oppose the proposal. It would provide a narrow exception to the generally applicable funding rules for one type of plan.

Section 305. Affiliation Requirements for Employers Jointly Maintaining a Voluntary Employees' Beneficiary Association

Current Law

Under Treasury regulations, a voluntary employees' beneficiary association ("VEBA") is not tax-exempt under section 501(c)(9) of the Code if it benefits employees who do not share an employment-related common bond. An employment-related common bond generally exists only among employees of the same employer (or affiliated employers), employees covered by a collective bargaining agreement, members of a labor union, or employees of unaffiliated employers doing business in the same line of business in the same geographic locale. The IRS has interpreted the same geographic locale requirement as prohibiting a VEBA from covering nonunion employees of unaffiliated employers located in more than one state or metropolitan area. The same geographic locale requirement was held to be invalid by the 7th Circuit in *Water Quality Ass'n Employees' Benefit Corp.* v. *United States,* 795 F.2d 1303 (1986).

Proposal

The proposal would exempt VEBAs maintained by unaffiliated employers from the same geographic locale requirement if they (1) are in the same line of business, (2) act jointly to perform tasks which are integral to the activities of each of the employers, and (3) act jointly to such an extent that the joint maintenance of a voluntary employees' beneficiary association is not a major part of the employers' joint activities.

Administration Position

We oppose the proposal. The same geographic locale requirement helps target the tax benefits available under section 501(c)(9) to organizations with the greatest need for support. The VEBA tax exemption was initially intended to benefit associations formed and managed by employees of a single employer or of small local groups of employers, to provide certain welfare benefits to their members in situations where much benefits would not otherwise have been available. Congress was concerned that such associations might not be viable without a tax exemption. By contrast, larger associations covering employees of unrelated employers in different geographic areas are more likely to be viable even without a tax exemption, and the benefits they provide are more likely to be able to be provided through commercial insurance.

The fact that unaffiliated employers would be required under the proposal to conduct certain joint activities does not address these concerns. Moreover, we are concerned that the nature and required level of joint activities under the proposal is so unclear that the exemption will apply to a large group of employers. This would have serious revenue consequences and, in addition, would undermine those provisions of the Code that prescribe the treatment of insurance companies.

Although we oppose the proposed exemption from the geographic locale requirement for the reasons state above, we understand that the one-state or metropolitan area rule may be too restrictive in states or metropolitan areas with too few employees in the same industry to form an economical multiple-employer VEBA. A better alternative to the proposal in the bill that would be more consistent with the purpose of section 501(c)(9) would be to limit VEBAs to a three-contiguous-state area, or a larger area if the Secretary determined that the employer group in the three-state area was too small to make self-insurance economical.

Section 306. Treatment of Certain Governmental Plans

Current Law

Excess benefit plans of governmental and tax-exempt employers providing benefits for certain employees in excess of the section 415 limitations on benefits and contributions under qualified plans are subject to the provisions of section 457, which include an annual cap on benefits of $7,500 (or, if less, 33⅓ percent of compensation).

Benefits payable under qualified defined benefit plans generally are limited to the lesser of $90,000 (indexed) or 100 percent of compensation. A number of circumstances may give rise to required adjustments to these limitations, including situations where benefits commence before age 62, in the case of a governmental plan, or where there is less than ten years of service or participation in the plan.

Proposal

The proposal would exempt governmental excess benefit plans from the provisions of section 457. The proposal would also exempt benefits under governmental plans from the 100 percent of compensation limitation. Finally, the proposal would exempt certain survivor and disability benefits under governmental plans from the 100 percent of compensation limitation, from the adjustment for pre-age 62 commencement, and from the participation and service adjustments generally required to be made to the section 415 limitations on benefits. The proposal would be effective for taxable years beginning after 1986.

Administration Position

We oppose the retroactive excess benefit plan proposal. The scope of the proposal is narrowly drafted to cover only excess benefit plans maintained by one limited group of those employers subject to section 457.

We oppose the proposal creating a retroactive exception to the 100 percent of compensation limitation. The proposal would violate the long-standing policy against permitting benefits payable under qualified defined benefit plans to exceed 100 percent of compensation, and does not present an appropriate case for making an exception to that policy.

We also oppose the survivor and disability benefits proposal. The proposal is retroactive and narrowly drafted to apply only to a limited group of employers.

Section 307. Modifications of Simplified Employee Pensions

Current Law

Under current law, an employer may establish a SEP that accepts elective salary reduction contributions. In order for such an arrangement to qualify, the employer generally may have no more than 25 nonexcludible employees, at least 50 percent of all nonexcludible employees must elect to make such contributions, and the deferral percentage of each eligible highly compensated employee must not exceed 125 percent of the average deferral percentage of all eligible nonhighly compensated employees. If an employer maintains a SEP (with or without a salary reduction feature), the plan generally must be provided to all employees who have performed service for the employer in at least 3 out of the last 5 years.

Proposal

The proposal would permit employers with up to 100 nonexcludible employees to set up salary reduction SEPs and would eliminate the 50-percent participation requirement. In addition, the proposal would exempt a salary reduction SEP from the otherwise applicable ADP test if a 3-percent nonelective employer contribution were made on behalf of all eligible nonhighly compensated employees. Finally, the proposal generally would require SEPs of all types to cover every employee with at least one year of service with the employer rather than 3 years of service out of the last 5.

Administration Position

We oppose the proposal to increase to 100 the maximum number of nonexcludible employees an employer may have in order to adopt a salary reduction SEP. We believe that the general rules applicable to elective deferrals are more appropriate for larger employers.

We also oppose the proposal to eliminate the 50-percent participation test and the proposal to create an exemption from the ADP test applicable to salary reduction SEPs. Our reasons for so doing are largely the same as those set forth earlier in this statement relating to section 105 of the bill. As a way of simplifying the administration of salary reduction SEPs, consideration could be given to modifying the average deferral percentage test applicable to such plans to operate based on the average deferral percentage for eligible nonhighly compensated employees as of the preceding year (or on a statutorily predetermined percentage for the first plan year of a salary reduction SEP in the case of an employer that has not previously maintained one.

We do not oppose the proposal to expand coverage under SEPs by generally including all employees with at least one year of service.

Section 308. Contributions on Behalf of Disabled Employees

Current Law

An employer may make certain nonforfeitable contributions to a tax qualified defined contribution plan on behalf of any disabled participant who is not highly compensated if an election is made.

Proposal

The proposal would permit nonforfeitable contributions to be made on behalf of highly compensated disabled participants and would waive the election requirement, if contributions were made on behalf of all disabled participants.

Administration Position

We would not oppose the proposal if it were modified to insure that the provision does not operate in a manner that discriminates in favor of highly compensated employees. We are concerned that, as presently drafted, contributions during disability could be provided for under a plan during years when the only disabled participants are highly compensated and such provisions could then be deleted in subsequent years when the only disabled participants were nonhighly compensated.

Section 309. Distributions Under Rural Cooperative Plans

Current Law

Distributions from cash or deferred arrangements may be made upon attainment of age 59½, and distributions from profit-sharing plans may be made in certain events, including attainment of a stated age. Distributions from pension plans (including money purchase pension plans) generally must not commence until retirement.

Proposal

The proposal would permit distributions after attainment of age 59 from a rural cooperative plan which includes a cash or deferred arrangement. Such distributions would not be limited to the cash or deferred portion of the plan. The proposal would be effective as if included in the Technical and Miscellaneous Revenue Act of 1988.

Administration Position

We oppose this proposal because it creates a retroactive special exception for a limited group of tax qualified plans. We believe the current law restrictions on preretirement distributions from pension plans are appropriate.

Section 310. Reports of Pension and Annuity Payments

Current Law

Persons maintaining or administering certain tax-favored retirement arrangements are required to file reports in the nature of information returns regarding the arrangements with the IRS and with the participants, owners, or beneficiaries under the arrangements. Under current law, failure to file the reports is subject to specific penalties rather than the generally applicable penalty for failure to file information returns.

Proposal

Under the proposal, failure to file reports regarding tax-favored retirement arrangements that are in the nature of information reports would be subject to the generally applicable penalty for failure to file information returns.

Administration Position

We do not oppose the proposal.

S. 2902 "CHURCH RETIREMENT BENEFITS SIMPLIFICATION ACT OF 1990"

Current Law

Church retirement and welfare benefit plans are subject to a number of special rules that are generally easier to satisfy than comparable rules applicable to plans maintained by other private employers. In some cases, church plans are exempt from those rules altogether.

For example, qualified church retirement plans are generally subject to pre-ERISA rather than current-law participation, coverage, vesting and funding requirements. They are also exempt from the accrual requirements, qualified joint and survivor annuity and qualified pre-retirement survivor annuity requirements, anti-alienation requirements, and a number of other requirements applicable to most qualified plans.

Similarly, church tax-sheltered annuities are exempt from all of the coverage, nondiscrimination and related requirements generally applicable to such annuities, and the limitations applicable to contributions under such annuities are higher than for comparable plans maintained by many other tax-exempt organizations. Church nonqualified deferred compensation plans are exempt from the deferral limits and other qualification requirements of section 457 of the Code. Finally, church group-

term life insurance plans are exempt from the nondiscrimination requirements generally applicable to such plans.

The definition of a church for purposes of these and other special rules varies, depending on the particular rule involved. For purposes of the special rules applicable to church qualified retirement plans, churches generally include churches and conventions or associations of churches, as well as certain organizations controlled by or associated with churches. The definition is generally the same for purposes of the rules applicable to church group-term life insurance plans, except that church universities, colleges, hospitals, and organizations whose basis for exemption is similar to that for church hospitals are excluded. The definition is significantly narrower, however, for purposes of the special rules applicable to tax-sheltered annuities and nonqualified deferred compensation plans, generally covering only churches and conventions or associations of churches, and certain qualified church-controlled organizations ("QCCOs") that do not derive a significant part of their income from the government or commercial activities.

Proposal

The proposal would change current law in three significant respects. First, it would consolidate the rules applicable to qualified church retirement plans in one new section of the Code. Second, it would eliminate differences among the definitions of churches for purposes of these and other special rules by generally adopting the definition used for purposes of group-term life insurance under current law. Finally, it would add a number of new special rules for church plans, as so defined, to the Code.

The proposed rules would exempt church plans from the trust requirement generally applicable to qualified retirement plans, and exempt qualified church retirement plans, tax-sheltered annuities, and self-insured medical plans from the nondiscrimination requirements applicable to such plans under current law. They would also narrow the definition of highly compensated employee for purposes of qualified church retirement plans (in some cases eliminating the one-highly compensated employee minimum under current law), eliminate ministers from consideration in testing retirement and welfare plans (including non-church plans) for compliance with applicable minimum coverage, nondiscrimination and similar rules, exempt church plans from the minimum participation requirements of section 401(a)(26), modify the vesting and coverage rules applicable to tax-sheltered annuities, limit the application of the aggregation rules to church organizations, and allow qualified voluntary employee contributions ("QVECs") for church plans.

Many of the changes discussed above would apply retroactively with respect to violations of the requirements of sections 401(a) and 403(b) and other rules for years beginning before January 1, 1990.

The proposal would also make a number of technical changes largely designed to clarify current law or make it easier to apply. These changes would include rules clarifying the ability of self-employed ministers to participate in church plans, and addressing a number of other issues.

Administration Position

The Administration opposes the proposal, except for certain technical changes that clarify current law or make it simpler to apply to church plans. Specifically,

1. We believe the proposed exemption from the trust and nondiscrimination requirements for most qualified church retirement plans and tax-sheltered annuities is not justified by differences in church organizational structures or polity, or other unique attributes of churches or church plans. Church employees are entitled to the same safeguards as employees of other organizations, regardless of their employer's internal administration. We have similar reservations about most of the other new special rules for church plans in the proposal. The proposed amnesty for such plans for plan years beginning prior to January 1, 1990, is contrary to our general policy against retroactive relief from prior compliance obligations.

2. We oppose the extension of the special rules currently applicable only to QCCOs to all church-controlled or affiliated organizations (other than hospitals and universities) to which the special qualified church retirement plan rules now apply, because it is inappropriate to provide special treatment reserved generally for churches to organizations that function more as secular charities or commercial enterprises. We are, however, sensitive to problems that exist in applying the QCCO definition, particularly the source-of-income rules, and would be willing to work with the staff to develop a simplified definition.

3. We oppose the consolidation of the special rules applicable to qualified church retirement plans in one section of the Code. We believe that the current statutory

approach of exempting church plans from certain provisions that are difficult to apply or inappropriate in the church plan context is the right approach, because it applies to the extent possible the same retirement policy for all employers and employees, and does not tend to perpetuate and enhance differences between the treatment of church and other plans.

4. Some of the technical items in the proposal, e.g., the clarification of the ability of self-employed ministers to participate in a church plan, and the rules dealing with asset pooling and self-annuitization, have the potential for clarifying or simplifying the application of certain provisions applicable to church plans, and we are willing to work with the staff to develop these more fully.

CONCLUSION

We welcome the opportunity to work with the Subcommittee to achieve meaningful simplification of the employee benefit provisions of the Code. S. 2901 contains a number of provisions which merit careful consideration in achieving this goal. I must end where I began, however—the Administration's final judgment on these proposals must be postponed until the revenue effects of the proposal are evaluated in the context of a final legislative package.

PREPARED STATEMENT OF ANTHONY C. WILLIAMS

INTRODUCTION

Mr. Chairman, my name is Anthony C. Williams and I am the Director of the Retirement, Safety, and Insurance Department for the National Rural Electric Cooperative Association ("NRECA"). I am here to express in the strongest possible terms NRECA's support for S. 2901, the "Employee Benefits Simplification Act." We believe that enactment of this bill would provide historic simplification of the rules regarding qualified retirement plans. Such simplification would, in turn, provide a major stimulus to the establishment and enhancement of retirement plans.

NRECA also wholeheartedly supports the provision of the bill that clarifies the law with respect to voluntary employees' beneficiary associations ("VEBAs"). This provision clarifies the extent to which different employers may maintain a common VEBA and thus achieve the significant health care cost savings that are crucial to expanding access to health care in this country.

NRECA

NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems serve over 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Various programs administered by NRECA provide pension and welfare benefits to over 125,000 rural electric employees, dependents, directors, and consumer-members in those localities.

NRECA has for many years been deeply interested in retirement and health care policy. In this regard, NRECA has sponsored studies of both areas, such as "Retirement Coverage in Smaller Firms: Evidence and Policy Implications," "Retirement Coverage in Smaller Firms: Toward a Solution," "Health Care Needs, Resources, and Access in Rural America," "The NRECA Survey of Health Coverage in Smaller Firms," and "The NRECA Plans and the Minimum Health Benefit." NRECA has made these studies available to Members of Congress and their staffs, as well as to officials within the Administration.

NRECA remains committed to the study of retirement and health care policy and to finding solutions to the vexing problems in these challenging areas.

THE NEED FOR SIMPLIFICATION OF THE RETIREMENT PLAN RULES

We believe that it is essential that the rules affecting qualified retirement plans be simplified. Before discussing why this need exists, it is important to clarify what we mean by simplification. Stated briefly, we view simplification as the elimination or modification of rules that impose administrative burdens on employers or employees that are not justified by tax policy or retirement policy. The rules in need of simplification have arisen not as the result of any one Act of Congress, but rather through the cumulative effect of years of layering one set of requirements on another. Under this view, the end result of simplification is not simply shorter statutes and regulations, nor does the end result include any fundamental change in tax policy or retirement policy. The end result is a very significant reduction in the time and money devoted to administering retirement plans.

We believe that this type of simplification will stimulate the establishment and enhancement of qualified retirement plans by lowering the major hurdle to such growth, which is the ever growing cost of plans. At the same time, this type of simplification will not undermine the important tax policy and retirement policy objectives of current law.

The need for this type of simplification exists with respect to both large and small employers, but is particularly acute with respect to the latter. Retirement plan coverage among employees of small employers is dismally low; NRECA's 1987 survey of employers in rural areas with 60 or fewer full-time employees revealed that less than 19 percent of the employers surveyed maintained a retirement plan. The survey also found that the primary reason for the lack of coverage was the cost of retirement plans. A simplification bill that would reduce this cost would have a major effect in raising the number of employees of small employers who can retire with dignity and security.

NRECA SUPPORT FOR S. 2901

S. 2901, if enacted, would achieve precisely the type of simplification that is described above and that we at NRECA believe is so desperately needed. The bill modifies burdensome rules that contribute little to tax policy or retirement policy.

This bill would not only stimulate the growth of the private retirement plan system, but would also play an important role in restoring the confidence of the business community in the tax system. Over the years, frequent changes in the tax law, as well as the creation of layers of burdensome requirements, have undermined businesses' respect for the tax system. This bill would not alone restore businesses' confidence and respect but it would certainly be an important step in the right direction and could serve as a signal to the business community that the lawmakers hear their concerns and want to address them.

Very simply, we at NRECA could not be more supportive of this bill.

SPECIFIC ISSUES

We would like to comment more specifically on certain provisions of the bill. However, we do not by any means intend to imply that we do not support the provisions not discussed or that we view such provisions as unimportant.

Section 401(k) plans.—In our view, the centerpiece of the bill's simplification provisions is the modification of the nondiscrimination rules applicable to section 401(k) plans. In general, section 401(k) plans are plans under which each employee decides how much to contribute to the plan and under which employee contributions are made on a pre-tax basis. Section 401(k) plans are probably the fastest growing type of retirement plan because of the flexibility they provide to each participant to plan for his or her own retirement needs. However, if any item has slowed the growth of section 401(k) plans, particularly among smaller employers, it is the application of complex nondiscrimination rules that require calculations based on the contributions made by each employee eligible to participate.

NRECA supports the policy objectives of the nondiscrimination rules. NRECA believes that the law should prevent qualified retirement plans from operating primarily for the benefit of highly compensated employees. However, we believe that the policy objectives can be achieved without the administrative burdens of present law.

Under present law, if an employer simply allows employees to make their own contributions under a section 401(k) plan, there is a significant likelihood that highly compensated employees will make much larger contributions than nonhighly compensated employees, even as a percentage of compensation, because highly compensated employees have more income not needed for current consumption. Thus, such types of plans often have problems under the nondiscrimination rules. In order to solve those problems, employers use various techniques. Two common and effective techniques include the use of "matching contributions" and "nonelective contributions." Matching contributions are contributions made by the employer on behalf of an employee based on the amount the employee himself or herself contributes. Matching contributions thus provide nonhighly compensated employees with a financial incentive to make their own contributions.

Nonelective contributions are contributions made by the employer on behalf of employees without regard to whether the employees made their own contributions. Nonelective contributions thus provide nonhighly compensated employees with a significant benefit even if they do not have sufficient disposable income to make their own contributions.

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As the level of matching or nonelective contributions is increased in a section 401(k) plan, it becomes increasingly likely that the plan will satisfy the nondiscrimination rules. Accordingly, when the matching or nonelective contributions reach a certain level, it seems unnecessary to require the employer to apply the burdensome nondiscrimination rules based on the actual contribution made by each eligible employee. In such circumstances, the nondiscrimination rules should be deemed satisfied without regard to the actual amount contributed by each eligible employee.

This is precisely what S. 2901 does. In general, under S. 2901, the nondiscrimination rules are deemed satisfied if the employer makes a matching contribution of a dollar for every dollar contributed by a nonhighly compensated employee, up to three percent of the employee's compensation, and a matching contribution of 50¢ for every dollar contributed by the employee between three and five percent of the employee's compensation. Alternatively, the bill provides that the nondiscrimination rules are generally deemed satisfied if the employer makes a nonelective contribution on behalf of each eligible nonhighly compensated employee of at least three percent of the employee's compensation.

There is no numerical formula that can demonstrate definitively that the levels of matching contribution and nonelective contribution chosen in S. 2901 are the correct ones. (For example, S. 2901 chooses a three-percent nonelective contribution as opposed to two percent or four percent.) It is rather a matter of judgment and line-drawing. Based on our own judgment and experience, however, we believe that the levels chosen by S. 2901 are fair and appropriate. If lower levels were permitted, more employers' plans would be deemed to satisfy the nondiscrimination rules, thus broadening the group relieved of a significant administrative burden. However, we are concerned that if the levels were lowered too significantly, the result would be a relaxation of the effect of the nondiscrimination rules that is not justified by the administrative relief.

On the other hand, if higher levels were required, the number of employers' plans that would enjoy relief from the burdensome application of the nondiscrimination rules would be dramatically reduced. We believe that any possible beneficial effect of such higher levels would be far outweighed by the increased administrative burdens that would result.

OTHER ISSUES RELATED TO SECTION 401(K) PLANS

We have focused our detailed comments on the section 401(k) rule described above. However, we would also like to emphasize our equally enthusiastic support of (1) the similar rule applicable to matching contributions under section 401(m) plans, (2) the new definition of highly compensated employees, and (3) the modified rules with respect to distributions from section 401(k) plans.

VEBAS

In general.—S. 2901 not only provides extensive simplification of the retirement plan rules but also provides a major advance in terms of health policy by clarifying the law with respect to VEBAs.

In general, VEBAs are trusts through which employers provide welfare benefits, such as health insurance, to their employees. The most important advantage of a VEBA is not found in the tax laws but rather in the fact that VEBAs provide small employers with a means of pooling their buying power and thereby reducing their health insurance costs. The reduction of the cost of health insurance is crucial to expanding the health insurance coverage of employees of small employers.

VEBAs also have certain tax advantages. These tax advantages were significantly curtailed by the Deficit Reduction Act of 1984 ("DEFRA"). *The provision of the bill relating to VEBAs would not modify any rule imposed by DEFRA.* On the contrary, the bill would enable small employers to maintain a VEBA, *subject to the DEFRA restrictions.*

In general, the current IRS position is that in order for different employers to maintain a common VEBA, the employers must either be (1) affiliated, or (2) in the same line of business and in the same geographic locale (such as within a single state). It is unclear under present law whether employers that are not subject to common ownership or common control may be considered "affiliated."

A narrow interpretation of affiliation, limiting it to the common ownership or control situations, would be inconsistent with sound health policy because such an interpretation would significantly reduce the ability of closely related small employers to band together to reduce their health costs. This result would also be inequitable because large employers, by virtue of their size, have access to such reduced costs.

Accordingly, NRECA wholeheartedly supports the provision of the bill that clarifies that employers are considered affiliated if they are in the same line of business and are closely related as measured by their joint activities. NRECA believes that this provision would serve important health policy objectives.

Multiple employer trusts.—We would like to emphasize that a VEBA maintained by such affiliated employers does not in any way resemble the abusive type of multiple employer trust that has caused concern among Congress, the Department of Labor, and state regulators. That concern relates to trusts that are marketed to unrelated small employers by third party entrepreneurs whose practices result in large gains for themselves and large losses for the small employers. A VEBA of the sort described in S. 2901 is almost invariably maintained by the affiliated employers themselves through a wholly controlled association that provides a broad array of ongoing services to the member employers. There is no third-party entrepreneur involved and thus no opportunity for the type of abusive practices causing the concerns.

In addition, we believe that Federal and state laws provide sufficient tools for regulators to prevent the abusive trusts. The current problem lies not in the laws, but in the enforcement of those laws. It would hardly seem appropriate for this problem, under which small employers are being victimized, to prevent legislation enabling small employers to use VEBAs to reduce their health care costs. The better answer would be for the laws to be enforced and to allow small employers the benefits of VEBAs.

The Administration's tax concerns.—The Administration has previously expressed tax-related concerns with a broader VEBA proposal, under which the "geographic locale rule" would not apply, so that unaffiliated employers could maintain a common VEBA solely on the basis of being in the same line of business. The Administration objected to this proposal on the grounds that it "would permit a VEBA to perform many of the functions of a nationwide insurance company, on a tax-exempt basis." We believe that the narrower rule set forth in S. 2901 addresses the concerns previously articulated by the Administration.

Even under a view of the law most favorable to the Administration, the basic distinction between an insurance company and a VEBA is that an insurance company provides insurance coverage to policyholders who typically have no relationship to each other. A VEBA, on the other hand, must provide coverage to employees who share an "employment-related common bond." In general, the IRS position is that employees share such a bond if their employers meet the tests described previously, i.e., that the employers are either (1) affiliated, or (2) in the same line of business and in the same geographic locale. *Accordingly, for example, under the IRS position, 100 employers with 100,000 employees in the same state could maintain a common VEBA even though the employers and employees have no relationship to each other other than being in the same line of business.* If such employees share an employment-related common bond, there can be little doubt that employees of a national group of employers share an employment-related common bond in the circumstances described in S. 2901, i.e., where their employers are not only in the same line of business but are integrally related to each other in ways that affect the employers' day-to-day operations.

Revenue effect.—We believe that the VEBA provision in S. 2901 should have little or no effect on Federal tax revenues. We believe that the provision is simply a clarification of the meaning of "affiliation" under present law.

Moreover, in the only court case to address the issue, the IRS position that employers in the same line of business must be in the same geographic locale was held to be invalid and thus not part of present law. *In the absence of any court case upholding the IRS position,* we submit that the geographic locale rule is not applicable. Without the geographic locale rule, the VEBA provision in S. 2901 does not permit any VEBA not permitted under present law and thus should not affect Federal tax revenues.

Three-state proposal.—Finally, we would like to mention one VEBA proposal that has been discussed in the past. The proposal, as most recently articulated by the Administration, would be "to limit VEBAs to a three contiguous-state area, or possibly larger area if the Secretary determined that the employer-group in the three-state area was too small to make self-insurance economical." Very briefly, we view this proposal as significantly more restrictive than present law, because, as noted, the geographic locale rule has been held invalid and thus not part of present law. Moreover, if this proposal were adopted in lieu of the provision in S. 2901, it would have a very adverse effect on health care policy as it would significantly limit small employers' ability to band together to obtain health insurance at a lower cost.

SEPS

Simplified employee pensions ("SEPs") were designed to be simple to establish and maintain. It was intended that SEPs would thus be an attractive option for employers, primarily small employers, that had failed to adopt a retirement plan due to the complex requirements. However, the attractiveness of SEPs to small employers has been undermined by the application of rules that are more restrictive than those applicable to other qualified retirement plans.

A 1989 report sponsored by NRECA entitled "Retirement Coverage in Smaller Firms: Toward a Solution" recommended that SEPs be "revised to increase their flexibility and encourage greater use while retaining their administrative advantages." This is precisely what S. 2901 does. For example, the bill significantly enlarges the group of small employers that may permit pre-tax employee contributions to SEPs by raising the maximum permissible number of employees from 25 to 100. The bill also provides that the special nondiscrimination rule applicable to such pre-tax employee contributions is deemed satisfied if the employer makes a nonelective contribution to the SEP on behalf of each eligible nonhighly compensated employee equal to at least three percent of the employee's compensation. In addition, the bill modifies the provision that currently requires SEPs to cover part-time employees that are not required to be covered by any other qualified retirement plan.

NRECA believes that the bill's SEP provisions, combined with the other retirement plan proposals discussed previously, could usher in a new era of broader retirement plan coverage among small employers.

PREPARED STATEMENT OF LARRY ZIMPLEMAN

The Principal Financial Group is a family of insurance and financial services companies with assets of more than $28 billion. Its largest member company, Principal Mutual Life Insurance Company (The Principal), is currently the sixth largest life insurance company in the nation ranked by premium income.

The Principal has 886,000 individual policy owners, 61,000 group employer customers, 21,000 pension contractholders, and 43,000 mutual fund share-holder accounts. In all, 6 to 9 million individuals and their families are served by the companies of The Principal.

Our main purpose in being here today is to discuss the effect of the Employee Benefits Simplification Act on smaller qualified plans. We will define "smaller plans" as plans involving the under 1,000 employee market.

The smaller end of the retirement plan market has been a main point of emphasis for us for many years. That is why The Principal traditionally sells more plans and group annuity contracts each year than anyone else. During 1989, for example, we sold over 3,500 contracts to fund pension and profit sharing plans.

These plan sponsors generally do not have the financial resources or the staff to assist them in designing and updating their pension plans. Our own representatives usually work in conjunction with the plan sponsor's agent or broker to try to design a plan that will work for them. We feel that all too often, input from these small plan sponsors is not gotten, or at least is not heard. That is why we appreciate the opportunity to be here today.

The Principal strongly supports the proposed Employee Benefits Simplification Act. In general, we are very encouraged by the proposed changes and feel they will help to ease the burden of pension and profit sharing plan sponsors nationwide. We applaud the proposed changes that allow partial rollovers and encourage terminated employees to make plan-to-plan transfers. Some will argue that the proposed bill doesn't go far enough to simplify pension benefits legislation. While other changes could (and should) be made, The Principal feels very strong that this bill is an excellent start to overall simplification. It offers badly needed relief to many overwhelmed plan sponsors throughout the nation. We heartily recommend its passage.

This bill deserves special attention because of what it intends to do--to simplify compliance for plan sponsors so they can concentrate more on what they do best--running their own businesses. The bill should allow sponsors to spend less time and money on administering their plans.

As this Committee is well aware, pension plan sponsors have been subject to many new laws since the passage of the Employee Retirement Income Security Act of 1974 (ERISA). Since its passage in 1974, an average of <u>one new law per year</u> has been passed that directly and significantly affects pension plans. None of these bills purported to simplify existing legislation and, in fact, did just the opposite. Unfortunately, there has been no consistent or comprehensive plan or policy behind these laws. Sponsors have been forced to spend more and more money on administrative, recordkeeping, and compliance issues. Many of these bills have been actual technical corrections to prior bills that were poorly conceived or drafted incorrectly. As sponsors spend more time (and money) on administrative matters, this leaves less resources for new or increased benefits for existing participants or to expand coverage to more employees. This bill rightly starts the pendulum swinging the other way.

SPECIFICS OF THE BILL

1. The proposed change to the definition of "Highly Compensated Employee" is a very positive one. The current definition in IRC §414(q) is unduly complicated and the proposed revision to (i) 5% owner, or (ii) more than $50,000 pay (indexed) will make it easer to identify highly compensated employees. We especially welcome the deletion of the "family aggregation

rule" which currently requires that family members of non-owners who are highly compensated employees are also considered as members of the highly-paid group.

2. The Principal also strongly supports the proposed change to use W-2 earnings as compensation under IRC §414(s). This change will provide one uniform definition of compensation for use throughout the plan--for testing for nondiscrimination, limits on contributions and benefits, and determination of highly compensated employees. The bill also allows flexibility to those sponsors who may wish to use some type of pay other than W-2 earnings.

3. The Principal supports the proposed change to the "Minimum Participation Rule" in IRC §401(a)(26). This change is the next best thing to total repeal of §401(a)(26), as it applies the 25 employee (formerly 50 employee)/40% rule to only defined benefit plans, where the potential for abuse in favor of an owner or highly paid employee is somewhat greater than under a defined contribution plan.

4. The addition of the safe harbors for qualified cash or deferred arrangements and matching contributions (i.e., 401(k) plans with an employer matching contribution) are also positive changes. We've found that many plan sponsors have great difficulty in understanding, let alone applying, the current average deferral and/or average contribution percentage test(s). These safe harbors are within a reasonable range and offer sponsors a great deal of potential relief from the hassles of constantly monitoring employee deferral percentages.

   The notice requirement should not be a burden on sponsors and, hopefully, it will encourage more employees to make contributions. Also, the change to refund deferrals in excess of the limits based on the actual amount deferred is a positive one.

   The Principal feels the ultimate goal would be the complete elimination of the tests as long as the employer contributions are made in the same percentage for all employees.

5. The Principal also supports the proposed changes to the "Distribution Rules." We feel the changes to encourage rollovers of partial distributions to an IRA or that encourage plan-to-plan transfers are also positive changes. Those changes should encourage and make it much easier for terminated employees to save more for retirement. We also support the repeal of the five-year forward averaging rule. The changes to the rollover rules make special five-year averaging unnecessary. This change will encourage plan payees to conserve their savings for retirement.

   The Principal feels that, in the interest of preserving plan dollars for retirement, consideration should be given to expanding the bill to further provide that no cash benefits above a certain threshold (say $5,000) be made available upon termination of employment. A plan need only to allow a vested plan participant to (i) roll over his or her money to an IRA or another qualified plan, (ii) have it transferred to another plan, (iii) have a deferred annuity purchased on his or her behalf, or (iv) require that the prior employer keep the assets in the original plan (there are funding vehicles available that would allow the employer to pass along the administrative costs of retaining those assets to the terminated participants).

   As a way of emphasizing the fact that a good portion of plan assets aren't being saved for the retirement years, in 1989 alone The Principal paid over $468 million in cash benefits to plan participants at termination of employment while paying just over $452 million in retirement annuities in that same year. (We paid another $80 million in cash retirement benefits in 1989.) These figures show that of a universe of 20,000 plans, collectively these plans paid nearly as many pre-retirement benefits as they did retirement benefits. Indeed, we've found many employers do little to discourage their former employees from taking cash. While some

of these former participants may save, roll over, or transfer to another plan all or part of these assets, our experience has shown that most participants spend this money well before retirement.

As an additional comment, we feel some consideration should be given to the total elimination of a cash retirement option as well. Consideration should be given to requiring plans to make only periodic payments or to roll over to an IRA.

Or, as a further disincentive to cash options at either termination or retirement, The Principal recommends that consideration be given to an increase in the excise tax under IRC §72(t) on early distributions from 10% to perhaps 25%.

The Principal also supports the change to the required distribution beginning date to the pre-Tax Reform Act of 1986 rules that allowed employees who were past age 70 to defer receiving their income until they actually retired.

6. The Principal also feels that the "Elimination of the One-Half Year" definition will help sponsors. Certainly, it is much simpler to tie a date to the year in which the employee's birthday occurs, not the 6 months after (or before) the birthday. Also, the rounding of cost-of-living changes to the nearest $1,000 will help, as will the rounding of the limit on employee deferrals to the nearest $100.

7. We are impressed that the bill's sponsors understand the administrative impact of this bill and have provided sponsors one year's relief in amending their plans to comply with the changes. This kind of foresight has been lacking in prior bills. As a result, sponsors are still digging out from the Tax Reform Act of 1986 and the flurry of pension-related bills passed in each of the next three years as well.

Those are our specific comments on the major highlights of the bill. As mentioned, we strongly urge that this bill be passed.

Beyond commenting specifically on the bill, we would offer the following comments on our nation's voluntary retirement system:

Employer-sponsored pension and profit sharing plans have long been considered one leg in the so called "three-legged stool" providing for the post-retirement needs of employees, along with Social Security and private savings. Several recent studies show that the number of new plans being started has decreased. Coverage within the active work force is shrinking. One study showed that smaller employers (under 50 employees) especially were reluctant to provide a plan for their employees.

One common reason for the decline in pension plan start-ups is administrative "complexity." Indeed, according to official IRS estimates, it takes an average plan sponsor with less than 100 employees over 72 person hours just to prepare the Form 5500C annual report for the plan. This estimate does not include the time needed to administer the plan on a day-to-day basis; it's merely an estimate as to how much time is needed to prepare the "average" annual report. If the trend continues, the three-legged stool could become wobbly. This could create heavier demands for Social Security benefits, especially since our national savings rate is currently low. This bill helps reduce much of that complexity. We feel more must be done to help ease the administrative burden on plan sponsors without increasing the potential for discrimination in favor of the highly paid group.

The Principal realizes how easy it is to sit back and criticize the current state of pension legislation. We aren't offering this statement because we believe our current system is bad. On the contrary, The Principal feels our nation's voluntary private retirement system is sound. Indeed, nearly 76 million Americans are currently covered under more than 900,000 pension and profit sharing plans. All told, these plans hold $1.8 trillion in plan assets--assets which will be available to help today's American workers enjoy their retirement years. Because our voluntary system is strong, we urge Congress to use caution and restraint when studying new proposals that would negatively affect retirement plans. Bills such as this are a definite step in the right direction, however. We might add that we feel that our private pension system is sound not _because_ of the current set of complex laws but _in spite of_ their complexity.

We strongly feel a national coalition on pension policy should be formed. The coalition should be a public group and should be charged with formulating a national pension policy to be used as a guideline or standard for all to follow: Congress, regulatory agencies and the private sector. The pension policy should set clear goals for our nation's private pension system and include concrete strategies for reaching those goals. In addition, a thorough analysis of the legislative impact and its subsequent regulatory burden as imposed by DOL or IRS guidelines should be required before any pension legislation is passed. We urge Congress to take action to create such a coalition.

Questions or comments may be directed to any of the following employees of The Principal:

Stuart Brahs, Vice President -- Federal Government Regulations: (202) 737-5930

Larry Zimpleman, Second Vice President -- Pension Operations: (515) 247-5651

Jack Stewart, Manager -- Pension Development Services: (515) 247-6389

PROPOSED PENSION SIMPLIFICATION BILL
COMMENTS BY THE PRINCIPAL FINANCIAL GROUP

The Principal Financial Group strongly supports Senator Pryor's proposed employee benefit plans simplification bill. In general, we are very encouraged by the proposed changes and feel they will simplify the lives of pension plan sponsors nationwide. We applaud the proposed changes that allow partial rollovers and encourage terminated employees to make plan to plan transfers. These steps will help ensure plan assets are available at retirement. We feel the proposed bill could be further strengthened to assure that assets are indeed available to pay retirement benefits, and that plans are not used as intermediary "savings accounts." In the spirit of helping devise a national retirement policy that encourages the retention of plan assets until retirement age, we offer these comments on the following points of the proposed bill:

CODE SECTION	PROPOSED CHANGE	REACTION	SUGGESTIONS/COMMENTS
Highly Compensated Employee Definition IRC §414(q)	5% owner or more than $50,000 pay (indexed)	STRONGLY SUPPORT. This change is definitely needed and will ease sponsors' administrative burdens without increasing potential discrimination.	Positive change.
Compensation IRC §414(s)	Use W-2 earnings; provides uniform compensation definition throughout plan for 415 limits, non-discrimination rules and determination of highly compensated employees.	STRONGLY SUPPORT. This would be a tremendous improvement over the current "hodge-podge" of compensation definitions and how they're used in plans. Vast majority of of plan sponsors will like.	If the base pay alternative is used, may need to provide a definition to follow.
Minimum Participation IRC §401(a)(26)	Only defined benefit plans subject to; these must benefit lesser of 25 employees/40% of total employees.	SUPPORT. Proposal to drop defined contribution plans is good. Smaller defined benefit plans won't be hurt by this if they are set up for bona fide employee groups.	Next best thing to complete repeal of §401(a)(26).

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CODE SECTION	PROPOSED CHANGE	REACTION	SUGGESTIONS/COMMENTS
Average Deferral Percentage Test IRC §401(k/m)	Offers several safe habor alternatives that would eliminate the need for average deferral or average contribution percentage tests.	SUPPORT. These safe harbors will encourage many sponsors to contribute more for the non-highly compensated group so as to avoid the ongoing testing hassles.	A good first step. Eventual goal should be complete elimination of the deferral percentage test(s), as long as any matching or discretionary contributions are made in the same percentages for all employees.
Distributions IRC §402	Allows partial rollovers. Encourages plan to plan transfers.	SUPPORT. Will encourage continued savings of plan assets. (See further comments below.)	Make sure the designated transferee plan (the receiving plan) is required to accept any designated transfer.
Miscellaneous	Elimination of 1/2 years. Rounding of various dollar limits to nearest $1,000.	STRONGLY SUPPORT.	Excellent ideas.

COMMENTS ON PLAN DISTRIBUTIONS:

The Principal feels that, in the interest of preserving plan dollars for retirement, consideration should be given to expanding the bill to further provide that no cash benefits above a certain threshold (say $5,000) be made available upon termination of employment. A plan need only to allow a vested plan participant to (i) roll over his or her money to an IRA or another qualified plan, (ii) have it transferred to another plan, (iii) have a deferred annuity purchased on his or her behalf, or (iv) require that the prior employer "keep" the assets in the original plan (there are funding vehicles available that would allow the employer to pass along the administrative costs of retaining these assets to the terminated participants).

As a way of emphasizing the fact that a good portion of plan assets aren't being saved for the retirement years, in 1989 alone The Principal (which provides full services to nearly 20,000 pension plans nationwide) paid over $468 million in cash benefits to plan participants at termination of employment while paying just over $452 million in retirement annuities in that same year. (We paid another $80 million in cash retirement benefits in 1989.) These figures show that of a universe of 20,000 plans, collectively these plans paid nearly as many pre-retirement benefits as they did retirement benefits. Indeed we've found many employers encourage their former employees to take cash (most likely to reduce the sponsors' reporting burdens). While some of these former participants may save, rollover, or transfer to another plan all or part of these assets, our experience has shown that most participants spend this money well before retirement.

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COMMUNICATIONS

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is the organization designated by the actuarial profession to represent its views on public issues in the United States. The Academy's 25-member Pension Committee is made up of representatives from all areas of pension practice. The committee includes actuaries who work with small as well as large plans, defined benefit plans and all types of defined contribution plans, union and nonunion plans, single-employer and multiemployer plans, and public as well as private plans. The Academy's membership, from which members of the Pension Committee are drawn, includes more than 3500 of the 4150 professional actuaries that are enrolled to practice under the Employee Retirement Income Security Act of 1974 (ERISA). As in other professions, individual actuaries may take exception to the positions adopted by the committee.

The purpose of this testimony is to state the strong support of the American Academy of Actuaries Pension Committee for S. 2901, The Employee Benefits Simplification Act, and its companion House bill, H.R. 5362. The Academy committee recognizes that the bills do not go nearly far enough in achieving the degree of simplification possible without undermining, the objectives of the current tax code provisions relating to qualified plans. Nonetheless, the changes proposed are in the right direction. They begin the process of strengthening private-sector, employer-sponsored retirement programs through greater simplification of the rules governing qualified plans. The bills are a first step, though perhaps a small one, toward enhancing qualified plan benefits for their intended, tax-favored purpose.

With regard to the specifics of the bill, the Academy Pension Committee strongly supports the proposed change to the minimum participation rules in Code Section 401(a)(26). This change would apply the 25 employee/40% rule only to defined benefit plans, where the potential for abuse in favor of highly compensated employees is' greater than under a defined contribution plan.

In addition, the Academy committee agrees with the authors of the bills that there is unnecessary complexity in determining and applying the current average deferral percentage and the average contribution test for qualified cash and deferred arrangements and matching contributions under 401(k) plans. The committee supports the proposed safe harbors and believes that they are within a reasonable range. The committee does note, however, that, although the 401(k) tests very much need to be simplified, utilization rules do serve a beneficial social function. Numerous studies have shown that employees generally are uninformed about their retirement benefits. Employers appear to make little effort to explain these benefits to workers and workers appear not to ask. The exception to this general situation is 401(k) plans, where the utilization rules make good employer/employee communication necessary to assure that appropriate numbers of rank and file workers participate in the plan.

The Pension Committee supports the proposed changes to the distribution rules under Code Section 402. These changes would encourage workers who change jobs to retain their pension savings for retirement. The Academy committee does not agree with others who assert that these rules would be ineffective in preserving benefits for retirement. As practioners, members of the committee observed that the provision of annuities for spouses increased when plans were mandated to include joint and survivor options. Similarly, the committee believes the proposed changes to encourage rollovers of partial distributions to an IRA and plan-to-plan transfers will encourage terminated employees to save more for retirement.

The committee strongly supports the proposed change to the definition of highly compensated employee. The current definition in Code Section 414(q) is unduly complicated and the proposed revision to (1) 5% owner or (2) more than $50,000 pay (indexed) will make it easier to identify highly compensated employees. Further, the committee applauds the deletion of the family aggregation rule which currently requires that family members of non-owners who are highly compensated employees are also considered as members of the highly-paid group. The family aggregation rules unfairly penalize family members who are highly compensated and make a significant economic contribution to the employer, especially in small firms. The committee also notes that 414(q) is an area where even further simplification could be achieved. A single test of highly compensated based only on compensation would seem sufficient to achieve the original intent of the Congress. The current compensation threshold of $50,000 (indexed) might also be raised. The top-heavy rules could also be removed from the Internal Revenue Code since their objectives are now met by provisions implemented as part of the Tax Reform Act of 1986.

The committee agrees with the proposed change to use W-2 earnings as compensation under Code Section 414(s), providing a uniform definition of compensation for use throughout the plan, for testing nondiscrimination, limits on contributions and benefits, and determination of highly compensated employees. The bill also allows flexibility to those sponsors who may wish to use some type of pay other than W-2 earnings.

Finally, the Pension Committee supports the provisions in S. 2901, that clarifies current law with respect to Voluntary Employees' Beneficiary Associations (VEBAs). Code Section 501(c)(9) describes VEBAs in rather broad terms, with certain additional requirements to satisfy tax exempt status specified in regulations. VEBAs are especially important in the provision of health insurance because they provide smaller employers with a means of pooling their buying power and their risks. The subsequent reduction in the cost of health insurance is important to expanding the access to health insurance for employees of smaller employers. Moreover, even medium-sized employers can obtain savings in health insurance costs through VEBAs. Such reductions in the cost of health insurance are beneficial to employees, and, further, they reduce the Federal tax expenditures required to support the current level of health insurance. Under current law it is unclear whether employers that are not subject to common ownership or common control may be considered "affiliated." Accordingly, the Pension Committee regards the broader interpretation of "affiliated employers" as a significant guaranty that will enable closely related small employers, as measured by their joint activities, to band together to reduce their health insurance costs.

As stated above, although this legislation is a good beginning, S. 2901 and the companion House bill, H.R. 5362, do not go nearly far enough. The additional provisions under the tax code for integrating benefits under qualified plans could be greatly simplified and still maintain their congressional intent. For example, in most cases, the "two-for-one" rule alone achieves Congress6 primary objective in revising the integration rules as part of the Tax Reform Act of 1986. The "two-for-one" rule, then, could be made the primary test with secondary limits for defined contribution plans at the current 5.7%, excess plans at 25% with at least 20 years of service, and offset plans at 40% with at least 20 years of service. Age 65, rather than the Social Security normal retirement age, could be used for all purposes.

There are also other areas where the committee believes substantial simplification is possible. Each area will require careful thought and analysis to ensure that the original intentions elf Congress are maintained and that potential abuses are clearly understood and curtailed.

CONCLUSION

The members of the American Academy of Actuaries Pension Committee believe that it is very important to the efficient administration of the tax law and to taxpayers' confidence in the tax system for Congress to strive to make the language of the law understandable and clear. To the extent that complexity exist in the law and clarifications are necessary to make statutory provisions more understandable, we believe that Congress should address these situations as quickly as possible so that taxpayers can plan business affairs with certainty knowing that they are in compliance with existing law.

Whether it is willful or unintentional, most often, it is the complex rules that are the easiest to abuse, and given that they are subject to misinterpretation, they become more costly to administer. Subsequently, it becomes more difficult to ensure that these rules are fairly enforced. An example of this complexity can be examined in the approach taken to the recently proposed regulations under 401(a)(4). The In-

ternal Revenue Service has relied heavily on the development of safe harbors in these regulations as a means to ensure reasonable compliance. We applaud IRS's efforts to develop workable, practical rules under Section 401(a)(4) and their willingness to work with practioners in developing final regulations. However, the Academy Pension Committee notes that the extensive use of safe harbors is required to assure reasonable compliance because the tax code's complexity in this area makes "facts and circumstances" tests extremely difficult to perform and difficult to monitor.

The Academy Pension Committee applauds the sponsors of The Employee Benefits Simplification Act for their efforts to begin the process of tax simplification, in one of the most complex areas of the Internal Revenue Code, and we enthusiastically endorse this proposed legislation.

AARP,
Washington DC, August 3, 1990.

Hon. DAVID PRYOR, *Chairman,*
Subcommittee on Private Retirement Plans and Oversight of the IRS,
Washington, DC.

Dear Senator Pryor: The American Association of Retired Persons commends you for your efforts to simplify the pension laws. Your bill, S. 2109, the Employee Benefits Simplification Act, provides a starting point for discussions on changes to simplify and improve the current pension system. The Association wishes to highlight some of the bill's important improvements, as wall as our concerns with some of the bill's proposed changes.

The bill proposes a number of changes In the currant distribution rules which would substantially improve this difficult area of pension law. In particular, the Association believes that the general requirement that most distributions greater than $500 be transferred directly to an Individual Retirement Account or other retirement vehicle is an important step. This effort to promote pension preservation will help retain pension money until it is needed in retirement, thus fulfilling the basic purpose of a retirement plan. One of the major problems with currant distribution rules is the encouragement of direct cash-outs to employees, who most often immediately spend money that had been initially set aside for retirement. This change will better preserve pension money and serve as a necessary incremental step toward greater portability of pension benefits. The bill should ensure, however, that the current joint and survivor annuity requirements, which are of particular importance to older women, are maintained.

The bill also modifies the current definition of highly compensated employees and the definition of compensation. The new streamlined definitions simplify an important component of a number of applicable pension tests generally intended to prevent discrimination in favor of higher-paid employees. The Association strongly believes that the proposed definition of a higher-paid employee as one who earns nearly $60,000 (indexed) in 1991 (not including certain forms of compensation) can be reduced. In addition, any attempts to further increase the proposed level of compensation would undermine the nondiscrimination rules.

The bill also proposes to facilitate the establishment of 401(k) plans by providing a safe harbor from the current nondiscrimination tests. The safe harbor is satisfied if the employer provides a matching contribution of 100 percent of the first percent an employee contributes, and 50 percent of the next 2 percent contributed. This match is similar to the one provided by the Federal Employees Retirement system (FERs). While this safe harbor will provide administrative ease, the Association is very concerned that the proposal will have the unintended effect of eroding protection for lower-income employees.

Under current 401(k) tests, the employer *must* have participation by a certain percentage of lower-paid employees in order to qualify. These requirements insure that any tax benefit for employee benefit plans equitably reaches the greatest number of employees, particularly lower-income employees. Under current law, the incentive is for the employer to encourage participation by rank and file employees in order to qualify the plan. Under the proposed safe harbor, the employer *need not* have participation by lower-income employees. The offer of a match is deemed sufficient, regardless of whether any lower-income employees actually contribute to the plan. In fact, because the employer must match any contribution, the employer has a financial incentive to exclude employees from the plan.

While the proposed notice requirement to employees for the 401(k) safe harbor is essential (and should be readable and understandable by the average employee), it is

clear that matching contributions alone are insufficient to draw many employees into the plan. Individuals who cannot afford contributions, often those most in need, are therefore left without any plan benefits. In order to ensure that lower-paid employees receive *some* plan benefits, the Association strongly recommends that the safe harbor be modified to include a mandatory 1 percent contribution for all non-highly compensated employees. This addition, which the model FERS plan already contains in order to ensure that all employees get some plan benefits, is essential to ensure the continued fairness of 401(k) plans.

In addition, the bill proposes lowering the current minimum participation rule from the current 50 employees (or 40 percent of all employees) to 25 employees, and would not apply even this standard to defined contribution plans. The Association believes this change does not simplify current law, but merely relaxes an important rule, and should be deleted from the bill.

The bill also addresses the promising area of Simplified Employee Pensions (SEPs). The maximum number of employees eligible for salary reduction SEPs is expanded, but the bill needs to also include benefit protections such as minimum participation standards and joint and survivor annuity requirements. The bill should also improve non-salary reduction SEPs in an effort to expand pension coverage, particularly among small employers. In addition, the bill should prohibit integration of SEP plans for reasons of equity and simplicity.

Again, AARP commends you for putting forth a proposal to advance progress towards pension simplification. The Association believes that the bill addresses a number of complex and confusing areas of pension law with important proposals for improvement and simplification. A number of areas discussed above, however, merit additional consideration and modification. The Association looks forward to working with you and the Committee to address these concerns and to advance legislation to improve our nation's pension laws.

Sincerely,

JOHN ROTHER, *Director, Legislation and Public Policy.*

STATEMENT OF ADAPSO, THE COMPUTER SOFTWARE AND SERVICES INDUSTRY ASSOCIATION

ADAPSO is the trade association of this nations leading computer software and services firms. Its almost 600 corporate members supply the public with information technology services, systems and business application software for mainframe, mini-, and personal computers, integrated hardware/software systems and network-based information services.

Given the breadth of the Employee Benefits Simplification Act, S. 2901, ADAPSO has a significant interest, particularly with respect to those provisions pertaining to the treatment of leased employees. Specifically, ADAPSO is concerned that the enactment of the Section 301(a) "control test" without properly defining the terms or including examples will inadvertently cause the misclassification of information technology service workers as leased employees.

WHAT ARE INFORMATION TECHNOLOGY SERVICE WORKERS AND COMPANIES

ADAPSO represents a large number of information technology service (ITS) companies, ranging in size from 10 to 25,000 employees and independent contractors. ITS workers are highly skilled and very well compensated, often changing employers every few years. ITS companies supply businesses with consulting, systems analysis, design, programming, and facilities management services. Clients are both large and small businesses which do not have sufficient or appropriate internal capabilities to meet their information technology objectives. Technical services are often provided at the client site, and assignments can be long as a few years or as short as a few hours.

IMPACT OF LEASED EMPLOYEE PROVISIONS ON INFORMATION TECHNOLOGY SERVICE FIRMS

Internal Revenue Code Section 414(n) leased employee rules were intended to correct the narrow abuses of privately-owned professional corporations which were "leasing" substantially all of their otherwise regular permanent employees in an attempt to evade the coverage requirements of the pension laws. Because of the uncertainties as to how these rules apply to ITS workers, potential clients are discouraged from retaining third-party ITS firms to fill their technical needs. Existing clients are burdened with additional and unnecessary record keeping requirements. Fur-

thermore, because of the uncertainties of 414(n), ITS workers are being terminated or transferred in the middle of a project thereby causing unnecessary disruptions and delays. Finally, ITS companies are being asked by their clients to provide confidential salary and benefit information on workers on assignment to them for purposes of qualifying a client's pension or benefit plan.

COMMENTS ON THE CONTROL TEST

How "control" in Section 301(a) is ultimately defined in Committee Report language will be the determinative factor as to whether the Employee Benefits Simplification Act is an improvement over the present-law "historically performed" test. ADAPSO urges adoption of a simplified and predictable control test which will permit the exclusion of highly-skilled information technology service workers from Section 414(n) while including only those individuals that Congress intended to protect. The control test set forth in S. 1129, *if properly defined and applied,* would narrow the class of leased employees to those truly under the control of the recipient. ADAPSO requests that the factors included within the S. 2901, *as modified and explained below* be adopted. To avoid an illogical application of this test, ADAPSO suggests that a firm which satisfies three of the four criteria is deemed compliant. The factors are:

(1) Does the Service Recipient Prescribe the Individual's Work Methods?

For purposes of Section 301, prescription of the individual's work methods should mean whether the recipient prescribes the technical details, means and sequences as to how the work should be performed. The control test should include an inquiry as to whether the ITS worker exercises discretion and independent judgment. Due to the technical nature of the information technology industry, ITS workers do exercise such discretion and independent judgment. In contrast, the mere requirement that an ITS worker is to follow generally accepted quality assurance techniques or finish tasks by a certain date is not sufficient to be considered control.

(2) Does The Service Recipient Supervise The Individual?

For purposes of Section 301, supervision should include the final authority to review the performance of an individual, hire and fire, or assign an individual to another client. Supervision should also include the prescription of technical work methods as described above.

(3) Does The Service Recipient Set The Individual's Working Hours?

For purposes of Section 301, setting the working hours should mean that the recipient must require most of the following: that the ITS worker begin and end his or her work day at a specified time, work a set number of hours per day or days per week (unrelated to the hours of operation of the recipient's facilities), or take breaks at either specific times or for a certain length of time.

(4) Does The Service Recipient Sets The Individual's Compensation Level?

For purposes of Section 301, setting the individual's compensation level should be defined to mean that the service recipient has a direct and unilateral right to establish and/or change a ITS worker's compensation or benefit level. Furthermore, if the service recipient is able to veto a change by the ITS company, the recipient is deemed to be able to set the compensation level.

EXAMPLE OF A NON-LEASED INFORMATION TECHNOLOGY SERVICE WORKER

ADAPSO believes that it is critical that the Committee Report includes examples of situations where an individual is and is not a leased employee. For purposes of Section 301, ADAPSO respectfully requests that the following example be included in the Committee Report.

> A programmer/analyst is an employee of or independent contractor for an information technology services company, and pursuant to a contract between the company and its corporate client, renders consulting, systems design, programming, facilities management or training services for its customer. In order to access the customer's computer or employees, the programmer/analyst works for an extended periods of time at the client's location, often conferring with the client's employees. If three of the following must be present: the programmer/analyst's work methods are prescribed by the ITS company; the programmer/analyst is supervised by the ITS company; the programmer/analyst's hours are not set by the customer; or the programmer/analyst's salary is not set by the customer, the programmer/analyst is not a leased employee.

CONCLUSION

ADAPSO and its member companies truly seek pension reform and simplification. S. 2901 is a step in the right direction, however, it does not go far enough in correcting the problems associated with Section 414(n). ADAPSO looks forward to a speedy and permanent solution to this issue and would welcome an opportunity to work with the Committee toward that goal.

STATEMENT OF THE AIR LINE PILOTS ASSOCIATION

The Air Line Pilots Association (ALPA), representing its 42,000 pilot members who fly for 50 commercial airlines, is appreciative of the opportunity to present this statement in support of S. 2901, the Employee Benefits Simplification Act. S. 2901 is a positive step toward simplifying the nation's overly complex private pension system. The positive components of S. 2901 include simplification of the rollover rules, modification of the minimum participation requirements, and imposition of required rollovers for pre-retirement distributions.

ALPA strongly supports the bill's provisions concerning rollovers of pension plan distributions. The bill expands the circumstances in which a distribution may be rolled over, by generally permitting rollovers for all distributions from qualified pension plans, regardless of the type of distribution or percentage.

The current pension distribution rules are extremely complex and unwieldy, and thus, should be a prime target for pension simplification. The simplification of the rollover rules in S. 2901 will have a positive effect on the pension system. These changes will increase pension portability by allowing plan distributions to be kept in the pension form. This in turn, increases retirement savings, an important goal of pension policy.

ALPA also supports the provision requiring certain pension distributions be transferred to an individual retirement account or another qualified pension plan. The bill contains sufficient exceptions to this requirement to protect the interests of retired employees, while at the same time satisfying the goal of increased retirement savings. These exceptions generally parallel the exceptions to the excise tax imposed on premature distributions. The proposed transfer requirement ensures that pre-retirement distributions will be kept in a pension form and will not be spent prior to retirement.

ALPA also supports elimination of the minimum participation requirement for defined contribution plans, as well as the reduction of the minimum participation requirements for defined benefit plans. This change targets defined benefit plans for application of the minimum participation rules, which is the area which has the greatest potential for discrimination.

It should be noted that S. 2901 does not go far enough in its attempt to simplify the nondiscrimination rules for qualified cash or deferred arrangements, or 401(k) plans. In the interest of pension simplification, the bill should eliminate the special non-discrimination test for 401(k) plans (referred to as the actual deferral percentage or ADP test) The $7, 000 annual limitation on contributions to 401(k) plans (indexed at $7,979 for 1990) under current law, already achieves the goal of limiting the contributions of highly compensated employees.

In conclusion, ALPA strongly supports S. 2901 as a positive effort to simplify the complex world of private pension plans. We agree with Senator Pryor that this bill is not "pro-business" or "pro-labor." S. 2901 is a positive and good step toward simplification of the pension system.

AMERICAN BAPTIST CHURCHES ,
THE MINISTERS AND MISSIONARIES BENEFIT BOARD,
New York, NY, August 1, 1990.

Hon. DAVID H. PRYOR, *Chairman,*
Senate Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service,
Washington, DC.

Statement in support of S. 2902, The Church *Retirement Benefits Simplification Act of 1990*

Dear Senator Pryor: In connection with the hearings regarding S. 2902 on August 3, 1990 before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, we are writing to set forth our views as to the crucial

importance of this bill to the American Baptist Churches in the U.S.A. In our denomination, pension and other benefits are provided by The Ministers and Missionaries Benefit Board (the "Board"), which was established in 1913 as a separate corporation expressly for this purpose. The pension benefits are provided through church retirement income accounts under Section 403(b) of the Internal Revenue Code (the "Code"). We have very serious problems with the rules currently applicable to our benefit programs under Code. Many of these problems would be alleviated by the enactment of S. 2902.

The legislation has two general purposes. First, it recodifies the rules applicable to church retirement plans so that such rules are more easily identified and churches will not be inadvertently affected by future legislation or administrative rulings and regulations. Second, it simplifies the rules relating to church benefit programs and makes such rules more workable in their application to the unique organizational structures of religious denominations.

The bill serves these purposes through a number of technical changes to the Internal Revenue Code, including the following:

(1) The bill expands the definition of church-related organizations that are eligible for relief from the Code's coverage and related rules when such organizations are included in a church plan. However, as under present law, church-related hospitals, colleges and universities are excluded from such relief. The bill clarifies that such hospitals, colleges and universities are subject to pre-ERISA coverage rules and to other nondiscrimination rules of present law.

(2) The Internal Revenue Service has recently indicated that employees of affiliated tax-exempt organizations may be required to be aggregated under Section 414 (b) and (c) of the Code and treated as employed by one employer for purposes of the pension rules. Such mandatory aggregation would create very serious difficulties for American Baptist Churches. Our denomination consists of approximately 5,800 local churches and church ministry and missionary organizations with approximately 8,500 clergy and lay employees across the United States. The Ministers and Missionaries Benefit Board is currently paying pension benefits to several thousand retired ministers and lay persons and their beneficiaries. Since the American Baptist denomination has a congregational structure, the relationships among the autonomous units are voluntary and associational. There is no "parent" church body that exercises control over them. In such a situation, the legal criteria to be applied for purposes of the aggregation rules are very unclear. Accordingly, any requirement that all of these units be aggregated and treated as a single employer will be unworkable as applied to our denomination. The bill would solve these problems by permitting church organizations to elect not to apply the aggregation rules.

(3) The bill clarifies that if one organization participating in our Section 403(b) church plan were to fail the applicable requirements, the other organizations participating in the plan will not be adversely affected.

(4) Many ministers engaged in their ministry are self-employed or are employed by secular or governmental employers (such as chaplains in a hospital or university). The bill would clarify that such ministers could participate in our denominational pension and welfare plans. Also, ministers who participate in our pension plan while they are employed by non-church employers will not need to be taken into account under the plans of such employers for purposes of the coverage and related tests.

(5) The bill will clarify that a church plan maintained by a number of different employers will not be treated as a single plan under Section 413(c) merely because the plan pools all of the assets of participants' accounts for investment and mortality purposes.

(6) The bill will correct certain technical problems in the way the Section 401(a)(9) minimum distribution rules apply to church plans. One problem relates to the exception for ministers from the requirement that distributions begin by April 1 of the year after the year of attaining age 70½. This exception will be modified so that a minister engaged in his or her ministry as an employee of an organization that is not a church (such as a hospital chaplain) will also be covered by the exception. The bill also clarifies that church plans need not purchase commercial annuities to satisfy Section 401(a)(9).

(7) The Tax Reform Act of 1986 provided that the $9,500 limit on elective contributions to Section 403(b) plans can be increased subject to three limits, one of which depends upon salary reduction contributions in all prior years. It may be impossible to apply this limit in some cases since records separating salary reduction and employer contributions may not have been maintained for all prior years for some individuals. The bill remedies this problem by deleting such limit for church plans. The remaining limits should be sufficient to prevent any excessive contributions.

(8) Prior to the repeal of Section 89, church medical plans were excluded from the nondiscrimination requirements of such section. With the repeal of Section 89, however, the rules applicable to self-insured medical plans under Section 105(h) have been reinstated. Because of the technical language of Section 105(h) and the regulations thereunder, a question arises as to whether church medical plans are subject to Section 105(h). The bill would eliminate this question by providing that Section 105(h) shall not apply to church medical plans (other than those of hospitals and universities).

(9) Prior to the repeal of Qualified Voluntary Employer Contributions ("QVECs") in the 1986 Act, American Baptist ministers and lay employees were able to make deductible contributions to QVEC accounts administered by the Ministers and Missionaries Benefit Board as a supplement to their Section 403(b)(9) retirement income accounts. Many ministers and lay employees would prefer to make deductible contributions to a church sponsored QVEC account than to a commercial IRA. The bill would restore their ability to do so by making QVEC contributions available to participants in church retirement programs.

The enactment of S. 2902 will clarify and resolve many questions that arise under the present provisions of the Code with respect to church sponsored benefit plans. S. 2902 will also relieve churches of many burdens and restrictions that were enacted without recognition of the crucial differences that exist between churches and the business sector. This legislation is of major importance to the American Baptist Churches in the U.S.A., and we respectfully urge that it be enacted.

Respectfully submitted,

HUGH D. PICKETT, *Associate Executive Director.*

STATEMENT OF THE AMERICAN SOCIETY OF PENSION ACTUARIES

The American Society of Pension Actuaries (ASPA) commends the efforts made by Senator Pryor to simplify the laws relating to employee benefit plans by the introduction of S. 2901. (We note that a similar Bill [H.R. 5362] has been introduced in the House of Representatives by Congressman Rod Chandler.) In recent years, there has been a tremendous increase in the complexity of the pension laws. This expansion has had the effect of substantially diminishing the number of employers establishing new pension plans, and substantially increasing the number of pension plan terminations. From 1986 to 1989, for example, new retirement plan formation has declined by about 63 percent and defined benefit plan formation has declined nearly 80 percent. For 1989, there were about *three times* as many terminations of defined benefit plans as there were startups. Simplification of the pension laws is essential to reversing these negative trends.

S. 2901 provides relief in a number of areas where simplification is critical. These areas include the Average Deferral Percentage (ADP) and Average Compensation Percentage (ACP) tests for Section 401(k) plans, the Section 401(a)(9) distribution rules, the "leased employee" rules, the minimum participation rules under Section 401(a)(26) and the rules relating to rollovers of pension distributions. However, there are a number of areas not covered by S. 2901 which we believe should be included in the Bill. Appearing below is a discussion of these areas, as well as an analysis of how improvements might be made in some of the Bill's provisions.

I. ITEMS WHICH SHOULD BE INCLUDED

• *Repeal of Section 415(e)*

The Tax Reform Act of 1986 imposes a 15 percent excise tax on annual distributions from all tax-advantaged plans to any individual in excess of $112,500, indexed or $150,000. When this excise tax was initially suggested, the President proposed that it be coupled with the elimination of the Section 415(e) restrictions. These are the combined plan 1.40/1.25/1.00 limits which are unbelievably complex. We feel it was foolish to have enacted the excise tax without eliminating Section 415(e) and that this Section should now be abolished.

• *Repeal of the Top Heavy Provisions under Section 416*

These provisions have outlived their usefulness given the vesting changes and compensation limitations applied to all plans under the Tax Reform Act of 1986. There is no longer any difference in the compensation limits applicable to top-heavy and non-top heavy plans. There is a limited difference between the vesting schedules applicable to each type of plan. The minimum accrual and contribution require-

ments are almost irrelevant as a result of the permitted disparity requirements of Section 401(l). Yet, the law still requires annual testing to determine whether or not a plan is top-heavy. The cost and complexity are not worth any benefit derived from these provisions.

• *Elimination of the Summary Annual Report Requirement*

This document provides little information useful to plan participants, and thus generates unnecessary paperwork.

II. ITEMS WHICH SHOULD BE MODIFIED

• *Elimination of Section 401(a)(26)*

The Bill limits the application of Section 401(a)(26) to defined benefit plans and lowers the number of employees that must benefit from a plan from 40 to 25. While these provisions are very useful in narrowing the scope of this Section, we believe total elimination is appropriate. The abuse which Section 401(a)(26) is designed to avoid can be precluded in a simpler fashion by modifications to the comparability provisions of Revenue Ruling 81-202.

• *Repeal of the Full Funding Limitation for Single Employer Plans*

The OBRA 1987 Full Funding Limitation is repealed for multi-employer plans, but not for single employer plans. Clearly this limitation is a significant obstacle to sound funding of pension plans and should be repealed for all plans.

• *Operational Compliance and Compliance Dates Should Be Coincidental*

The Bill delays the deadline for plan amendments required to reflect the changes in the law, but does not delay the deadline for operational compliance. This timing difference can and does lead to major problems in the administration of pension plans for two reasons:

1. A conflict between the terms of the plan and its operation is an invitation to litigation. A plan document is a contract which is enforceable by participants. When the terms of the contract differ from the manner in which the plan is operated, the participants do have certain legal rights which can be enforced. If the operational compliance results in a difference in treatment of an employee, that employee has a right to sue to enforce the plan as written.
2. The delay between the passage of the law, the date it is effective, and the long lead-time the IRS requires to issue even proposed regulations, has, in the past, resulted in a significant degree of confusion and uncertainty. The history of compliance with the Tax Reform Act of 1986 (TRA '86) is a classic example. TRA '86 was passed in 1986; the current deadline for document compliance is 1991; the operational compliance dates range from 1987 to 1989. Regulations for this law have only recently been issued in proposed form on one of the most significant areas affecting these programs, resulting in continued uncertainty as to what benefits are actually being provided. The IRS has permitted plans to freeze all benefits at the beginning of the 1989 plan year, and continue that freeze until the end of the 1991 plan year, primarily because operational compliance is not possible without a clearer understanding of the law and regulations. As a result, many employers are not now certain what benefit structure has been in place in 1989 and 1990 for their employees, and many employees are being told that the benefits they are earning in 1989 and 1990 will first be described to them, perhaps, in 1991.

All of this confusion could be avoided if operational compliance were coincidental with document compliance, and both were tied to the issuance of regulations by the Internal Revenue Service.

We would suggest that both operational and document compliance be required for the first plan year beginning 11 months after final regulations are issued by the IRS. We would also suggest that an employer be permitted, should it desire to avail itself of the effect of the changes, to make amendments earlier than that date, and have those amendments effective during the plan year in which the amendment is made.

• *Elimination of the ADP and ACP Tests*

While we would have preferred total elimination of the ADP and ACP tests, we nevertheless believe that the safe harbors provided under the Bill will furnish substantial relief for many employers from these onerous tests. Of course, many employers will be financially unable to make the level of contributions required under

the safe harbors. We still believe that total elimination of these tests, as was done for government plans, is the best course of action.

- *Repeal of the Family Aggregation Rule*

Section 414(q)(6) [Family Aggregation Rule] requires that certain employees who are related be considered a single individual for benefit purposes. Among other things, the effect of this provision is that the total compensation of family members that can be considered for benefit purposes is limited to $200,000. This limit discriminates against family members, who are effectively prevented from receiving pension benefits on their earnings simply because of their status as family members. The law presumes that there is something reprehensible about a business which employs family members of certain highly compensated employees, apparently because somebody assumed the compensation would, of necessity, be excessive. The Internal Revenue Service already has in its arsenal procedures to prevent the abuse against which the family attribution rules are directed through its ability to disallow deductions for unreasonable compensation. The family aggregation rule should be repealed in its entirety, rather than limited to five percent owners as the Bill currently provides.

- *Provide Relief For Five Percent Owners [Section 401(a)(9)]*

The Bill softens the rules for mandatory distributions after age 70 under Section 401(a)(9) for everyone except five percent owners. The failure to provide relief for five percent owners is highly inequitable. It is simply a penalty on ownership of a business, which essentially harms the small businessman. It is rare that an individual will own five percent of a large corporation.

- *Non-discrimination Against the Small Business Owner*

The definition of highly compensated employee is related to annual earnings of $50,000, with the exception of five percent owners. In other words, a five percent owner who earns $45,000 is considered highly compensated. This is another instance of discrimination against small business owners. Five percent owners should not be treated differently than other employees. We also suggest increasing the threshold amount in Section 414(q)(1)(B) to a level which more realistically reflects pay scales in today's economy.

ASPA, again, wishes to commend Senator Pryor on the introduction of S. 2901. We feel that this Bill is a significant step in the right direction. We believe that the incorporation of the above suggestions will greatly improve the proposed legislation and make this an even better Bill.

BUCK CONSULTANTS, INC.,
New York, NY, August 24, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
Washington, DC.

Dear Ms. Wilcox: Buck Consultants, Inc., a leading employee benefits consulting firm, would like to submit the following written comments on the proposed "Employee Benefits Simplification Act (S. 2901)," which was recently introduced by Senator David Pryor (D.-Ark.) and others. Also, enclosed are copies of the results of Buck's recent pension simplification survey and Buck's recent *For Your Benefit* publication about pension simplification.

GENERAL COMMENTS

Buck joins with many other members of the employee benefits community in commending Senator David Pryor (D.-Ark.) for proposing a significant first step toward simplifying the laws governing the U.S. pension system. S. 2901 is an important step in the right direction although, in its present form, it would leave in place a number of intricate Federal requirements that continue to complicate the operation of pension programs. In addition, S. 2901 would also require plan changes that would further complicate the administration of pension plans.

Many crucial regulatory issues still need to be addressed. A bill (or even bills) need to be enacted to truly simplify regulation of our retirement benefit delivery system. However, as the employee benefits community knows from the experiences of recent years, the proposed legislation needs to be well-thought out and all of its implications adequately assessed before enactment.

SPECIFIC COMMENTS ON S. 2901

The following are Buck's specific comments on S. 2901.

Highly-Compensated Employees

S. 2901 would cut the number of highly-compensated categories from the current four to two. Thus, under the bill, highly-compensated employees for a plan year would include only 5% owners in the current or preceding plan year and employees earning over $50,000 (as indexed) during the calendar year preceding the plan year being tested. While this proposed change in the definition of highly-compensated employees would reduce the number of categories, it does not provide any real relief for those administering these plans and in some circumstances will be adding administrative burdens.

The bill, as originally presented, does not limit the overall number of potential highly-compensated employees in the $50,000 (as indexed) category—as is currently the case. Buck believes that the more than $50,000 (as indexed) category should be limited to the top 10% of employees ranked by pay in the calendar year preceding the plan year being tested with, if necessary to meet IRS concerns, a minimum number of highly-compensated employees for employers with relatively few employees. Thus, the limit on the $50,000 (as indexed) category along with the inclusion of 5% owners would be a more accurate definition of a highly-compensated group of employees and an easier and much simplified provision to administer.

401(k) Nondiscrimination Tests

S. 2901 proposes design-based alternatives to passing the mechanical Average Deferral Percentage (ADP) and Average Contribution Percentage (ACP) nondiscrimination tests. However, the alternatives could prove to be quite expensive for employers not currently contributing the specified contribution levels. Also, the alternatives could prove unpopular for employers that currently meet the required levels of contributions because of the conditions attached to these contributions.

Thus, we believe the design-based alternatives would be much more acceptable to plan sponsors if the required employer contributions were *not* required to be fully vested but, instead, could be subject to a plan's regular vesting schedule and could be withdrawn under the current defined contribution rules governing plan withdrawals.

Also, as concerns the design-based alternatives, the written notice requirement should be eliminated. This requirement would be a needless duplication and an unnecessary administrative burden.

However, we further believe that the current annual limit on elective deferrals is safeguard enough against potential discrimination in favor of highly-compensated employees and, thus, the mechanical ADP test should be eliminated altogether.

Similar rules should provide that if employers place a reasonable limit on the amount of after-tax contributions that participants may contribute (e.g., 8% and limit the level to which employer matching contributions would be made to the first 3%-4% of compensation, then the ACP test could be eliminated as well.

These would be truly significant steps toward simplifying the administration of 401(k) and after-tax savings plans.

Plan Distributions

Buck strongly urges that the provisions in S. 2901 that would generally require the transfer of most distributions before age 55 to an IRA or another qualified plan, should not be included in any simplification bill. These provisions are not truly pension simplification and relate more to pension portability. In addition, the mandatory transfer provision would not do much to actually achieve pension portability because employees always could withdraw the transferred funds from their IRAs—although with the imposition of a 10% additional tax. However, these new requirements certainly would impose more administrative burdens on those sponsoring plans.

The implications and issues concerning pension portability must be carefully studied and pension portability should never be hastily enacted.

Taxation of Distributions

S. 2901 proposes to eliminate 5-year averaging for qualified lump sum distributions. Buck opposes the outright elimination of 5-year averaging and suggests instead that the availability of 5-year averaging be replaced with 10-year averaging for all participants who terminate with five or more years of service—not just grandfathered employees as a means of simplifying plan administration and recordkeeping.

Governmental Plans

Buck supports the provisions that would make Internal Revenue Code Section 457 inapplicable to amounts accrued under an unfunded Section 415 excess benefit plan with respect to governmental plans. However, this provision should be extended to nonprofit organizations

In the absence of this amendment, governmental and nonprofit employers are at a distinct disadvantage in comparison with the private sector when it comes to attracting and retaining highly-talented, high-paid employees.

Minimum Required Distributions

Buck commends the inclusion in S. 2901 of the provision to return generally to pre-Tax Reform Act of 1986 (TRA'86) minimum required distribution rules thereby eliminating the need to make pension payouts to active employees other than 5% owners.

Minimum Participation Rules

The further amendments to Code Section 401(a)(26) as proposed in S. 2901 are commendable.

Leased Employees

The S. 2901 provision that would replace the historical test with a control test for purposes of determining if leased employees are to be treated as employees of the employer that hires leased employees through a leasing organization is another commendable provision.

ADDITIONAL SUGGESTED PROVISIONS

Social Security Offset Plans

Buck believes that there should be a design-based safe harbor for PIA offset plans in the Internal Revenue Code and suggests that Code Section 401(a)(4) be amended to provide the safe harbor provision. For the safe harbor to be operative under a PIA offset plan, the offset should never be more than one-half of the gross benefit. A reasonable safe harbor for PIA offset plans would substantially cut plan administrative costs and, thus, would go a long way toward meaningful pension simplification.

Maximum Combined Plan Limits

In its current form, S. 2901 does not address the Section 415(e) combined plan limits. Prior to the enactment of TRA'86, the 15% excise tax on excess distributions from all tax-favored retirement plans (e.g., qualified plans, IRAs) was discussed as a replacement for the combined maximum plan limits. Although TRA'86 was enacted, Code Section 415(e) was not simultaneously deleted. Thus, in keeping with the intention behind the creation of the 15% excise tax, Buck believes the combined maximum plan limits should now be eliminated. This would eliminate the need for certain calculations and, thus, would ease plan administration.

Minimum Funding

We at Buck believe that any pension simplification legislation should include amendments to the Section 412 minimum funding provisions of the Code. The amendments should eliminate the complicated deficit reduction calculation. Also, the amendments should provide an alternative to the present 150% of current liability funding limit that would permit employers to fund their plans soundly to meet expected future benefit obligations.

We suggest an alternate limit that would permit employers to fund their plans based on projected liability taking into account salary increases.

CONCLUSION

Buck commends many of the provisions of S. 2901, identified above, that would foster the goal of pension simplification. However, there are some provisions that logically should not be part of a simplification effort. We also strongly believe that pension simplification is needed and warranted. Pension simplification would go a long way toward shoring up the U.S. pension system.

Again, we believe S. 2901 is a step in the right direction, and we offer any assistance to the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the IRS in its work toward pension simplification.

Very truly yours,

FREDERICK W. RUMACK, *Director of Tax and Legal Services.*

Attachment.

PENSION SIMPLIFICATION?

Report on a Survey of Business and Benefit Executives

July 1990

BUCK CONSULTANTS

There is increasing concern about the complexity of the government-imposed rules regulating the private pension system.

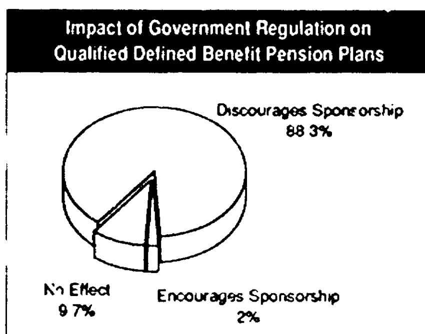
This led Buck Consultants to survey business and benefit executives to determine their views on the rules, their practices and what corrective measures they would recommend. 681 executives from 610 organizations responded. This is a report of the findings. (Respondents answered before they had an opportunity to study the Section 401(a)(4) regulation package.)

- Respondents report the suspension of benefit accruals for an estimated 37,000 employees and retirees as a result of IRS delay in issuing regulations.
- Over four-fifths of the respondents welcome the move to simplify private pension regulations, but over half indicate that simplification may bring additional problems.
- Two-thirds of the respondents say that there appears to be little or no coordination among government agencies in regulating the private pension system. Virtually none of the respondents indicate that government agencies work in harmony.
- Almost nine out of ten respondents indicate that current regulation discourages sponsorship of qualified defined benefit plans and just over half of the respondents say that regulation discourages sponsorship of qualified defined contribution plans.
- Only 5% believe that the rules succeed at encouraging employers to provide overall retirement benefits. 59% of the respondents indicated that the rules succeed at generating revenue for the federal government.
- The average and median estimated cost of regulatory compliance is 7.2% and 5.0% respectively as a percent of total benefit cost.

Respondents were given a list of possible goals of government-imposed regulation and were asked which goals are being met. Significantly, 59% of the respondents see regulation as effective in generating revenue for the government, but only 6% see regulation as strengthening private pension programs and only 5% see regulation as encouraging employers to provide retirement benefits. Here is a more complete summary of the responses.

The Rules Succeed At	
Generating Revenue for the Federal Government	59%
Prohibiting Employer Abuse of Pension Deductions or Design	34%
Promoting Retirement Equity	19%
Providing a Framework for Retirement Security	19%
Strengthening the Private Pension System	6%
Encouraging Employers to Provide Retirement Benefits	5%

A significant finding of the survey is that almost nine out of ten respondents conclude that government-imposed regulation discourages employers from sponsoring qualified defined benefit pension plans.

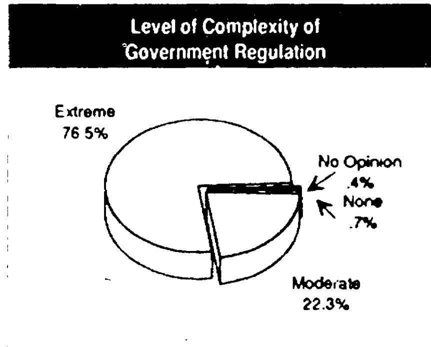


Just over half of the respondents say that sponsorship of defined contribution plans is discouraged by government regulation.

Almost a quarter of the respondents believe that regulation encourages employer sponsorship of defined contribution plans. Presumably because respondents believe that defined benefit plans are discouraged by regulation, many respondents reason that regulation encourages defined contribution plans — even though over half of the respondents believe defined contribu. . . ı plans themselves are subject to excessive regulation.

For example, over three-quarters of the respondents say that the ADP and ACP nondiscrimination tests for 401(k) defined contribution plans should be eliminated or simplified — making this the most popular change advocated by the respondents.

Three-quarters of the respondents say that government-imposed laws and regulations are extremely complex. This is consistent with the view already discussed that current regulation discourages employers from sponsoring retirement plans.

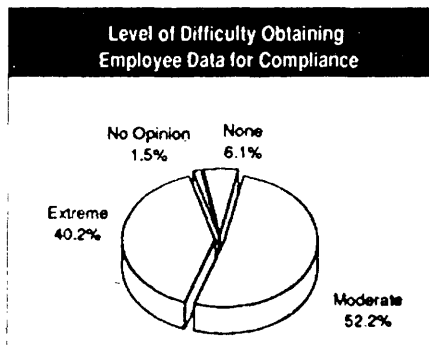


Respondents most often cite the following reasons for saying that compliance is extremely difficult:

- extremely high level of difficulty in understanding and implementing the rules,
- arduous task of consolidating employee census, compensation and benefit data for compliance testing, and
- unreasonable effective dates under the Code and regulations.

Respondents point to several other problems they have encountered in complying with government-imposed regulation. These included the failure of regulatory agencies to clarify gray areas, conflicting rules and the unacceptable frequency with which rules change.

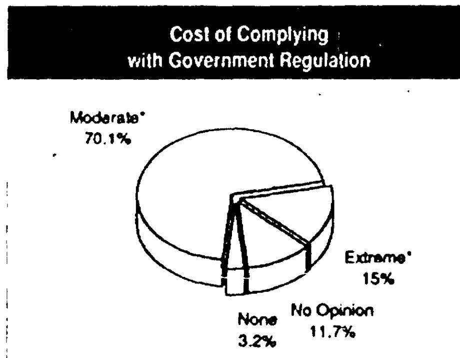
Two out of five respondents consider it extremely difficult to obtain employee data to comply with the government-imposed rules. Slightly more than half of the respondents believe that obtaining data is moderately difficult.



Some claim that obtaining employee data to satisfy regulations is easier for large employers. However, the following breakdown of organizations indicates otherwise.

	1,000 or Less Employees	1,001 to 5,000 Employees	Over 5,000 Employees
No Difficulty	10%	6%	3%
Moderately Difficult	57%	53%	45%
Extremely Difficult	28%	41%	52%
No Opinion	4%	1%	1%
Total	100%	100%	100%

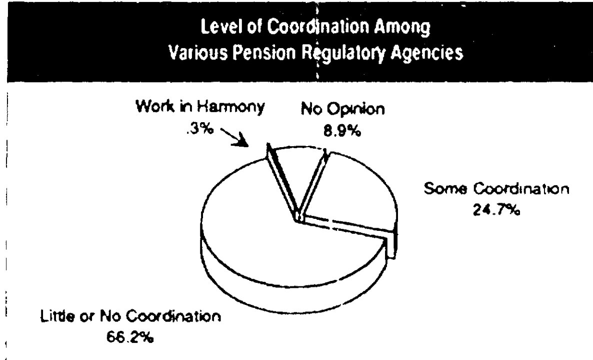
70% of the respondents say that the cost of compliance is *"moderate"* while 15% find it *"extreme."*



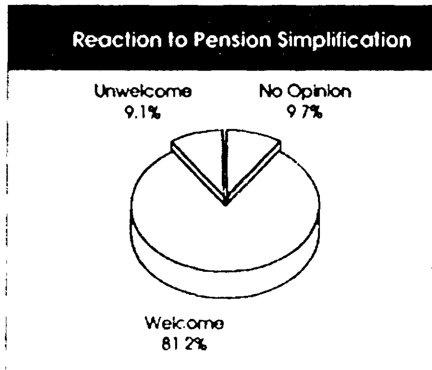
*Respondents were told that generally moderate cost would be under 10%

Of the 610 organizations covered in the survey, 317 provided estimated cost data. The median estimated cost for regulatory compliance is 5% of total benefit cost and the average estimated cost is 7.2%.

Virtually everyone who responded believes that there is at least some lack of coordination among the various agencies that administer the government-imposed employee benefit rules. This lack of coordination also makes compliance with the government regulation more difficult.



Over 80% of the respondents say they would welcome simplification. However, there is concern that so-called simplification can lead to more problems for the private pension system.. Thus, over one-half of the respondents express concern that *"simplification"* might bring with it additional problems.

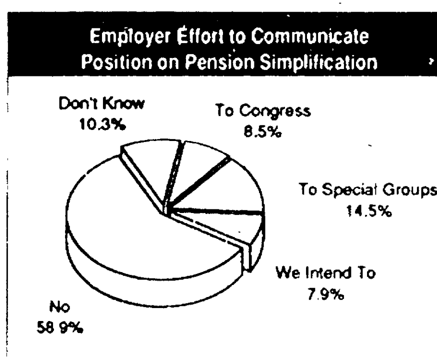


Respondents were asked what changes they would find desirable to simplify government-imposed regulation. Clearly burdensome discrimination tests are prime candidates for change.

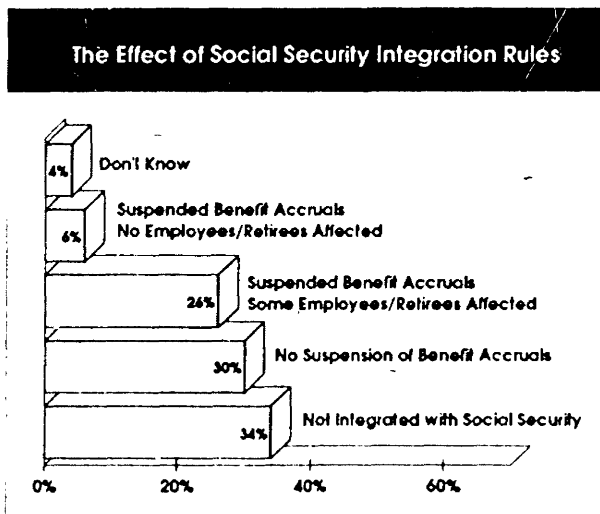
No change	2%
No opinion	19%
Eliminate or simplify the ADP and ACP nondiscrimination tests for 401(k) plans	78%
Eliminate or simplify minimum participation rules*	72%
Create a standard definition of highly compensated employees	72%
Simplify the definition of highly compensated employees	71%
Allow *"one-time"* testing for general nondiscrimination subject to certain conditions	63%
Eliminate or modify top-heavy rules	48%
Simplify the rules governing affiliated service groups and leased employees	46%
Allow offsets based on the Social Security Primary Insurance Amount in certain cases	36%
Allow KSOPs to be treated as a single plan for ADP & ACP nondiscrimination testing**	19%
Eliminate or simplify taxation of distributions	63%
Eliminate or simplify excise tax on excess distributions (including lump sum)	55%
Simplify hardship rules for 401(k) plans	52%
Delay effective dates of many of the TRA '86 changes	47%
Eliminate or simplify the full funding limitation	45%
Simplify REA consent requirements	34%

*Survey conducted before the IRS issued revised minimum participation rules.
**Of the employers (4% of the respondents) with KSOPs, 86% want this change.

Over 30% of the surveyed organizations are making their views about pension simplification known to Congress or to special interest groups. However, almost 60% of the organizations surveyed are not communicating their position. The survey statistics reveal a greater tendency for large organizations (over 5,000 employees) to communicate their position to Congress or special interest groups than their smaller counterparts.



The IRS delay in issuing general nondiscrimination regulations and Social Security integration regulations has made it necessary for many employers to suspend benefit accruals for certain employees and retirees. 561 employers responded to a question on suspending benefit accruals. Almost a third of the responding organizations (179 employers) say that they suspended benefit accruals for certain employees and retirees pending the issuance of final regulations. Based on the responses, we estimate that for these employers the suspensions have affected about 37,000 employees and retirees.



The respondents overwhelmingly would welcome simplification of the government-imposed rules regulating the private pension system. However, many express concern that what might be imposed by the government as simplification could, in fact, result in additional complications. There is talk of simplification in Washington. Whether true simplification will occur remains to be seen.

Individuals responding to this survey varied widely and included those holding the positions of CEO, CFO, president, vice president, director and manager of benefits. Likewise, the organizations are as diverse as the individuals who represent them. Although organizations varied by number of employees, location and business line, many of the organizations are the largest and most influential in the United States.

The following series of tables show the type and size of the organizations represented in this survey report.

Number of U.S. Employees of Responding Organizations

Number of Employees	Number	Percent
1,000 or Less	184	34%
1,001 to 5,000	177	32%
5,001 or More	186	34%
Total	547	100%

Geographic Location of Responding Organizations

This table generally represents the state with the largest concentration of employees.

Geographic Location	Number	Percent
Northeast	234	39%
South	150	25%
Midwest	107	18%
West	103	17%
Total	594	100%

Industrial Classification of Responding Organizations

Industrial Classification	Number	Percent
Manufacturing	289	47%
Service	165	27%
Non-profit	50	8%
Governments	24	4%
Other	81	13%
Total	609	100%

Types of Retirement Plans
of Responding Organizations

Type of Plan	Number	Percent
Noncontributory Defined Benefit	475	79%
Contributory Defined Benefit	84	14%
Thrift/Profit Sharing with 401(k) Component	269	45%
Thrift/Profit Sharing without 401(k) Component	79	13%
Separate 401(k)	226	37%
Money Purchase	59	10%
ESOP	73	12%
KSOP	23	4%
403(b)	24	4%
Other	25	4%
Number of Respondents	603	

In May 1990, Buck Consultants mailed Pension Simplification Survey questionnaires to approximately 6,000 business and benefit executives nationwide. This survey report summarizes the observations of 681 business and benefit executives from 610 organizations nationwide on the issues concerning the simplification of federal government rules on the private pension system.

For organizations from which there were multiple responses, special techniques were used in some instances to estimate the cost of compliance and number of employees and retirees affected by the suspension of benefit accruals.

Where answers to questions were mutually exclusive (e.g., a question answered by a *"yes"* or *"no"*), the total number of responses was used as the denominator in determining the percent of total. For questions where more than one answer was possible (e.g., types of plans sponsored), the total number of respondents answering the question was the denominator in determining the percent of total. Because of rounding, percentages do not always sum to 100%.

As would be expected with a survey of this type and size, not every respondent answered all of the questions. Consequently, the statistical analyses throughout the report are representative of the number of respondents in proportion to the number of responses received for each response choice within a question.

All response data was tabulated in aggregate. Additionally, for comparison purposes, the response data was stratified question-by-question by various demographic characteristics. The data was also stratified question-by-question by selected opinion responses.

STATEMENT OF THE CALIFORNIA STATE TEACHERS RETIREMENT SYSTEM

I wish to thank the Subcommittee for the opportunity to express the views of the California State Teachers' Retirement System (STRS) on S. 2901, the "Employee Benefits Simplification Act" and to extend the System's support to Senator Pryor and the co-sponsors of S. 2901 in their efforts to simplify the rules governing pension plans, particularly as they apply to governmental plans. The ability of public pension plans like the California STRS to maintain compliance with the tax code provisions governing qualified plans has been made extremely difficult by the numerous law changes in recent years and the almost overwhelming complexity of the existing rules. Senator Pryor, the co-sponsors of the bill and the members of this subcommittee should be commended for taking positive steps to begin the process of simplifying this difficult area. They deserve the wholehearted support of all plan sponsors and administrators, including those in the public sector, in their efforts.

We are focusing our comments on the provisions of the bill (Section 306) that deal specifically with governmental plans. We have also attached an Appendix that sets out technical comments on certain other provisions of the bill.

STRS strongly supports the provisions of Section 306 of S. 2901 that are designed to simplify the application of the section 415 limitations to public plans and to permit governmental employers to establish nonqualified excess benefit plans on the same basis that is now available to private sector employers.

Of greatest significance to STRS are the provisions of S. 2901 that would modify the section 415 limitations. The application to governmental plans of these complex limitations, which were designed primarily to prevent abuses in the private sector, has been an almost constant source of problems for public plans, and STRS has been no exception. We applaud the efforts of the co-sponsors and this subcommittee to alleviate the difficulties we have encountered in complying with the existing section 415 limitations.

We believe that strong policy reasons support exempting governmental plans, many of which cover thousands of relatively low paid public servants, from certain of the provisions of section 415 that are applicable to plans maintained by corporations and other taxable business entities.

First, subjecting governmental plans to the full range of section 415 limitations is not warranted by the underlying rationale behind section 415. Section 415 was designed to prevent wealthy, highly compensated individuals from building up huge tax sheltered and tax deferred balances in retirement plans, beyond their reasonable needs for retirement. At its heart, section 415 is an anti-abuse provision.

The kinds of abuses that the section 415 limitations were designed to prevent are, for the most part, not present in governmental plans:

- There is little opportunity in most governmental plans for the relatively few highly compensated employees to accumulate a benefit wholly disproportionate to their reasonable retirement needs (that is, to misuse the system for tax avoidance purposes). Governmental plans, by definition, are sponsored and maintained by a state or local government, having its own constitutional prerequisites, regulatory apparatus and voter accountability. Given such constraints, there is little chance that the abuses at which section 415 is aimed can develop.
- In the case of STRS, benefits are prescribed by statutes enacted by the state legislature. The ability of the plan to provide disproportionate benefits is obviously constrained by the political realities inherent in having to raise state and local taxes to pay for the benefits.
- STRS is subject to a constitutional prohibition against reducing benefits and therefore has much less flexibility to change its benefit structure to comply with changes in the section 415 limits than does a private plan.
- Governmental employers, including those that make contributions to STRS, receive no tax benefit from deductibility of contributions, unlike private employers who enjoy a significant tax subsidy for retirement plan contributions. Thus, revenue considerations underlying recent changes to section 415 are of less significance in the public plan arena.
- Unlike private sector employees, STRS members do not receive social security benefits, by virtue of their employment as public school employees, as a supplement to their pensions and personal savings. Thus, a reduction in the level of benefits as a result of the section 415 limitations places an even greater burden on STRS retirees and disabilitants than would be true of private sector employees.

In summary, STRS, like other public plans, is subject to considerable scrutiny by other state agencies and, ultimately, the voters, in fixing the level of benefits that will be paid. The tax benefits provided to private plans are far less significant in the

case of a public plan like STRS. Accordingly, the potential for abuse that section 415 was designed to eliminate is largely nonexistent in governmental plans, and application of the full range of section 415 limitations to such plans is unjustified.

Second, the existing limitations on defined benefit plans under section 415 have caused considerable problems for governmental plans and for STRS in particular. STRS has made substantial efforts to comply with section 415. STRS sought and obtained state legislative action to amend the plan to comply with 1986 tax law changes and to elect the special grandfather provision of section 415(b)(10). As a consequence, STRS is not eligible to make use of the special governmental plan provisions in section 415(b)(2)(F) (preserving pre-1986 rules on reducing the dollar limitation for early commencement of benefits) with respect to participants joining the plan after 1989. Even after this action, however, compliance with the existing section 415 rules continues to create significant problems for STRS, in areas that do not involve the abusive situations that section 415 was enacted to prevent.

Two specific problems exist for STRS under current section 415, both of which are centered on the combination of (i) the 100% of compensation limitation, (ii) the definition of compensation for section 415 purposes (that excludes certain nontaxable compensation), (iii) the actuarial reduction in the $90,000 limitation on account of early payment of benefits, and (iv) the ten-year phase-in of the limitations for new employees.

First, the application of the 100% limitation, without including income deferrals under sections 402(a)(8), 403(b) and 457, elective cafeteria plan benefits under section 125 and employer pickups under section 414(h), can significantly reduce even relatively small pensions payable to members with long periods of public service.

By way of example, STRS has about 300,000 active members. Last year, about 6,800 of those members retired, at an average final compensation of about $31,500. Over 800 of those members (12%) had in excess of 35 years of service with STRS, which would qualify them for a retirement allowance of 70% or greater. Given the high degree of likelihood that many of those individuals either had a second source of income (from a spouse's earnings) or had reached a stage in life where family financial obligations are reduced, it is quite likely that many of them were in a position to defer compensation as a means of saving for retirement, or to elect nontaxable forms of benefits, under the various provisions of the Code that apply to such elections.

Given the existing exclusion of the nontaxable amounts from the definition of compensation for section 415 purposes (but not for general benefit computation purposes under the plan) and the leveling effect of the three-year high average compensation used for purposes of section 415(b), it is easily seen that many of these relatively low-paid, high service retirees would be adversely affected by the existing 100% of compensation limitation. Yet, this action would be taken to reduce benefits to those who, in 1989, would otherwise have received an average retirement allowance of about $31,500 under the terms of the plan. This clearly is not the abusive situation that section 415 was intended to prevent.

Amending the limitations as proposed in S. 2901 would eliminate this problem, because the 100% of compensation limit would no longer apply. Therefore, we strongly support this provision of the bill.

Second, the existing limitations can cause serious reductions and create substantial hardship on employees and their beneficiaries in reducing disability and death benefits that would otherwise be payable under the plan. Because these benefits are payable well before an individual reaches normal retirement age, the reduction in the dollar limitation when the benefit begins early can cause a substantial reduction in the amounts that would otherwise be payable to a disabled employee, or to the beneficiaries of a deceased employee.

Governmental plans, like STRS, are somewhat unique in providing substantial disability and death benefits as a part of a qualified retirement plan. In many cases, this serves to replace some of the workers compensation, social security disability and long term disability benefits that are available to private sector employees. As a consequence, the STRS benefits are subject to the section 415 limitations, whereas comparable benefits provided to employees in the private sector are not. Again, this appears to be an unintended effect of the section 415 limits and clearly does not involve an abusive situation.

Amending the section 415 limitations applicable to disability and death benefits, as proposed in the bill, would eliminate this problem and would put STRS and other governmental plans on an even footing with private sector employers (which provide analogous benefits outside their qualified plans, on a tax-deferred basis).

Accordingly, STRS strongly supports the provisions of S. 2901 that simplify and rationalize the section 415 limitations on governmental plan benefits.

One technical revision that STRS would present for the subcommittee's further consideration is the issue of the continued effect of the section 415(b)(10) grandfather election under the bill. As was mentioned above, the California legislature amended the STRS plan and adopted the grandfather rule, with the effect that STRS is subject to the private plan rules on reduction of the dollar limitation for early commencement of benefits. The subcommittee should consider including a provision in the bill that would permit governmental plans to revoke existing section 415(b)(10) elections, so that such plans would be treated the same as other governmental plans after enactment of the bill. Again, STRS feels that it has made substantial, good faith efforts to comply with existing section 415 and that its members should not be disadvantaged, as compared with other governmental employees, as a result of those efforts.

STRS also supports the provisions of the bill that would permit governmental entities to provide nonqualified excess benefit plans on the same basis that such plans are provided in the private sector. Such plans would provide state and local governments with needed flexibility to provide benefits in excess of the section 415 limits, to the extent necessary to attract and retain highly qualified employees.

In conclusion, STRS strongly supports the provisions of the bill that are applicable to governmental plans. In the Appendix, we have also made a number of technical comments on certain other provisions of the bill, for the subcommittee's consideration.

Statement of Employers Council on Flexible Compensation

Mr. Chairman, my name is John N. Erlenborn and I am testifying on behalf of the Employers Council on Flexible Compensation (ECFC) in support of S. 2901, the "Employee Benefits Simplification Act."

The ECFC is a non-profit membership association founded in 1981. The over 400 members of ECFC are plan sponsors of cafeteria and 401(k) plans and the leading actuarial, insurance and accounting firms which design and administer flexible plans.

Mr. Chairman, I am a partner in the Washington, D.C. office of Seyfarth, Shaw, Fairweather & Geraldson, a national law firm, and I specialize in employee benefit matters. During my 20 years in Congress, I served on the House of Representatives Committee on Education and Labor. I helped draft the Employee Retirement Income Security Act of 1974 (ERISA) and managed the bill creating ERISA in the House and in the Senate-House Conference Committee.

Mr. Chairman, in the years since the enactment of ERISA, many changes have been made in the law applicable to employee benefit plans. All too many of these measures have introduced additional complexity in the tax Code. The frequency of this legislation and the resulting complexity have proven to be a deterrent to the establishment and maintenance of pension plans. We applaud you and your cosponsors for recognizing this fact and proposing S. 2901 in an attempt to remove unnecessary layers of rules. The result will be a significant reduction in time and money spent in administering pension plans and an increase in the availability of these plans to America's workers.

Plans sponsored by both large and small employers will benefit from this simplification, but the need is most acute among small employers. Approximately one half of the private workforce now enjoys participation in an employer sponsored, tax qualified pension plan. The uncovered portion of the workforce is highly concentrated among those employed by small businesses. These employers are discouraged from adopting tax favored pension plans by the complexity of the tax Code and the frequent changes requiring expenditures for professional services. Peeling away layers of complexity will encourage more employers to provide tax qualified pension plans to their employees, thus enlarging the percentage of employees who will have enhanced security in their post employment years.

Although ECFC is in support of the various aspects of simplification incorporated in S. 2901, we would like to focus our remarks today on the proposed changes in the nondiscrimination tests contained in §401(k) of the tax code. This section, providing for cash or deferred arrangements (CODAs), was enacted in 1978 and was not the subject of much attention for the next few years. Upon the publication of the regulations implementing §401(k), the advantages of funding plans with employee elective salary deferrals and employer matching contributions became apparent and within a short time §401(k) plans were adopted by a significant number of employers.

Employees welcomed the opportunity to participate in these plans for many reasons, among them the advantages afforded by investing pretax contributions in a plan that provided tax free compounding of investment earnings. Many plans allow a choice of investment vehicles which provides an opportunity for self directed investment by participants. Finally, these plans with separate accounts for participants provide the portability that is not available in defined benefit plans.

The rapid growth of §401(k) plans and the resultant tax revenue deferral prompted the Administration to recommend, and the Congress to enact, restraints on the future use of these plans in the Tax Reform Act of 1986 (TRA '86). The additional complexities introduced in this section by TRA '86 have proven to be especially disruptive. TRA '86 reduced the permitted disparity between contributions by highly and nonhighly compensated employees. TRA '86 also placed a separate dollar limitation on annual elective deferrals of $7,000, indexed ($7,979 for 1990). The prior limitation was the Section 415 defined contribution limitation of $30,000. This new annual elective deferral limitation obviates to a great degree the need for nondiscrimination tests based upon actual utilization of the 401(k) cash or deferred arrangement (CODA) since the CODA represents only a small percentage of the overall defined contribution limit.

TRA '86 also added §401(m) with a new set of rules (and, therefore, an additional layer of testing and increased complexity) for matching contributions and after tax employee contributions. The principal source of administrative difficulty and expense is the need to monitor elective deferrals throughout the plan year and apply a formula to determine the allowable salary deferral for highly compensated employees based upon the deferrals elected by the nonhighly compensated. It is not until the close of the plan year that the plan administrator knows with certainty which employees are classified as highly compensated and what the salary deferrals for each class have been. At this point many plans fail the so-called "nondiscrimination" test and deferrals of the highly compensated may have to be refunded or reclassified as after tax contributions.

This collecting of data and repeated testing is reminiscent of the infamous §89 which was repealed by Congress last year. The lesson to be learned from that experience is that employee benefit plans that are designed to be available and fair to both highly and nonhighly compensated employees should not be branded as discriminatory. It has been recognized in our past experience with §401(k) plans that a fairly generous employer matching contribution and communicating the terms of the plan tend to get nonhighly compensated employees to participate and salary defer.

S. 2901 recognizes the realities and provides alternative safe harbors based upon either a minimum matching contribution, or a 3 percent of compensation nonmatching contribution, together with a requirement for communicating the terms of the plan. Plans with these generous matching provisions should not be considered discriminatory regardless of the actual participation by employees.

Often the average age of the workforce, employee turnover and other factors beyond the control of the sponsoring employer have more impact on the actual participation of nonhighly compensated employees than anything the employer may be able to do to make the plan attractive to them. I have been told of an instance where two employers in the same line of business, with almost identical plans and the same benefits consultant designing the communications, have had diverse results in participation. In the case of the employer who had been in business longer and had an older more stable workforce, the plan had a high degree of participation by the nonhighly compensated. The younger business with a younger workforce did not. This kind of result is illustrative of why participation should not be the criteria upon which the law bases the test for discrimination.

The §401(k) and §401(m) rules as enacted in TRA '86 applied to the then authorized but not then operating Federal Thrift Savings Plan (TSP), a cash or deferred arrangement. As Federal employees began to make decisions relative to participation and salary deferral, it became apparent that the nondiscrimination provisions of §401(k) would severely limit the deferrals allowed to be made by highly compensated Federal employees. Congress, in its wisdom, exempted the TSP from the nondiscrimination rules, observing that the plan by design was not discriminatory relative to the nonhighly compensated.

Mr. Chairman, we agree that a plan, such as the Federal TSP, which is designed to be available to all nonhighly as well as highly compensated employees on the same basis, is not and should not be treated as discriminatory. Therefore, the inclusion in S. 2901 of alternative, safe harbor, design based tests under §§401(k) and 401(m) is justified and will provide equality of treatment between private sector plans and the Federal plan.

The bill (S. 2901) would simplify the definition of highly compensated and provide a new definition of compensation. These changes together with the new safe harbor provisions will allow employers to design a qualified plan that will not require the administrative expense and uncertainty of participation testing. For other plans which will be subject to testing, the other provisions of the bill will provide greater certainty and ease of administration which will be most helpful to them.

S. 2901 does not provide a solution to all of the problems of complexity with which employers and plan administrators are confronted. It is a giant step in that direction and its enactment will help to extend qualified pension plan benefits to a larger segment of the workforce in years to come. Senator David Pryor and Representative Rod Chandler, his counterpart as principal sponsor in the House of Representatives, and all of the cosponsors of these bills are to be commended. We look forward to working with you in efforts to see that the bill's provisions are enacted at the earliest possible time.

CHURCH

The Church Pension Fund
800 Second Avenue
New York, NY 10017
212 661 6700
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VIA CERTIFIED MAIL
RETURN RECEIPT REQUESTED

August 1, 1990

Robert A. Robinson
President

The Honorable David H. Pryor
267 SROB
Washington, D.C. 20510-0402

RE: The Church Retirement Benefits Simplification Act of 1990 (S. 2902)

Dear Senator Pryor:

Retirement pensions and benefits for the Episcopal Church's clergy, lay employees, and their families are provided for in plans of The Church Pension Fund and Affiliates, the Church's Official Agencies for pensions and benefits. Our Clergy Plan (retirement pensions only) is a long-established §401(a) church plan; our several other plans also are duly qualified church plans.

The Episcopal Church and The Church Pension Fund strongly support The Church Retirement Benefits Simplification Act of 1990. This is landmark legislation for us. It brings much needed, long overdue simplification and important clarification to present church retirement pension law; it resolves other aspects of that law which are giving many churches great concern.

Its cornerstone, for plans such as ours, is that it carves out a special niche in the code, the proposed new §401A ("Qualified Church Plan") with simple rules for qualified church retirement plans. Specific code provisions will spell out the retirement pension rules for churches (especially §401A) and simplify many of these rules. Future legislation peculiarly appropriate for retirement plans of secular employers will not impact church retirement plans. This Act, and §401A, are of great importance to us here. Our Bishop A.D. Stewart plans to so testify on Aug. 3rd.

The Act's other major result is bringing workable consistency to coverage and related rules that presently apply to church retirement plans. Believe it or not, rules now applicable to retirement income account plans under §403(b)(9) are significantly different from rules applicable to §401(a) plans such as our Clergy Plan. S. 2902 applies the same rules to all plans. Otherwise, present law is a Procrustean Bed for some denominations, due to the extensive variety and complexities of church polities, nationwide. The Act puts all church plans on a level playing field in that regard

This proposed legislation is a consensus arrived at in over three years of deliberations by the Church Alliance - all the mainline Jewish and Protestant denominations. It is, in their view and my own, revenue neutral. We here have worked long and closely with the Church Alliance. We here believe the Act has the support of the Catholic Church. Respectfully, it is what the churches find is necessary in the tax code as to church retirement plans. The Episcopal Church and other denominations will be able to stop worrying about the many complexities we all now face. This, at least indirectly, benefits some 261,000 clergy and 114,000 lay workers of the Jewish and Protestant faiths - denominations comprising some 66,000,000 churchmen, nationwide, at a minimum.

Your understanding and initiative in introducing the Act are very much appreciated here at The Fund and by the Church we serve. I have much appreciated, also, the invaluable help received from Jeff Trinca of your staff in this connection. If there is any way in which I or any of us can be of further assistance to you you have but to call upon me. I am, believe me,

Very truly yours,

Robert A. Robinson

RAR:mjk

cc: 1. The Most Rev. Edmond Lee Browning, D.D., The Presiding Bishop
2. Mr. Robert A. Addison (Chairman, CPF), 3. The Rt. Rev. William A. Beckham, DD (Vice Chairman, CPF)

In the Service of the Episcopal Church

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE

ERIC

The ERISA Industry Committee (ERIC) is an association of over 125 major corporations. ERIC represents a broad cross-section of major American employers that collectively maintain comprehensive benefit plans for over 25 million employees and dependents. Thus, ERIC has a vital interest in legislation affecting the maintenance and operation of voluntary employer-provided benefit plans.

We appreciate the opportunity to present our views on S.2901, The Employee Benefits Simplification Act, and we appreciate the support of Chairman Pryor and the Subcommittee for employer-sponsored plans We look forward to continuing to work with you.

The comments that follow are based on a preliminary review of S.2901 by our members. Our members' preliminary efforts have been to evaluate the bill in light of the guidelines for simplification that we presented in our testimony before the Subcommittee on March 23, 1990, and that are summarized in the General Comments below; to assess the impact of the bill on their current plans; and to determine the bill's impact on changes in plan structures now being made to conform plans to the Tax Reform Act of 1986 and other recent amendments to benefits law.

GENERAL COMMENTS

We have strong reservations about broad-based pension simplification at this time. Our reservations are based on the constant changes in plans required by the overwhelming volume of pension legislation in recent years, on the condition that any benefits legislation be crafted so that it does not increase revenue expenditures, and on the frequent inclusion in simplification proposals of theoretically simple amendments that impose rigid constraints on plan design. Experience has shown that simplistic design requirements often lead to complex, impractical, and unpopular results in the workplace. Moreover, we are concerned that many recent amendments requiring substantive changes have provided little or no lead time for employers to comply or employees to adjust.

The laws governing pension plans have been changed on an almost annual basis over the past decade. Additional change, even if it seems to simplify the Internal Revenue Code, often is complex in application. New legislation likely will require employers once again to revise their record keeping and data collection systems and to re-test their plans for compliance with new legal standards More troubling, "simplification" can require employers again to redesign their plans.

These problems are more than mere inconveniences. Providing a stable retirement income to employees requires long-term planning. Constant change exacerbates the gridlock that has brought defined benefit plan growth to a halt and threatens the expansion of coverage under all forms of retirement plans. In many cases, employers and employees may actually be better off with current law, even if current law appears more complex.

Constant change is costly. Each revision required in computer systems, administrative procedures, or plan design costs money that would be better spent on benefits. Small and medium-sized employers often drop their plans rather than pay attorneys' and consultants' fees for yet another round of changes.

We realize that our concerns might appear to be inconsistent with your goals. They are not. Instead our concerns are based more on the question of whether this is the right time to move forward, on a desire to look carefully at the precise impact of each specific proposal to determine whether the proposal truly simplifies compliance with the law, and on the possibility that revenue-raising proposals and other non-simplification proposals might be included in a final package approved by Congress.

Any proposed change in benefits law should be subject first to a careful analysis to determine whether the proposal is likely to enhance or diminish the benefits system. That analysis must include whether employers who provide benefits to their employees can comply with the proposed change without disrupting the administration of their established benefit plans and whether they are given sufficient time to put the change into effect.

We believe that, if Congress determines to reduce the burden on employers and the confusion among employees in the benefits area, Congress should follow these guidelines:

- identify discrete areas (such as the leased employee rules) where simplification would reduce the administrative and compliance burdens on plan sponsors, the Internal Revenue Service, and the public without imposing rigid constraints on plan design;
- carefully consider the costs, including the compliance costs, of imposing any new rules on employee benefit plans;
- reject proposals that would upset the retirement planning of employees, retirees, and their families;

- reject proposals that are likely to curtail existing plans or discourage the formation of new plans;
- select more realistic effective dates for any new rules that are enacted, and insist that the Internal Revenue Service allow taxpayers to act on the basis of a reasonable good faith interpretation of the law until a reasonable period of time after a complete set of final regulations is issued; and
- insist that the Internal Revenue Service comply with the Administrative Procedure Act when issuing legislative regulations.

We believe that adherence to these guidelines will dramatically reduce the confusion, uncertainty, and complexity that now envelope the administration of employee benefit plans and that discourage employers from establishing plans for their employees. In our view, some of the provisions of S.2901 meet these guidelines; others do not.

Our specific comments on the provisions of the bill follow. However, our comments are preliminary and are made without the benefit of revenue estimates. In our view, a worthwhile proposal may no longer be supportable if it becomes clear during the legislative process that the provision will be coupled with restrictive, revenue-raising amendments.

SPECIFIC COMMENTS ON S.2901

SECTION 101 – DEFINITION OF HIGHLY COMPENSATED: Section 101 eliminates the $75,000 test, the 20% test, the officers test, and the family member aggregation rules that apply to the 10 most highly compensated employees.

A. Elimination of the $75,000 test and the officers test and the restriction of the family member aggregation rules to 5% owners will simplify plan administration for major plan sponsors. We support these revisions.

B. On the other hand, we believe that elimination of the provision of current law that generally limits the highly compensated group to employees in the top 20% of the payroll typifies the type of arbitrary change that has caused confusion and consternation in recent years.

Employers that now use the 20% rule to define their highly compensated employees will not know whether their plans will meet the Internal Revenue Code's qualification standards under the revised definition. Depending on the characteristics of the employer's workforce and its benefit plans, the elimination of the 20% rule can cause an employer's plans that now qualify under the Internal Revenue Code's nondiscrimination and coverage rules to fail these tests.

Employers already are revising their data collection systems and testing their plans this year in accordance with the 380 pages of newly proposed nondiscrimination regulations under I.R.C. §404(a)(4) and related provisions. Since further clarifications regarding these regulations are expected from the Internal Revenue Service this year and final regulations will not be issued for some time, this process clearly will continue into next year and perhaps into 1992. Under the bill, plans using the 20% rule either must change in midstream or start the process all over again in 1992. If the results are unfavorable, radical plan changes could be required.

We see no reason to subject plans to this possibility.

C. In addition, elimination of the 20% rule in favor of a single $50,000 threshold means that an employer with high average wages will have an unreasonably large percentage of its workforce classified as highly compensated employees. For example, one ERIC member with over 100,000 employees reports that nearly 50% of its workforce will be treated as highly compensated under the bill. For employees earning over $50,000 but not in the top 20% of the payroll, contributions to savings plans could be cut back. These employees will view the change as arbitrary and unfair.

A simpler alternative might be to increase the $50,000 threshold to a level that is more realistic in today's economy (e.g., at least $75,000). Given the current budgetary constraints, however, it would be preferable to retain the 20% rule (and the companion excludable employee rule in I.R.C. §414(q)(8)) until such time as a more realistic compensation threshold for highly compensated employees can be established.

D. Current law already permits employers with geographically dispersed operations to elect to use a single $50,000 threshold to identify their highly compensated employees. See I.R.C. §414(q)(12). Thus, for many employers, the bill does not provide a rule that is any simpler than what is already available under current law.

A preferable and less disruptive alternative to the bill's provisions would be to allow any employer to elect to use the single $50,000 threshold to identify its highly compensated employees, without regard to the geographic dispersion requirement of current law.

E. Under the proposed amendment, it also is unclear whether the indexing of the $50,000 amount that already has occurred under current law would be preserved. The explanation accompanying the bill indicates that the drafters intended to preserve the previous indexing; however, similar statutory language in I.R.C. §401(a)(17) did not result in indexation of the $200,000 limit in that section until 1990 (one year after section 401(a)(17) became effective). See Prop. Treas Reg §1.401(a)(17)-1(a).

F. If amendments to the definition of highly compensated employees are enacted, the January 1, 1992, effective date of the provision simply does not provide sufficient time for plans to adjust to yet another change

SECTION 102 – DEFINITION OF COMPENSATION Under Section 102, the general definitions of compensation under I.R.C. §§414(s) and 415(c) are changed to "wages shown on the W-2 form" or "base pay".

A. ERIC strongly opposes this change. Regulations issued by the Internal Revenue Service in May of this year have been favorably received and have provided much-needed stability in this area By contrast, S.2901 would compel many employers to alter their plans' definitions of compensation to conform to the provisions of the bill. Many employers again will be faced with changing their plans' benefit formulas; communicating to employees changes in long-standing plan provisions; revising their data collection systems; and restructuring their plans.

B. The provisions of the bill apparently apply retroactively with respect to former employees who are classified as highly compensated former employees under I.R.C. §414(q)(9). This will require employers to reconstruct compensation data for all former employees in order to determine if they are classified as highly compensated using the new definition of compensation. In many cases this will have to be done manually, since the data no longer will be available on computer. In other cases it will be impossible, since the necessary data no longer exist.

C. The option under the bill to use "base pay" instead of W-2 compensation is confusing The explanation of the bill defines base pay by referring to the regulations under I.R.C. §414(s) recently issued by the Internal Revenue Service. These regulations, however, do not define base pay. Moreover, although the statement accompanying the bill indicates that the use of base pay is subject to an undefined nondiscrimination standard, the bill itself does not impose a nondiscrimination standard.

If the intent of the provision regarding base pay is to authorize the use of alternative definitions of compensation as is currently permitted under I.R.C. §414(s)(3), then the reason for the amendment made by the bill is unclear. If base pay is intended to mean something different from the options provided under current law, then employers will be left completely in the dark as to the actual impact of the amendment until new regulations are promulgated. New regulations are not likely to be available by the effective date in the bill, exacerbating the gridlock already choking the system.

D. In summary, we believe the change is unwarranted and will cause more complexity in application than current law.

SECTION 103 – MODIFICATIONS OF COST-OF-LIVING ADJUSTMENTS: Section 103 provides that cost-of-living adjustments in the I.R.C. §415 limitations on contributions and benefits will be based on third quarter (September 30) data rather than on fourth quarter (December 31) data and provides that the resulting dollar limits will be rounded to the nearest $1,000.

A. Basing the cost-of-living adjustments on third quarter data and rounding the dollar limits to the nearest $1,000 will simplify both plan administration and communications with employees. We support this provision as it is presented in S.2901.

SECTION 104 – MODIFICATION OF MINIMUM PARTICIPATION REQUIREMENTS: Section 104 limits the application of the minimum participation rule in I.R.C. §401(a)(26) to defined benefit plans and reduces the 50-employee requirement to 25 employees.

A. The newly proposed I.R.S. regulations issued under §401(a)(26) appear to solve most of the problems that the previously proposed regulations had created. However, S.2901 would further simplify compliance with §401(a)(26).

<u>SECTION 105 – NONDISCRIMINATION RULES FOR QUALIFIED CASH OR DEFERRED ARRANGEMENTS AND MATCHING CONTRIBUTIONS</u> Section 105 of the bill provides design-based safe-harbors whereby plans may satisfy the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test of I.R.C. §401(k) and (m) without reliance on annual testing. The bill also changes the order in which excess deferrals and excess contributions are distributed from first distributing funds to employees with the highest deferral and contribution percentage to first distributing funds to employees with the highest dollar amounts of deferrals or contributions.

A. The proposed legislation correctly identifies the ADP and ACP rules as one of the more complex testing procedures required under current law. The safe harbor in the legislation is itself complex, and we have not, therefore, been able to evaluate it fully as of this date. We have the following initial comments:

B. The provisions in the bill limiting the rate of matching contributions for highly compensated employees appear to be technically flawed. For example, the language in the bill requires matching contributions for each individual highly compensated employee to be compared with matching contributions for each individual nonhighly compensated employee. <u>See</u> §401(k)(11)(B)(ii) and §401(m)(10)(B)(iii). This is an operational test, not a safe-harbor based on plan design. As drafted, these provisions preclude <u>any</u> matching contributions for highly compensated employees if a single nonhighly compensated employee chooses not to contribute to the plan. In addition, the bill incorrectly refers to the level or amount of the employer's matching contributions instead of the <u>rate</u> at which the employer makes matching contributions.

C. Changing the order of distributions of excess deferrals and contributions from the highest percentage of deferrals and contributions to the highest dollar amounts may be a worthwhile change, but is not simplification. It substitutes one complex rule for another and will require yet another round of changes in employers' data processing systems and re-education of employees. Moreover, unlike the safe harbors discussed above, this provision is not optional. It will apply to all 401(k) and 401(m) plans. Thus, the proposed January 1, 1991, effective date is completely unrealistic.

D. Although the bill does not reduce the $7,000 (indexed) limit on 401(k) deferrals, we are concerned that amendments to the ADP test could result, during further consideration of the bill, in a revenue-driven reduction in the $7,000 limit. We decidedly prefer the current rules to a reduction in the $7,000 limit and would oppose any reduction in this limit.

<u>SECTION 201 – TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST</u>: Section 201 of the bill liberalizes rollover rules for distributions from qualified plans and eliminates 5-year averaging beginning January 1, 1991. The section also preserves 10-year averaging, as under the Tax Reform Act of 1986, for individuals who attained age 50 before January 1, 1986, and retains current law treatment for net unrealized appreciation on employer securities.

A. While we support liberalization of the complex rollover rules, we do not support the concurrent and precipitous elimination of 5-year averaging. We recognize that some practitioners and policy makers argue that averaging has less value under the current tax rate structure than it did under the pre-1986 Act structure and that many employees already roll over their distributions to Individual Retirement Accounts instead of utilizing 5-year averaging. For an individual who intends to retire within the next few years, however, and who has planned his or her retirement savings with the intent of taking a lump-sum distribution, this amendment will be disruptive and could result in the loss of thousands of dollars of retirement savings. This is the type of precipitous change that has drastically reduced employee confidence in the pension system and employer interest in providing pension plans. If this amendment is enacted, we believe it is imperative that a long lead time, similar to that provided for 10-year averaging under the 1986 Act, be provided.

B. For similar reasons, we also strongly support the bill's maintenance of the 1986 Act provisions for 10-year averaging and the current treatment of net unrealized appreciation on employer securities. <u>Employees have a right to expect the government to provide stable rules for their long-term savings arrangements</u>.

C. While the intent of the legislation is to retain the 1986 Act provisions for 10-year averaging and current treatment of net unrealized appreciation, §201(b)(43) of the bill repeals the "5-times" rule for lump sum distributions. Under the "5-times" rule, the $150,000 (indexed) threshold for the 15% excise tax on large distributions is multiplied by 5. The "5-times" rule should be retained.

<u>SECTION 202 – QUALIFIED PLANS MUST PROVIDE TRANSFERS OF CERTAIN DISTRIBUTIONS TO OTHER PLANS</u>: Section 202 requires a distribution exceeding $500 and made before age 55 to be rolled over to an IRA or other qualified plan unless it qualifies for one of a limited number of exceptions.

A. We oppose this provision. The provision does not simplify pension law. Instead it imposes a new policy that may result in complex regulation and certainly will require massive re-education of employees. Much of the recent complexity in pension law stems from the fact that every

year Congress has passed legislation imposing a new vision of what the pension system ought to look like. This provision clearly helps to create the problem that the bill seeks to solve.

B. We are concerned that the mandatory transfer provision will expose employers to the risk of substantial additional litigation. Employees who are disappointed with the IRA's investment performance might institute litigation against the employer for choosing a transferee IRA that has not performed as well as the employees believe it should have.

SECTION 203 – REQUIRED DISTRIBUTIONS FROM QUALIFIED PLANS: Section 203 changes the age at which mandatory distributions are required under I.R.C. §401(a)(9) from age 70½ to age 70. In addition, section 203 requires a plan to begin making distributions to a 70-year-old employee who has not yet retired only if the employee is a 5% owner. For employees who are not 5% owners, the provision requires an actuarial increase in an employee's accrued benefit if the employee works beyond age 70.

A. The limitations on the application of the mandatory distribution rules would help to reduce administrative complexity while targeting the provision to the circumstances that Congress was concerned about when it amended the mandatory distribution rules. The current distribution rules make little sense to employees, and this amendment will make more sense to them.

B. The bill should clarify the relationship between the new actuarial increase requirement and the post-age-65 accrual requirement in I.R.C. §411(b)(1)(H) to assure that an employee who works beyond age 70 is not entitled to receive both an actuarial increase and additional benefit accruals.

SECTION 301 – TREATMENT OF LEASED EMPLOYEES: Section 301 replaces the "historically performed" test of current law with a control test. The amendment is similar to an amendment that the Senate approved in 1989.

A. ERIC strongly supports passage of legislation to modify the current law leased employee rules by replacing the historically performed test with a control test. Current law is both overreaching in scope and incomprehensible in practice. We emphatically believe that this change should be enacted at the earliest possible time.

SECTION 302 – ELIMINATION OF HALF-YEAR REQUIREMENTS: Section 302 changes age 59½ to age 59 and age 70½ to age 70 wherever they appear.

A. The amendment requires changes in plan administration and notification of employees The proposed January 1, 1991, effective date does not provide the necessary lead time for compliance.

SECTION 305 – VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS: Section 305 provides that employers will be treated as though they are affiliated, for purposes of the regulations under I.R.C. §501(c)(9), if they (1) are in the same line of business, (2) act jointly to perform tasks that are integral to the activities of each of the employers, and (3) act jointly to such extent that the maintenance of a voluntary employees' beneficiary association is not a major part of the employers' joint activities.

A. The amendment should be clarified to make clear that employers that are considered affiliated under existing law will not be subject to the bill's new requirements. For example, the members of a controlled group of corporations or other related entities should not fail to be treated as affiliated simply because they do not meet the requirements imposed by the bill.

SECTION 311 – DATE FOR ADOPTION OF PLAN AMENDMENTS: Section 310 provides that plan amendments required under the bill need not be made before January 1, 1992, if the plan is operated in accordance with changes required by the bill.

A. While this provision is welcome, it underscores the fact that the bill requires plan amendments almost immediately after most employers have just finished amending their plans to conform to previous changes in the law. In order to make the changes in their plans and plan administration that the bill requires, major employers will be required to spend money that otherwise could have been spent in providing benefits to employees. Many small and medium-sized employers may simply terminate their plans rather than pay for yet another round of plan amendments. Rejecting unnecessary amendments and, where amendments are needed, providing more realistic effective dates would be a far better solution.

B. The provision should also be amended to provide delayed effective dates for collectively bargained plans until the expiration of the last-to-expire of the bargaining agreements in effect when the bill is enacted. Of course, the effective date for collectively bargained plans should not be earlier than the effective date for nonbargained plans.

STATEMENT OF THE ESOP ASSOCIATION

The ESOP Association expresses support for Senator Pryor's and his colleagues efforts to simplify the general ERISA tax code provisions with the proposed bill S. 2901. The ESOP Association is a national non-profit association of nearly 2000 members. It is headquartered at Suite 1207, 1100 17th Street, N.W., Washington, D.C.

Although there are many special rules in ERISA pertaining only to employee stock ownership plans (ESOPs), ESOPs are ERISA plans. Thus, the complexity of ERISA tax law provisions bedevil the ESOP company as much as any qualified plan sponsor. Furthermore, evidence shows ESOP companies frequently sponsor other ERISA plans, such as defined benefit plans and Section 401(k) plans. We can all rally behind Senator Pryor's legislation.

As to specifics, we note the following:

(1) The ESOP Association expresses support for his and his cosponsors' decision to maintain, in essence, the current law treatment of the net unrealized appreciation of employer securities distributed to plan participants or their beneficiaries.

We note with extreme dismay that the Treasury Department has taken the position that the net unrealized appreciation (NUA) should be taxed at distribution. Treasury glibly dismisses the potential unfairness of its position by stating the securities may be rolled over tax free. One, many qualified plans and IRA arrangement will not accept employer securities in a rollover. Two, this Treasury statement does not address the hardship of taxing a retired participant for income not realized.

The ESOP Association strongly believes that making an individual liquidate assets to pay taxes is patently unfair.

We urge Senator Pryor and his committee colleagues not to follow the recommendation of Treasury to tax the NUA gain of distributed employer securities distributed in a lump sum;

(2) We also comment that S. 2901's provision for mandatory trustee-to-trustee transfers of plan distribution may create a difficult administration problem for ESOPs and other plans that hold and distribute employer securities. Many IRA's and plans will not accept employer securities. While we do not have a specific suggestion for exempting ESOP distributions from the trustee-to-trustee transfer provisions, this relief may be reasonable. It may also be possible to address the problem by leaving the decision as a permissive one by the participant or beneficiary. In other words, the trustee-to-trustee transfer would be subject to the participant's authorization and thus permit a direct distribution to the participant in those situations where no plan is available to accept the employer securities;

Also, the trustee-to-trustee transfer has to be molded to the unique ESOP and stock bonus "put" rules for distribution of employer securities that are not readily tradable on a stock market. (Code Section 409(h)). Note that the recipient of the employer securities that are not readily tradable, can "put" the securities back to the plan sponsor, who has to buy, or repurchase" the stock at fair market value. This "put" decision is usually exercised quickly, shortly after distribution; but the participant may delay the "put" decision for just over one year from date of distribution. A trustee-to-trustee transfer that overrides the employee's "put" power would be a very negative blow to ensuring that the ESOP participant receives protection as to his or her plan assets upon distribution of non-tradable stock; and

(3) We believe that the $50,000 per year of threshold definition of highly compensated employees (HCE) is too low an amount. We would recommend a higher threshold, perhaps as high as $80,000.

A very important ESOP provision is the ability to contribute 25% of payroll plus interest under Code section 415(c)(6), *if* no more than one-third of the employer contribution is allocated to HCE's.

In many regions of our nation, the pay of $50,000 is lower than that of skilled and senior production line personnel, and low level management jobs. Certainly $50,000 is lower than many mid-level management personnel.

If the HCE definition is changed to a $50,000 threshold, it could adversely impact the payment of ESOP debt of certain established ESOP companies because of a pre-enactment debt retirement scheme utilizing the 415(c)(6) provisions.

Once again, we salute your and your colleagues introduction of S. 2901, and look forward to its enactment with minor modifications.

EVANGELICAL LUTHERAN CHURCH IN AMERICA, BOARD OF PENSIONS,
Minneapolis, MN, August 1, 1990.

Hon. DAVID H. PRYOR,

U.S. Senate,
Washington, DC.

Re: *The Church Benefits Simplification Act of 1990*

Dear Senator Pryor: I am writing to you for the purpose of expressing full support for the Church Benefits simplification Act of 1990 (S. 2902) which you introduced into the senate on July 25, 1990. I am pleased that you have agreed to sponsor this bill which will be of significant benefit to the Board of Pensions and the many clergy and lay workers serving the Evangelical Lutheran Church in America.

I am President of the Board of Pensions of the Evangelical Lutheran Church in America (ELCA). The Board of Pensions is a unit of the ELCA which manages the pension, medical/dental, survivor and disability plans for the Church. The benefits are provided to pastors, associates in ministry, and lay employees of the ELCA. The Board of Pensions provides benefits to over 42,000 active or retired members and beneficiaries through its various plans with assets totaling approximately two billion dollars.

The ELCA is the largest Lutheran church body in the United States, having been formed in 1988 as the result of a merger between The American Lutheran Church (ALC), the Association of Evangelical Lutheran Churches (AELC) and the Lutheran Church in America (LCA). Approximately 11,000 congregations serve over 5.2 million members through the pastoral services of 16,500 clergy members.

The Board of Pensions, as an active participant in the Church Alliance, wholeheartedly supports the Church Benefits simplification Act of 1990. The Act makes significant strides in modifying and simplifying the procedures which the Board of Pensions must follow in administering a benefit program for this Church. While the Board of Pensions recognizes the importance of all of the provisions in the Church Benefits Simplification Act, the following provisions are of particular importance to the Board of Pensions:

1. *Coverage Rules.* This provision will bring all of the ELCA-controlled or associated organizations (other than church hospitals, colleges and universities) under the same coverage and related rules that have historically applied to our congregations and synods. This standardization of rules relating to pensions facilitates the provision of pension and other benefits to the employees of the many camps, orphanages, nursing homes and other social service agencies that make up a vital part of the overall ministry of our Church.

2. *Ministers Participating in church Plans and Self-Employed and Other Ministers.* A second significant improvement contained in the Act relates to provisions that allow for ministers engaged in the exercise of their ministry to be disregarded in testing the church plans in which they actually participate, as well as the retirement and welfare plans of their employer, for compliance with the coverage and related rules. Additionally, the legislation makes it clear that self-employed ministers and other ministers who are employed in the exercise of their ministry by secular employers will be permitted to participate in the retirement and welfare benefit programs maintained by the Board of Pensions. These provisions are particularly important to our clergy serving in specialized ministries.' They facilitate the portability of pension and other benefit plans as our ministers move from service in a congregation to other ministries such as a hospital or prison chaplaincy. While the vast majority of our ministers serve in the typical congregational setting, hundreds of them also serve in specialized ministries throughout the world. This legislation will be significant in enabling the Board of Pensions to continue to provide a comprehensive pension and other benefit package for our chaplains, no matter where they are serving the church.

3. *Church Plans that Self-Annuitize Benefits in Pay Status.* The Board of Pensions of the ELCA like many other denominational church pension plans, self-annuitize pension assets in order to provide a stream of annuity payments by pooling all of the assets of retired individuals for mortality purposes. The Act will allow the church pension boards to continue this practice.

In conclusion, Senator, on behalf of all of the many clergy, associates in ministry, and lay workers serving the Evangelical Lutheran Church in America throughout the United States, I would like to thank you for your continuing effort and support in sponsoring this important legislation.

Sincerely,

JOHN G. KAPANKE, *President.*

STATEMENT OF GALLOP, JOHNSON & NEWMAN

We represent a number of organizations that contract with hospitals throughout the United States to provide emergency medical coverage at the hospitals' emergency departments. This statement sets forth our concerns over the potential application of existing and proposed employee leasing rules to the emergency medicine physician practice.

Emergency Medicine Practice. Emergency medicine is a medical specialty that has been recognized since the early 1970s. Many hospitals find it necessary to contract for emergency medicine coverage with outside independent emergency medicine physicians. The hospitals generally contract with independent organizations who provide for the emergency medical coverage. This coverage may be for weekends, night shifts (6:00 p.m. to 6:00 a.m.) or on a full 24-hour 7-days a week basis. This specialized practice is particularly beneficial to rural hospitals that many times are otherwise unable to obtain qualified emergency department coverage. Greater usage is also occurring in urban hospitals. Most of these hospitals are Section 501(c)(3) organizations, although some are for profit. In many instances, the hospitals' cost of retaining 24-hour emergency medical coverage through outside emergency medicine physicians, including standby costs, is reimbursable through Medicare.

After a contract with a hospital is obtained, the emergency medicine physician provider organizations will contract with qualified emergency physicians to provide the hospital with the emergency medical coverage. Many of these independent physicians provide emergency medical coverage through these organizations on a part-time basis for multiple hospitals and their availability to provide such coverage may be concentrated over a period of months, sporadically during the year, certain days during the year, etc. These physicians typically have other medical practices independent of their contractual obligations with the organization contracting with the hospital to provide emergency medical coverage. A much smaller group of independent emergency medicine physicians contract with these organizations on a full-time basis, generally providing emergency medical coverage only at one hospital.

In contracting with an emergency medicine physician provider organization, the independent emergency physicians are generally free to choose and change the number of hours they want to work and what periods of time they want to work within the times specified in the hospital contract. Emergency medicine physicians, are usually paid a fee on an hourly basis because the nature of emergency medicine rests upon having qualified physicians available, rather than the number of patients seen or the amount of billings.

It is important to note that many of the organizations contracting with the hospital are not licensed to practice medicine and do not control how an emergency medicine physician practices emergency medicine at a particular hospital. The contracting hospital also does not control these physicians. At the hospitals, the physicians are subject only to the rules and regulations required of all physicians, whether hospital physicians or outside physicians providing medical services on the hospital premises. These physicians are not entitled to participate in any of the hospital employee benefit plans.

Emergency medicine physicians generally provide emergency medical. coverage 12 hours at a time. On an annual basis, most of these physicians would be classified as highly compensated individuals under the tests for determining such status under the Internal Revenue Code.

Impact of Employee Leasing Rules. Because of the nature of the emergency medicine practice, the employee leasing tax rules are of concern to the hospitals, the contracting organizations, and the independent emergency medicine physicians.

Currently, Section 414(n) of the Code provides that an individual will be treated as a leased employee of the service recipient for qualified plan purposes if (1) the services are provided pursuant to an agreement between the recipient and "the leasing organization," (2) such person has performed such services on a "substantially full-time basis" for a period of at least one year, and (3) such services are of a type historically performed, in the business field of the recipient, by employees.

The potential application of the "substantially full-time basis" test and the "historically performed" test to emergency physicians is of concern. As a result of possible interpretations of these two tests, there is potentially significant uncertainty as to the treatment of emergency medicine physicians vis-a-vis the hospitals (and the organizations that contract with the hospitals to provide emergency medical coverage).

With respect to the substantially full-time basis test, given the unique nature of the emergency medicine practice and its coverage requirements, it is possible that

part-time independent emergency medicine physicians will sometimes provide sufficient hours of coverage at a particular hospital to satisfy the hourly threshold set forth in Treasury's proposed regulations, and thus come within the substantially full-time basis test, although this generally can never be determined in advance. For example, an independent emergency physician who provides just three 12-hour shifts (6:00 p.m. to 6:00 a.m.) of coverage per week at a single hospital for each week during a particular year would provide 1872 hours of coverage during the year (3 x 12 x 52). We think that all would agree that these physicians on an aggregate annualized basis are highly compensated. However, because a physician may not be within the class of highly compensated at a particular hospital under the existing Code rules, we respectfully urge that this situation be addressed.

To clarify the part-time physician situation, the definition of highly compensated should include an alternative hourly compensation test. This hourly compensation test would include in the definition of highly compensated those individuals who earn in excess of a specified amount per hour. Such a test would address part-time situations that may exceed the hours of coverage threshold during a particular year. For example, if the highly compensated annual threshold is $50,000, we would propose an hourly threshold of $25 per hour ($50,000 divided by 2,000 hours). Thus, an emergency physician who provides coverage at a fee of $25 or more per hour would be highly compensated.

In addition to our concern over the "substantially full-time" component of Section 414(n), we are also concerned about the "historically performed by employees" component. While many hospitals historically have used independent contractors to provide emergency medical coverage, a small percentage of hospitals have used hospital employee physicians and the "historically performed by employees" component of Section 414(n) could be viewed as being satisfied.

The physician provider organizations, like other groups commenting on the leased employee proposal, were not initially concerned about the "historically performed" test in Section 414(n) because of the historic practice of treating emergency department physicians as independent contractors. However, in August 1987, the Internal Revenue Service issued proposed regulations providing very broad rules that go far beyond the scope and intent of Section 414(n). We understand that at the August 3, 1990, hearings on Senate Bill 2901, the Department of Treasury acknowledged that these regulations were too broad, that they would be withdrawn, and that more narrow regulations would be issued in the future specifically addressing the abusive transactions that prompted the enactment of Section 414(n).

Section 301 of Senate Bill 2901 is intended to simplify and clarify the intended scope of the employee leasing rules by substituting a "control" test (a service provider would be deemed to be a leased employee if the service provider performed services under the control of the service recipient, assuming the other requirements of Section 414(n) were satisfied) for the "historically performed by employees" test in Section 414(n) of the Code. Given the Internal Revenue Service's interpretation of the "historically performed" test set forth in its proposed regulations, the proposed control test would appear to be an improvement over the existing "historically performed" test. We are, however, concerned that the proposed "control" test is still somewhat subjective and subject to varying interpretations.

To prevent the unintended application of these rules to particular categories of service providers, we would suggest for consideration that the Internal Revenue Service be given specific regulatory authority to exclude specific categories of taxpayers from the application of Section 414(n) and that the committee report reflect a Congressional intention not to have these rules apply to emergency medicine physicians.

In addition, clarification of the control test would be helpful. In this regard, we would request consideration of statutory or committee report language along the lines of the following:

> A person should not be deemed to be under the control of the service recipient solely because the person is subject to the recipient's rules and regulations which are applicable to all service providers providing similar services, such as safety and health standards, confidentiality standards or professional practice standards. Professional practice standards would include professional standards imposed by a service recipient applicable to all professional service providers. For example, this would include hospital rules and regulations governing medical practice applicable to all physicians providing medical services on hospital premises (regardless of the identity of the person or entity responsible for enforcing such rules). As a result, a physician providing medical services at the emergency facilities of a hospital would not be treated as a leased employee solely because the physician

is subject to the hospital's rules and regulations governing medical practice at the facilities.

CONCLUSION Although the intent behind Section 414(n) was to prevent abuse, we are concerned that the purpose has been lost over time and that the rules are being interpreted to encompass situations not intended by Congress or in need of being addressed. While we believe the proposed "control" test set forth in Senate Bill 2901 represents an improvement in this complicated area, we continue to be concerned that such a test will be subject to varying interpretations. We believe our suggested clarifications would go a long way in addressing these concerns.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute, the national association of the American mutual fund industry, welcomes the opportunity to comment on S. 2901, the Employee Benefits Simplification Act.

INTRODUCTION

The Institute's membership includes 3,026 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $967 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders.

Mutual funds have traditionally served as vehicles through which investors of modest means may channel their investment dollars into the nation's economy through a diversified, professionally managed pool of investments. Mutual funds are increasingly providing the investment medium for retirement income programs, including both qualified defined contribution and defined benefit plans, IRAs and Simplified Employee Pensions (SEPs) In addition, many mutual funds sponsor prototype retirement programs for employers seeking to adopt a qualified plan or SEP.

SUPPORT FOR SIMPLIFICATION

The Employee Benefits Simplification Act has as its goals and objectives the simplification of the tax laws with respect to employee benefit plans. The Institute endorses these objectives, and supports legislative efforts to simplify the many complex and often burdensome laws applicable to the operation of employee benefit plans and the distributions from such plans and IRAs. In this regard, the Institute and its members would also support further legislation which will substantively simplify these laws. For example, simplification of the "top-heavy" rules now contained in Code section 416 and the distribution rules under Code section 401(a)(9) would do much to alleviate the complexity and confusion which currently exists in employee retirement benefit law and which would remain even after enactment of this legislation.

The Institute has several comments regarding specific provisions of the legislation which are discussed below.

REVISION OF CODE SECTION 402

Section 201 of S. 2901 would amend Code section 402 to allow an employee or the surviving spouse of the employee to rollover or transfer any distribution to an individual retirement account (IRA) or another qualified plan. Current law restricts rollovers depending on whether (i) the amount equals 50 percent of the balance to the credit of the employee, (ii) the distribution is part of a series of periodic payments or (iii) the employee separated from service. These rollover complexities under current law deter savings without regard to retirement policy objectives.

The Institute supports the legislation's simplification of the rollover rules under Code section 402. The Institute also endorses revising the current law restriction on rollover of employee contributions so that these amounts may be transferred or rolled over to further increase the amount of savings available to an employee at retirement.

TRANSFERS OF PRE-RETIREMENT DISTRIBUTIONS

Section 202 of S. 2901 would add new Code sections 401(a)(30) and 417A to require transfer of pre-retirement distributions in excess of $500 to an eligible transferee plan. The legislation defines an eligible transferee plan as an "individual retirement plan designated by the employee in such form, and at such time, as the transferor plan may prescribe." The eligible transferee plan may also include a successor em-

ployer's defined contribution plan which provides for acceptance of plan-to-plan transfers.

The Institute supports the approach of the legislation in promoting the IRA as the portability vehicle. However, we are concerned that the term "individual retirement plan" is not defined in the legislation and could allow for the creation of a new, more complex portability vehicle. The legislation should clarify that the current law IRA as defined in Code section 408(a) is the eligible transferee plan when no successor employer's defined contribution plan provides for acceptance of transfers.

The IRA represents an existing, simple portability vehicle to accomplish the objectives of promoting pension plan portability and preserving plan assets for the payment of retirement benefits. It would do little to assure the use of pension benefits for retirement to create a new or more complex portability vehicle or to encumber the transferee IRA with additional requirements. For these reasons, it is important that transfers to IRAs occur after other rules relating to distributions are applied, such as spousal consent requirements under Code section 417.

In light of the above, the Institute recommends that the legislation be clarified to change references to "individual retirement plan" in proposed Code section 417A to "individual retirement account as defined in section 408(a)."

We also recognize that the legislation creates additional complexity by establishing $500 as the minimum required amount for transfers of pre-retirement distributions. Code section 417 currently requires plan administrators to obtain written consents for distributions in excess of $3,500. As a result, the legislation's $500 minimum for pre-retirement transfers would create three types of retirement plan distributions: (1) Amounts of $500 or less which may be distributed to the employee, (2) amounts between $500 and $3,500 which will be transferred directly to an eligible transferee plan and (3) amounts in excess of $3,500 which will require written consent under Code section 417 before the amount is transferred to an eligible transferee plan. The Institute recommends that the minimum amounts in Code section 417 and proposed Code section 417A be made uniform in the interests of employee benefits simplification. We recommend the proposed $500 minimum transfer amount be increased to $3,500.

SEP SIMPLIFICATION

Section 307 of S. 2901 would expand the availability of salary reduction options in SEPs to employers with 100 or fewer employees. We agree that SEPs can be the vehicle by which employers not currently maintaining pension plans could be encouraged to provide retirement income for their employees. For this reason we support the legislation's expansion of the availability of these arrangements. Simplification or modification of the "top-heavy" provisions of Code section 416 would also enhance the attractiveness of these arrangements to employers.

We thank the subcommittee for the opportunity to present these comments.

STATEMENT OF LEVI STRAUSS ASSOCIATES, INC.

Chairman Pryor and members of the Subcommittee, my name is George James and I am the Chief Financial Officer and Senior Vice President of Levi Strauss Associates, Inc. ("LSAI"). On behalf of LSAI, I would like to thank the Subcommittee for the opportunity to address the leased employee provision of the Employee Benefits Simplification Act, S. 2901. I also believe that I speak for virtually everyone who is involved in employee benefits planning and administration in saying that the efforts of Senator Pryor in developing his simplification bill are much appreciated and LSAI looks forward to working with you and others in developing a proposal that promotes both the equity and simplicity of the private pension system.

LSAI is the world's leading manufacturer of apparel. The apparel industry is a labor intensive business. Last fiscal year, we employed approximately 23,500 persons in this country to make over 100 million pairs of pants. The apparel industry is subject to extreme fluctuations in market demand for individual products. For example, in our third quarter of 1989 we experienced sharp upward demand for our products. This caused us to increase the number of domestic contractors in use from an original forecasted number of 60 to over 135 independent contractors who were actually engaged in 10 states in a short three-month period.

The primary purposes of using independent contractors are: (1) to address periodic capacity constraints in LSAI's own facilities, (2) to address sporadic peak product demand, (3) to service a demand that, from LSAI's perspective, is relatively small or that is not expected to last indefinitely, and (4) to utilize the specialized expertise of particular contractors. It is easy to see that, if LSAI were forced to address these

problems with its own employees and facilities, it would have to open and close plants at a rate that would be disruptive to the employees and their communities, which LSAI considers unacceptable.

THE LEASED EMPLOYEE PROBLEM OF CURRENT LAW

Under the Internal Revenue Code of 1986 (the "Code"), an employer must treat leased employees as regular employees for purposes of the various qualification rules for pension plans, notably the minimum participation, minimum coverage, and nondiscrimination rules. Section 414(n) of the Code provides a three-pronged test for determining whether a person is a leased employee:

(1) he or she performs substantially full-time services for the recipient of those services;

(2) such services are provided pursuant to an agreement with a leasing organization; and

(3) such services are historically performed by employees of persons in the business field of the recipient.

The latter requirement is often referred to as the "historical performance" test.

Thus, under the current rules, many employees of LSAI's contractors may be considered the employees of LSAI. I use the word "may" because we have no practical way of knowing how long other companies' employees spend during any year making products for LSAI. The contracting companies themselves probably do not keep accurate records as to how long each of its employees spends working on LSAI's products and how long those workers spend working on other companies' products.

LSAI has no control over the individual workers' work methods, hours, or wages, nor does the company directly or indirectly provide a work place or equipment for these workers. To be sure, the contractors must produce products that meet LSAI's standards of design and quality, and LSAI inspects the manufacturing process in the contractors' plants in order to prevent product defects or delays as early in the production process as possible. LSAI does not, however, have direct or indirect control over the work of any of the contractors' employees. Each of the contractors holds itself out to other clothing manufacturers for contract work, and the contractors normally service other manufacturers in addition to LSAI. In fact, it is virtually certain that, under the current rules, some contractors have employees who were LSAI's leased employees and other employees who were leased employees of a competitor of LSAI.

THE OVERBREADTH OF THE CURRENT STATUTE

Congress first enacted rules to restrict the use of leased employees by plan sponsors in 1982 as part of Tax Equity and Fiscal Responsibility Act (TEFRA). Congress was concerned about employers (largely professionals) attempting to elude the tax qualification rules by transferring their staffs to outside organizations and leasing them back. In this way they were able to provide tax-preferred benefits only to highly compensated individuals without violating the various plan qualification rules. The historical performance test appeared to eliminate such abuse.

The historical performance test caused new problems, however, especially as it was expansively interpreted in Treasury's proposed regulations. The term "leasing organization" is not well defined and could easily include any third party, including a regular contractor. Thus, an employee of a contractor who provides services for a recipient could be considered an employee of the recipient for plan testing purposes, even though the recipient does not supervise that worker, does not set that worker's hours, has nothing to do with setting that worker's wages, and, in fact, has no practical way of knowing who that worker is.

THE SOLUTION IN THE EMPLOYEE BENEFITS SIMPLIFICATION ACT

Section 301 of the Employee Benefits Simplification Act provides a simple, equitable solution to the problems involved in the historical performance test. That provision would replace the historical performance test with a control test. In other words, a worker would not be considered a leased employee of a service recipient unless that worker was under the control of the recipient.

Much has been said in recent months about the lack of clarity in the control test. However, any lack of clarity could easily be resolved by further statutory or report language that included specific criteria that would be used by plan sponsors and the Treasury in determining whether a worker was under the control of the service recipient. For example, a similar proposal approved by the Finance Committee last

year clarified that relevant factors in determining whether an individual is under the control of a service recipient would include whether the service recipient (1) prescribes the individual's work methods, (2) supervises the individual, (3) sets the individual's working hours, and (4) sets the individual's level of compensation.

The most important improvement in the control test is its ease of application. It is much easier to determine whether workers under a plan sponsor's control are performing substantially full-time services for that plan sponsor than it is to determine whether workers under another party's control are performing services for that plan sponsor.

Finally, I would like to address the concerns that many may have about the danger that the control test may cause a return to the abuses of the pre-TEFRA rules. With proper guidance about the meaning of "control," these abuses can be prevented.

Prior to TEFRA, a plan sponsor only had to include common-law employees in testing its pension plans under the various qualification rules. "Control" was a large element of the common-law definition of "employee." If committee report language were adopted that was similar to that which accompanied last years Finance Committee leased employee proposal, however, the definition of "control" for purposes of determining whether an individual was a leased employee would be stricter than the definition of "control" under the common-law. For example, if an individual was under the direction of a recipient but the leasing organization retained the right to replace the individual, that individual would be the common-law employee of the leasing organization but the leased employee of the service recipient. This difference between the common-law control test and the narrower control test as proposed for leased employees has been recognized in a similar provision recommended by the majority tax staff of the House Ways and Means Committee.

CONCLUSION

LSAI strongly supports the adoption of the leased employee provision of S. 2901. We believe that it represents a simpler alternative to the historical performance test while preserving the safeguards of the leased employee rules. Nevertheless, we would welcome the opportunity to work with you or your staffs in working out any problems you believe may result from the new control test.

LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION,
Los Angeles, CA, August, 23, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
Committee on Finance,
U.S. Senate,
Washington, DC.

Re: In support of S. 2901

Dear Ms. Wilcox: This letter is a statement for the record for the hearings on S. 2901, the Employee Benefits Simplification Act.

SUMMARY

The Los Angeles County Employees Retirement Association (LACERA) strongly supports S. 2901 and ~~the efforts of~~ Senator Pryor, and all of the other sponsors of S. 2901, to simplify the Federal tax laws that concern employee retirement plans. LACERA particularly supports the enactment of Section 306 of the bill, which will greatly simplify the administration of retirement plans for public sector employees and eliminate unintended adverse consequences for lower paid employees.

DISCUSSION

Established by California statute, LACERA provides retirement benefits to over 95% of the employees of the County of Los Angeles. LACED provides retirement benefits to over 35,000 retired members and their beneficiaries, and over 68,000 active members. It holds assets of over $10.3 billion. LACERA is a qualified retirement plan under the Internal Revenue Code.

LACERA strongly supports the goals of S. 2901 to simplify the Federal tax laws concerning retirement plans. As Senator Pryor has said, the pension system has become increasingly difficult to work with as layer upon layer of legislative and regulatory complexity have been added over recent years. Public sector plans have been spared some of these changes, but increasingly we must devote time and re-

sources to dealing with technical rules that put hurdles in the way of our primary mission—to provide a secure level of benefits to Los Angeles County employees.

We support S. 2091 as the first step toward simplification of the Federal tax laws and toward a rational and cohesive Federal policy for retirement income. With Senator Pryor, we hope that S. 2901 is the first in a series of actions to rationalize and simplify the existing pension rules.

LACERA especially supports enactment of Section 306 of S. 2901. Section 306 will change the rules under Section 415 of the Code for public sector retirement systems in ways that will significantly reduce administrative costs and also eliminate potential adverse impacts on lower paid employees. Section 306 recognizes that the current Code Section 415 "limitations" rules adversely affect lower paid public sector employees, and therefore should be changed.

We would be please to work with Senator Pryor and other sponsors of S. 2901 to ensure its enactment.

Very truly yours,

CHARLES F. CONRAD, *Retirement Administrator.*

MARYLAND TEACHERS AND STATE EMPLOYEE SUPPLEMENTAL RETIREMENT PLANS,
Baltimore, MD, August 28, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
Washington, DC.

Re: S. 2901—Employee Benefits Simplification Act

Dear Ms. Wilcox: I want to register support for the passage of this legislation. Enactment will help a large number of Maryland citizens.

Employees of the State of Maryland and school teachers within the state covered by the now closed Employees Retirement System and the Teachers Retirement System have been eligible to transfer to the new Maryland Pension System programs since 1980. But the Tax Act of 1986 put severe restrictions on rolling over refunds of employee's after tax contributions and interest into IRA's at the time of transfer.

Maryland enacted legislation believing that it was in the best interest of its taxpayers to permit and encourage its employees to transfer between Systems if they wished to do so. Many did between 1980 and 1987. Since 1987, the effect of the current income tax scheme has been to restrict individual's freedom to choose how best to manage the funds accumulated for retirement by effectively removing the option to save the funds in question within an IRA. In so doing, Federal tax policy has muted the beneficial effects of the 1980 state legislation on both individuals and the taxpayers of Maryland.

The Employee Benefits Simplification Act will clarify what has been a confusing arrangement of eligibility standards for rolling over distributions from qualified pension plans into IRA accounts thus providing a vehicle for continued and increased savings which everyone knows our U.S. Leadership has been advocating. Thank you for doing whatever you can to assure the passage of this needed legislative remedy.

Sincerely,

ARTHUR N. CAPLE, JR., *Executive Director.*

MORRIS, GARLOVE, WATERMAN & JOHNSON,
Louisville, KY, August 20, 1990.

Ms. LAURA WILCOX, *Hearing Administrator,*
Senate Finance Committee,
Washington, DC.

Re: Employee Benefits Simplification Bill (S. 2901)

Dear Ms. Wilcox: I am writing in support of the Employee Benefits Simplification Bill (S. 2901). The amendment to Internal Revenue Code Section 401(a)(26) is especially needed because it will alleviate unnecessary complexity for defined contribution plans. Protection for employees is provided under Section 401(a)(4). If Section

401(a)(26) is not amended, many employers will terminate their defined contribution plans, a result contrary to the intent of the legislation.

I urge the Committee to support the amendment of Internal Revenue Code Section 401(a)(26) under the Employee Benefits Simplification Bill (S. 2901). Thank you for your consideration.

Sincerely yours,

MICHAEL T. HYMSON.

Statement of the National Association of Computer Consultant Businesses

I. Introduction: The Technical Services Industry

There has been a great deal of concern about the complexity and fairness of various pension laws. The National Association of Computer Consultant Businesses ('NACCB') is particularly concerned about harm caused to its technical services firm members, their service recipient clients, and technical workers as the result of IRS enforcement of the existing 'leased employee' provisions in § 414(n) of the Internal Revenue Code. We support the general principles behind S. 2901, i.e., the pension laws must be simplified. However, we believe that there must be some changes to S. 2901 if the harm caused by § 414(n) is to be eliminated. Before addressing the details of our position, a short description of the technical services industry is necessary.

Technical services firms send their workers to their service recipient clients who need non-permanent, highly-skilled computer and engineering experts for specialized projects. These workers -- who are either employees of the technical services firms or are independent contractors -- are very well compensated, whether they are paid on an hourly, daily, weekly or some other basis; for example, hourly rates typically exceed $25 per hour. Because a client's software or hardware project often encompasses several stages of development until a final product emerges, the worker may spend as long as two or three years providing services to the client. Continued involvement by the worker throughout all phases of the project helps assure quality control, high efficiency, timely completion, and lower costs. But after a particular project has been completed, many highly-skilled experts will leave both the client project and the technical services firm. These workers either want to maintain independence and find work elsewhere, or the technical services firm did not have other service recipient clients with immediate needs for persons with these experts' unique skills. Because these highly-skilled experts are so highly compensated and because long-term employment by the technical services firm is not contemplated in many instances, technical services firms often do not fund any retirement plans for these workers. This arrangement is entirely satisfactory to the all parties -- the workers, the technical services firm, and the firm's clients.

Unfortunately, however, § 414(n) is severely disrupting these natural relationships among a technical services firm, its workers, and its clients. Because of § 414(n), workers are being terminated from their projects in mid-stream, clients are facing project delays and quality concerns, and technical services firms are left confronted with an unnatural turnover of personnel. Simplification and reform of § 414(n) can eliminate most of these problems in the technical services industry.

II. Background of § 414(n)

Section 414(n) was adopted because pre-existing pension laws were inadequate to protect against certain abuses in industries other than the technical services industry. For example, pre-existing pension laws allowed medical doctors to provide themselves substantial retirement benefits and yet refuse to provide similar benefits to their non-highly compensated employees like receptionists and nursing assistants. Such discrimination against non-highly compensated employees was possible because these workers were literally fired as employees of the doctors' firms, and then 'leased back' to the doctors as employees of an outside company which specialized in providing such support staff workers to its clients. Section 414(n) was intended to end these abuses by requiring such leased employees to be judged as if they were direct employees of the firms which actually use their services, e.g., the doctors' firms.

Although the technical services industry has been hard hit by § 414(n), situations involving technical workers have never been considered as being even remotely akin to the abuses which triggered § 414(n). Major service recipient users of highly-skilled technical experts typically seek the support of technical services firms to meet special short-term (i.e., not indefinite) project requirements of a non-routine basis and because such technical services firms are better at locating and screening the expert workers required for these short-term project needs.

III. Legislative Reforms That Should Be Included in S. 2901

A. Adopt A Short, Simple and Predictable 'Control Test'

We are very concerned that S. 2109's proposal to use a 'control' test to define 'leased employee' will be too broadly implemented by the IRS. We believe that any test should permit the exclusion of highly-skilled technical service workers from the § 414(n) rules, while including as 'leased employees' only the types of workers that those rules were intended to protect. In fact, the 'control' test proposed in § 301 of S. 2901 may present far more problems than exist under the current law.

By way of background, under present law the IRS inquires whether the leased employees are performing services that have been 'historically performed by employees'. To determine if services have been 'historically performed by employees', the IRS has included reference to the IRS 20-question common law employment test -- itself a 'control' test that has long been criticized as too long, too vague, and far too unpredictable.[1/]

When the 'control' test first emerged in 1989 as part of pension simplification in Chairman Bentsen's June 13, 1989 amendments to S. 1129, we and others were relieved that the Chairman had apparently simplified and narrowed the 20-question common law 'control' test into only 4 specific factors to determine if a worker is under the 'control' of a service recipient.[2/] We also believed that these 4 factors, when properly defined and applied, would significantly narrow the class of leased employees -- which was, of course, a major goal of S. 1129. When the S. 1129 provision was incorporated into S. 5 and passed the Senate on June 23, 1989, the simple 'control' test was one step closer to enactment.

Unfortunately, the simple version of Chairman Bentsen's amendments changed significantly by the time they were reflected in the October 1989 Senate Finance Committee Explanation of Title VI of the Revenue Reconciliation Act of 1989. The 'control' test had suddenly expanded.[3/]

If the October 1989 Senate Finance Committee Explanation is what is intended by the 'control' test in § 301 of S. 2901, we oppose this test because we will be placed in the same situation as presently exists regarding the 'historically performed' test; namely, the workers who perform services for the service recipient will be deemed leased employees because the IRS will be able to consider as many or as few factors as it desires -- whether or not they are in the 20-question common law employment test -- in order to conclude that the service recipient exercises 'control' over the workers. In fact, the situation will be even worse than it is today because many of the additional factors that the IRS may rely upon are not even stated in that legislative history, but are instead left up to the Secretary.

1/ As the IRS Manual states, 'Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to final results and as to the details of when, where and how the work is to be done.... The factors or elements that show control are described below in the following 20 items.' IRM-Administration, Exhibit 5(10)00-4. This 'control' test has long been criticized. See, e.g., Report of the Comptroller General, GGD-77-88 (November 1977). In fact, former Assistant Secretary of the Treasury Donald Lubick testified -- in a remarkable understatement -- that the common law employment test was 'developed centuries before the income tax to determine the rules of the doctrine that the master is liable for the torts of his servant .... Those are the tests that we are using to determine the incidents of taxation. There are 20 factors in the regulations that are in many cases extremely difficult to apply because various of these factors go in different directions.' Hearings on H.R. 3245 before Subcommittee on Select Revenue Measures of House Ways & Means Committee, 96th Cong., 1st Sess., at pp. 5, 9.

2/ These 4 factors are whether the service recipient (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's compensation level. Chairman Bensten's remarks that the 'control' test 'may include' these 4 factors could be interpreced to allow some other factors to be considered, but at least the 'control' test emphasized only 4 factors.

3/ The Senate Finance Committee Explanation referred to the 4 specific factors, and then went further:

> The determination of whether an individual is controlled by the employer is based on all the facts and circumstances. Among the factors that are relevant in this determination are whether the recipient organization: (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's level of compensation. Other factors that may be considered include those that are relevant for determining whether the employer is responsible for employment taxes on the compensation paid to the individual. The Secretary may designate other relevant factors. It is not necessary that all these factors indicate that the individual is under the control of the employer in order to find that such individual is a leased employee. Nor is it necessary that the recipient organization be responsible for employment taxes in order to find that the individual is a leased employee because, if the recipient organization is liable for employment taxes, the individual is an employee of the organization who generally must be taken into account. (emphases added).

We do not offer this conclusion as a hypothetical matter. We have been involved in a substantial number of employment tax audits in the technical services industry in which the sole basis for judging a worker's employment tax classification is the 20-question common law employment test. Even many of the IRS agents who are conducting these audits admit that this test is too long, too complicated, and too unpredictable to apply from case to case -- and yet substantial back employment tax liabilities depend on this test. But the 'reform' proposed for § 414(n) by § 301 of S. 2901 will now bring this same length, complexity and unpredictability to the retirement plan area. Many service recipients' retirement plans could be disqualified as the result of unbridled IRS application of the 'control' test, if the 'control' test is defined as in the October 1989 Senate Finance Committee Explanation.

For these reasons, if Congress is truly seeking reform then we strongly urge that the 'control' test be narrowed to but a few simple and predictable factors. We believe that a 4 factor test can be adopted, and that the service recipient should be deemed to have 'control' where any 3 of the 4 factors is adverse to the service recipient. However, we urge that 2 of the factors previously specified by the Committee Explanation be combined into a single factor and that a new, highly relevant fourth factor be added, as discussed below.

B. Provide Well-Defined Examples of What Each Factor in the 'Control Test' Means and How To Apply It

Even if the 'control' test is reduced to but a few factors, it is very likely that the IRS will almost always find that a service recipient has 'control' unless there is detailed guidance on how those factors are to be applied. To effectuate 'reform', the new legislation must specify the details and amount of 'control' that service recipients must exercise before the workers are to be deemed 'leased employees'.

1. Does the Service Recipient Prescribe the Individual's Work Methods?

Care must be taken to distinguish between a service recipient's actions that provide some general direction to a worker as to results, and those actions that prescribe the individual's work methods. In any situation, it could be concluded that some aspect of what is prescribed by a service recipient constitutes 'work methods'.

For purposes of the § 301 'control' test, prescription of the worker's work methods should mean that the service recipient prescribes the details, means and sequences as to how the worker's services will be performed.

For example, service recipients which utilize temporary secretarial help often require a secretary to greet visitors in a certain manner, to take telephone messages in a certain way, to type documents in a certain format, and to file documents in a certain order. By prescribing the details, means and sequences of the work methods used by such workers, the service recipient may be said to be prescribing the worker's 'work methods'. On the other hand, if a highly-skilled technical expert is given a complex project to handle, but he or she is told to complete the project under a timetable and in stages set by the service recipient, and according to well-accepted quality assurance techniques in the industry, the service recipient cannot be said to be prescribing the worker's 'work methods' because such general requirments do not amount to control over the details, means and sequences of the complex task.

As set forth below, we urge that this factor -- 'prescribing the individual's work methods' -- actually be combined with the next factor into a newly designated category that would singly replace both factors.

2. Does the Service Recipient 'Supervise' The Individual?

This factor is very vague -- the term 'supervise' can mean almost anything. Our concern is that the question whether the service recipient 'supervises the worker' will almost always be answered in the affirmative by the IRS unless the term 'supervises' is substantially narrowed. One of America's great jurists explained in a landmark employment tax case that supervision of some sort is inherent in any joint undertaking, even involving independent contractors.[4]

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[4] Judge Learned Hand said: 'In the case at bar the plaintiff did intervene to some degree; but so does a general building contractor intervene in the work of his subcontractors. He decides how much the different parts of the work must be timed, and how they shall be fitted together; if he finds it desirable to cut out this or that from the specification, he does so. Some such supervision in inherent in any joint undertaking, and does not make the contributing contractors employees.' Radio City Music Hall Corp. v U.S., 135 F.2d 715, 718 (2d Cir. 1943) (emphasis added).

For purposes of § 301, supervision should mean direction as to the details, means and sequences of the method in which the worker performs his or her work -- and, in this sense, an inquiry about 'supervision' is very little different from the above inquiry about whether the service recipient 'prescribes the worker's work methods'.

For the above reason, we urge that the first two factors in the 'control' test -- i.e., prescribing work methods and supervising the worker -- be combined under one factor that inquires whether the service recipient 'supervises the individual by prescribing the details, means and sequences of the work methods used by the individual'. In the case of secretarial workers, such supervision is likely; in the case of highly-skilled technical experts, such supervision is typically absent.

3. Does the Service Recipient Set the Individual's Working Hours?

Whenever a worker performs services at the facilities of a service recipient, it can be said that the service recipient must -- to some degree -- establish some working hours for the worker. For example, if the service recipient's offices are open on only certain days or during certain hours, then the worker's working hours are similarly limited. However, these types of limitations on the worker's working hours do not constitute the type of 'control' by the service recipient which would suggest that the worker is a leased employee.

For purposes of § 301, setting the working hours should mean that the service recipient must require most of the following: that the worker begin his or her work day at a specific time or times, not end his or her work day before a certain hour, work a set number of hours every day, work no more than a certain number of hours each day (unrelated to the hours that the service recipient's facilities are open), or take lunch breaks or coffee breaks at either specific times or not to exceed specific durations. Only the restriction over such details regarding working hours demonstrates that the service recipient has sufficient 'control' of the worker's working hours.

Thus, for example, a secretary or receptionist for a service recipient will likely have his or her hours set by the service recipient. In contrast, a highly-skilled technical expert will not likely have his or her hours set in this respect.

4. Does the Service Recipient Set the Individual's Compensation Level?

In every situation involving a worker provided by a temporary services agency, the service recipient has some impact on setting the worker's compensation level. If, for example, the service recipient will pay no more than so much per hour or per week for that worker, then the temporary services agency will reflect the service recipient's limitations in the compensation that it will pay the worker. For purposes of § 301, setting the individual's compensation level should mean more; it should mean that the service recipient has a direct and controlling right to establish the worker's compensation level.

For example, if the service recipient requires that the actual compensation paid to the worker be set at a specific dollar amount, has the right unilaterally to raise or lower that rate over the objection of the temporary services agency, or can veto a decision of the agency to raise or lower that rate, only then does the service recipient have sufficient 'control' to set the worker's compensation level.

5. Does the Individual Exercise Discretion and Independent Judgement As to Matters of Significance?

For purposes of § 301, the 'control' test should require an inquiry into whether the worker exercises discretion and independent judgment as to matters of significance in his or her work -- yet this factor is missing entirely from any discussion of § 301. This is not to say that the worker must have final authority to make a critical decision, but only that any recommendations made by the worker to higher level decisionmakers must be the result of the worker's exercise of such discretion and independent judgment. If the worker does truly exercise such discretion and judgment, the service recipient's 'control' over that worker is significantly limited. This factor really goes to the heart of what § 414(n) should cover.

For example, secretaries, janitorial staff, data processing keypunch operators and similar workers typically do not exercise any discretion or independent judgment over matters of significance. On the other hand, highly-skilled technical experts, emergency room physicians and advertising executives typically do exercise such discretion and judgment over significant matters .

For these reasons, this factor should be made part of the § 301 'control' test.

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In addition to identifying these factors, it is important that any reform legislation specify how the factors will fit together. If the first two factors in the 1989 'control' test -- i.e., prescribing work methods and supervision -- are combined, and if the fifth factor immediately above is used, then there will be 4 specific factors. We urge that the legislation specify that 'control' will be deemed to reside in the service recipient only if at least three factors are answered adversely. For example, if the worker does exercise discretion and independent judgement on significant matters, then the service recipient will be deemed to have 'control' only if all 3 other factors are answered affirmatively.

As important, we believe that it is critical that the Committee Report use examples of situations which are clearly intended to involve 'leased employees' -- such as secretaries -- and those which are not -- such as highly-skilled technical workers (like computer systems analysts and software engineers) and physicians. The Committee Explanation in 1989 stated that 'Persons who perform services incidental to the sale of goods or equipment or incidental to the construction of a facility generally are not leased employees'. For purposes of §301, your explanation of the 'control' test should similarly state that 'Highly-skilled technical professionals generally prescribe their own work methods and work free from detailed supervision, set their own work schedules, and exercise discretion and independent judgment as to significant matters so as not to be considered leased employees.'

6. The IRS Should Have the Burden of Demonstrating That a Service Recipient Has 'Control'

No matter how simple and short the 'control' test may be, a large amount of discretion is built into it, much the same as exists with regard to the 20-question common law employment test used by the IRS. A key step to eliminating arbitrary and overbearing results under the 'control' test is to place the burden on the IRS to demonstrate that a service recipient exercises 'control' over the worker.

C. Simplify and Reduce the Compensation Level in § 414(n)

We generally support the proposed changes in § 101 of S. 2901 which simplify the definition of 'highly compensated employee' in § 414(q). There is a need to have a simple and absolute dollar limit -- $50,000, indexed over time -- as a gauge of compensation. However, we strongly urge three additions be made to § 101 in S. 2109.

First, some sort of 'sworn statement', made under penalty of perjury, should be available as an alternative to showing the service recipient client a worker's W-2.

Second, compensation should include a worker's wages from more than one employer if the worker provided services to multiple employers during any year.

Third, as an alternative to looking at a worker's compensation in the prior year, service recipient clients should be permitted to rely upon a worker's current compensation in deciding whether the worker is 'highly compensated'.

1. Adopt a 'Sworn Statement' Alternative to Showing a Worker's W-2 Form to a Service Recipient Client

One result of § 414(n) is that service recipient clients have been requesting detailed and proprietary compensation information from leasing organizations in order to determine which workers are highly compensated. The use of a W-2 Form as the source of compensation information, as proposed by § 102 of S. 2901, still provides the clients the opportunity to determine such proprietary information about the leasing organizations which serve as their vendors -- e.g., mark-ups, estimated overhead costs, profit margins. 5/ Just as it would be inappropriate and potentially anti-competitive to require manufacturers to reveal to their customers the mark-up for each product, it is likewise be inappropriate for the leased employee laws to require the revelation of similar information by vendors of services to their customers.

5/ A client knows how many hours per year the worker has performed services for it and how many dollars it has paid to the leasing organization for those services. This makes it fairly easy to calculate a worker's effective hourly rate and to compare it to the hourly rate paid by the client -- and thus to determine the vendor's mark-up.

An acceptable method of preventing the disclosure of such proprietary information would be to allow the service recipient clients to rely upon sworn statements, made under penalty of perjury by the leasing organization or the leased employee, that the employee is highly compensated within the meaning of § 414. The service recipient should be allowed to rely upon this sworn statement. It should be emphasized that the concept of a sworn statement is not new. One positive feature of Section 89 -- before it was repealed entirely -- was that § 89(g)(2)(B) allowed employers to rely upon sworn statements that employees were already receiving health insurance coverage. Likewise, § 102 of S. 2901 should be modified so that sworn statements may be used.

2. Consider Compensation from Multiple Employers

S. 2901 defines "highly compensated employee" in § 101 to include any employee who "has compensation for the year from the employer in excess of $50,000." This definition should be amended to consider compensation received by an employee from one or more employers during the year.

It is not uncommon in the computer industry for a worker to choose to provide services, often simultaneously, to more than one recipient and to choose the number of hours he or she will work for each recipient. For example, during a calendar year a systems analyst may provide 1,600 hours of services to recipient A (30 hours per week average), 200 to recipient B and 100 to recipient C. This worker may earn $48,000 from recipient A, $6,000 from B, and $3,000 from C. Total compensation is $57,000, but the worker would still be deemed non-highly compensated because no one recipient has paid the worker over $50,000. Section 101 in S. 2901 should be modified so that this worker, if deemed a leased employee, is considered highly compensated.

3. Simplify the Calculation of Compensation So That Employees Will be Deemed Highly-Compensated If Their Annualized Compensation Rate (Hourly or Daily Rate, Weekly Salary, Etc.) Is Above $50,000 Per Year

S. 2901 should be modified in § 102 so that as an alternative to looking at W-2 compensation for the preceding calendar year, it is permissible to determine if a leased employee is highly compensated by looking at current compensation.

Reference to current compensation is a fair and simple way of deciding which workers are highly compensated. Since the purpose of the leased employee provision is to prevent discrimination against non-highly compensated leased employees, there is little sense in counting a leased employee for discrimination testing purposes if the leased employee is currently highly compensated. If a firm certifies to the service recipient client that the worker is being regularly compensated at an hourly rate (or a daily, weekly or some other rate) that when annualized is at or above $50,000 per year (adjusted for cost of living increases), then that should be the end of the matter and the worker should be deemed "highly compensated".

The test for current compensation would, of course, depend upon the use of a sworn statement as was suggested above with regard to the prior year's W-2 compensation. Because the statement would cover compensation not yet actually paid, but which is annualized, the statement would have to meet very strict standards. For example, the signer of the statement would have to certify that the leased employee is currently being paid at a rate of compensation that, when annualized according to the Secretary's formula, is above $50,000 per year. The signer would have to state that for the remainder of the calendar year, as long as the employee is still providing services, then he or she would continue to be compensated at a rate that when annualized would exceed $50,000 per year in compensation. In short, the use of a sworn statement regarding annualized compensation would be an excellent reform and simplification of the present law regarding leased employees.

As to the method of annualization of a worker's compensation, this task should be relatively simple and left to the Secretary of the Treasury. For example, workers who are paid hourly rates would be deemed to be compensated at an annual rate that is equal to 2080 times the hourly rate. The Department of Labor has had many years of experience in enforcing various laws which require a certain level of wages, and the Secretary might find some of that precedent useful by analogy.

The only conceivable objection to this approach might be that the hourly or other rate is not really an indication of what the worker will make in a year. But this objection is based upon a highly unreasonable assumption that firms will somehow make a temporary wage adjustment in order to pay a higher hourly or other rate simply to get the benefit of annualization of the rate. Not only do marketplace forces work against this manipulation, but this potential abuse can be protected against by imposing the requirement that the rate be regularly paid. That requirement can be imposed as part of the sworn statement obligation.

C. Provide Specific Code Language or Commentary Explaining That Independent Contractors are Not 'Leased Employees'

When the 'control' test emerged last year there was a major concern that it could unwittingly result in unfair discrimination against bona fide independent contractors. This result was less likely as the result of a floor colloquy between Senators Bentsen and Kerry (see June 23, 1989 Congr. Record at page S. 7470), but it is important that this colloquy be included again this year -- and strengthened.

In particular, the problem arose in 1989 because some persons attempted to draw an erroneous implication from the 'control' test. They suggested that if an independent contractor is sent to a service recipient client by an intermediate 'broker' firm and the independent contractor is not under the control of the intermediate 'broker' firm, then the independent contractor must be under the control of the service recipient client of that broker firm -- in other words, one of those two parties must have 'control' over the contractor, or so they thought. In fact, and contrary to this implication, when the worker who performs services for a service recipient client is a bona fide independent contractor -- whether he or she has contracted directly with the service recipient client or through an intermediate 'broker' firm -- then this independent contractor works <u>under his or her own control</u> and should <u>not</u> be considered as a 'leased employee' of the service recipient client.

The need for the clarification of independent contractors generally is particularly important in the technical services industry. Other changes in the tax laws that affected this industry, particularly the 1986 Tax Reform Act, have already created great disruptions in the use of independent contractors. Now, unless § 414(n) is clarified, some service recipients may erroneously believe that the 'control' test makes it even more risky for them to use independent contractors.

For these reasons, an expanded version of the Bentsen-Kerry colloquy should be included in the legislative history of the 'control' test proposed in § 301 of S. 2901.[6/]

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In conclusion, we applaud efforts to bring some reasonableness to the application of the 'leased employee' rules. However, we emphasize that unless the 'control' test in § 301 is carefully defined and explained, with illustrative examples, as set forth herein, the § 414(n) problems will only magnify rather than decrease. We also urge that the definition of 'highly compensated employees' be amended and that care be taken to protect the ability of independent contractors to provide their services either directly or through third-party broker firms.

6/ This version would add the following: 'This bill does not intend to disadvantage legitimate independent contractors who provide services to recipient organizations either directly or through intermediate third-party 'brokers'. If a legitimate independent contractor provides services to a recipient organization, either directly or through a broker, then it is very likely that he or she is working under his or her own 'control' for purposes of this bill, and not under the 'control' of the recipient organization or the broker within the meaning of § 414(n). If that is the case, the independent contractor is not a 'leased employee'. Indeed, no inference should be drawn in those circumstances that the recipient organization is any more likely to be exercising 'control' over the independent contractor than in the situation in which an intermediate third-party employer provides its own employees (as opposed to independent contractors) to the recipient organization.'

STATEMENT OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

My name is Robert A. Georgine and I am presenting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 240 pension and welfare plans, or their sponsors. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development—legislative, administrative, and judicial—of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

As you are aware, starting with the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), layer after layer of complex and burdensome rules have been imposed on private retirement and profit sharing plans, most often without any apparent regard for social policy objectives. The NCCMP has consistently opposed such piecemeal legislation and warned that changes in the pension area should not be enacted without careful consideration by the labor as well as tax committees in the context of a comprehensive national retirement policy.

On behalf of the Coordinating Committee, I applaud your effort to simplify some of these complex and burdensome new rules in the Employee Benefits Simplification Act ("Bill"). Hopefully the Bill will undo some of the harm that has been done to the private pension system by overregulation in recent years.

The Bill contains many provisions that may be helpful for multiemployer plans. I would like to express our strong support for two of these—the multiemployer plan exemptions to the full funding limitation and the annual valuation requirement. In addition, I would like to comment briefly on two provisions of the bill that might require adjustments to assure that no new problems are created. These provisions relate to multiple-employer VEBAs and to actuarial adjustments for benefits of employees over age 70. Of course, I assume that this Bill will not be used, and urge you to guard against its use, as a vehicle to impose any further rules or burdens on private plans. (I am not commenting on provisions of the Bill, such as modifications to the actual deferral percentage requirement, that have little or no impact on multiemployer plans.)

1. The Need to Exempt Multiemployer Plans From the Additional Full Funding Limitation Enacted in OBRA '87

The NCCMP strongly supports the Bill's provision of an exemption for multiemployer plans from the additional full funding limitation enacted in the Omnibus Budget Reconciliation Act of 1987 ("OBRA '87").

OBRA '87 amended the full funding limitation set forth in Internal Revenue Code ("Code") section 412(c)(7) and Employee Retirement Income Security Act of 1974 ("ERISA") section 302(c)(7) to define the full funding limitation as the excess over the value of the plan's assets of the lesser of: (1) 150 percent of the plan's current liability; or (2) the plan's accrued liability. Prior to passage of OBRA '87, the limitation was simply the excess of the plan's accrued liability over its assets. Current liability is to be determined based on interest rates that reflect current annuity purchase rates and fall within a range linked to recent interest rates on long-term Treasury bonds. The legislative history of OBRA '87 shows that this change was made to prevent abusive, tax-motivated overfunding of pension plans. This type of abuse does not occur in multiemployer plans.

The imposition of this new full funding limitation on multiemployer plans is particularly inappropriate, because multiemployer plans—which are not subject to the funding requirements in new Code section 412(l)—continue to use pre-OBRA '87 actuarial assumptions for all other plan funding purposes. Multiemployer plans tend to use relatively conservative funding assumptions, because those plans can be highly vulnerable to short-term fluctuations.[1] Under current conditions, the interest rates called for to set the new full funding limitation are substantially higher than the rates that substantially all multiemployer plans use for plan funding.

This could cause a multiemployer plan to find that contributions otherwise needed to meet minimum funding would not be currently deductible. If a plan increases benefits to keep contributions within the full funding limit in one year, the contribution rate fixed in the bargaining agreement may not be enough to cover the

[1] Employer contributions to multiemployer plans are fixed in labor contracts that run for several years, so they cannot be adjusted to match changes in plan funding needs in the interim. They are also typically based on some measure of the level of covered work by plan participants (e.g., cent-per-hour).

resulting funding requirements in following years, based on assumptions used for minimum funding purposes. Since contributions are contractually set for a multiyear period, they cannot be modified from year to year in response to fluctuations in the full funding limit. And in those cases where the benefits as well as the contributions are fixed in the bargaining agreement, there would be no solution short of annual collective bargaining, which would take an unacceptable toll on labor-management relations.

The current spread between the market-based interest rate called for to determine the new full funding limit and the rates multiemployer plans generally use for funding purposes is a very serious problem. Of even greater long-term consequence for multiemployer plans, however, is the fact that, because the full funding limit rate will vary from year to year in accordance with financial market conditions,[2] a significant element of instability has been introduced into multiemployer plan funding arrangements. If it is virtually impossible to predict with any assurance what the deduction limits will be over the life of the bargaining agreement, it will be comparably difficult for the union and employers to negotiate a contribution level that will assure both current deductibility and continued sound plan funding while the agreement is in force.

It is important to note that contributing to a multiemployer plan creates no opportunity for an employer to manipulate taxes. All multiemployer pension contributions are the product of labor negotiations. An employer with a contractual contribution obligation cannot vary the amount it pays from year to year to suit its year-to-year tax situation. Moreover, the pension contributions represent part of the negotiated compensation package. It has long been recognized that employers are generally called upon to spend the same amount on compensation in some other form, if it does not go into the pension plan.

Amounts contributed to multiemployer plans are held solely for the benefit of the covered employees, the overwhelming majority of whom are union-represented rank-and-file workers. As the law does not allow surplus multiemployer plan assets to revert to any contributing employer, a company that contributes more than is needed for plan benefits has lost the use of that money forever. Since more dollars into the pension fund generally mean fewer dollars for wages, health care or other benefits, the union's constituency also loses if the plan is overfunded. Thus, neither the union nor the employers have any incentive to maintain artificially high multiemployer plan contribution rates. The tax-manipulation concerns that prompted enactment of the additional full funding limit do not apply to multiemployer plans.

Perhaps more important, applying the additional full funding limit to multiemployer plans will not likely serve any revenue-raising purpose. If a company sponsoring a single-employer plan finds that the contribution it has planned to make for a year will not be deductible, the company simply does not make the payment. At the end of the year that may translate into higher taxable income for the employer.

In a multiemployer situation, the employer cannot stop contributing, regardless of the full funding limit, without violating its labor contract. Faced with a deduction crisis, some plan boards of trustees will increase benefits in order to increase the deduction limit. Such a response to the short-term market fluctuations that will determine the limitation could, in some cases, create a continuing need for higher employer contributions over the long term, and correspondingly higher tax deductions. Rather than helping to meet Federal deficit reduction goals, in a multiemployer plan context, applying the change in the full funding limitation could hamper Federal deficit reduction goals.

In addition, studies prepared on behalf of the NCCMP show that virtually no tax revenue can be attributed to the imposition of the additional full funding limitation on multiemployer plans. These studies considered approximately 25 percent of all multiemployer pension plans for the years 1984 through 1988. They concluded that the number of multiemployer plans that, faced with an issue relating to the additional full funding limitation, fail to either increase benefits or have a percentage of their contributions allocated to other tax-exempt vehicles (such as a welfare plan), thereby resolving the issue without any increase in tax revenue, is insignificant.

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[2] The rate must be within 10% of a four-year moving average of Treasury long-term bond rates, with the most recent experience to be most heavily weighted. But within that range, the interest rate must reflect current market prices for insurance company annuities.

2. The Need to Change the Pension Plan Annual Valuation Requirement to a Tri-Annual Requirement for Multiemployer Plans

The NCCMP also strongly supports the Bill's provision that would require multiemployer plans to perform valuations no less frequently than every three years, rather than annually.

Section 7881(a)(6)(A) of the Omnibus Budget Reconciliation Act of 1989 amended Code section 412(c)(9) and ERISA Section 302(c)(9) to require pension plans to have actuarial valuations performed annually, instead of every three years, as was permitted under prior law. The Joint Tax Committee's description of the change states that annual valuations are necessary because the minimum required contribution for a plan year under the minimum funding rules enacted in OBRA '87 depends on the plan's funded status for that year.[3]

However, in recognition of the unique nature of multiemployer plans and the fact that additional contribution requirements are not needed for them because they are generally well funded, OBRA '87 provided exceptions from its minimum funding changes for multiemployer plans. The only requirement applicable to multiemployer plans for which an annual valuation would be necessary in all cases is the additional full funding limitation enacted in OBRA '87 and discussed above. Once we obtain an exemption from that limitation, there will be no reason to impose on all multiemployer plans the burden and expense of annual valuations.

3. The Need for Safeguards to Ensure that the Bill's Multiple Employer VEBA Provision Cannot Be Abused With Respect to Davis-Bacon and Similar Work

Section 305 of the Bill contains an off-Code provision that would permit employers to be treated as affiliated for purposes of satisfying the requirements for maintaining a multiple employer VEBA, if such employers: (1) are in the same line of business; (2) act jointly to perform tasks that are integral to the activities of each of the employers; and (3) act jointly to such an extent that the joint maintenance of a voluntary employee's beneficiary association is not a major part of the employers' joint activities.

The introductory statement explains further that:

> "Under the bill, employers are considered affiliated, for example, in the following circumstances: the employers participating in the VEBA are in the same line of business and belong to an association that provides to its members a significant amount of each of the following services: (1) research and development relating to the members' primary activity; (2) education and training of members' employees; and (3) public relations. In addition, the employers are sufficiently similar (e.g., subject to similar regulatory requirements) that the association's services provide material assistance to all of the employers. The employers also demonstrate the importance of their joint activities by having meetings at least annually attended by substantially all of the employers. Finally, the employers maintain a common retirement plan.
>
> "On the other hand, it is not intended that the mere existence of a trade association is a sufficient basis for the member-employers to be considered affiliated, even if they are in the same line of business. It is also not sufficient if the trade association publishes a newsletter and provides significant public relations services, but only provides nominal amounts, if any, of other services integral to the employers' primary activity."

We understand that this provision is being sought to provide relief in a particular situation that does not involve work on Davis-Bacon Act or other prevailing wage work. However, we urge you to make clear, in legislative history, if not in the statute, that this provision may not be abused by employers with respect to such work. We suggest the following language:

> "This section is not intended to apply with respect to noncollectively bargained voluntarily employee beneficiary associations maintained by employers for prevailing wage work on public construction or service projects."

The Davis-Bacon Act and certain other similar statutes require employers to pay employees working on certain government-financed projects the "prevailing wage." Under the Davis-Bacon Act, this "prevailing wage" is determined by the Department of Labor based on the total value of wages and other benefits paid by employ-

[3] Staff of the Joint Committee on Taxation, 100th Cong., 2d Sess., Description of the Technical Corrections Act of 1988, 431 Comm. Print 1988 (the annual valuation requirement was originally included in, but not enacted as part of, this bill).

ers in the area. However, employers may satisfy the prevailing wage requirement by paying any combination of wages and employee benefits.

Some employers attempt to circumvent the intent of the Davis-Bacon and similar acts, and to reduce their payroll taxes, and, thus, their total labor cost, by putting as great a portion of the total wage package as possible into multiple-employer pension and employee welfare benefit plans. Contributions to such plans are tax deductible and not subject to payroll taxes, including FICA, FUTA and workers compensation. Typically, these employers contribute to these arrangements only for those of their employees who are working on prevailing wage projects and only while such employees are working on such projects.

This abusive payroll tax avoidance device, however, has been hampered in the context of VEBAs by the requirement that employees eligible to participate in the VEBA share an employment-related common bond. As discussed above, the Bill would clarify this requirement in certain specified circumstances. The language we suggest above would provide the necessary assurance that this clarification could not be interpreted to relax any barriers to these payroll tax-avoidance schemes provided under current law by the employment-related common bond requirement.

4. Actuarial Adjustment for Benefits of Post-Age 70 Retirees

Section 203 of the Bill would provide that, in the case of an employee (other than a five percent owner) who retires in a calendar year after attaining age 70, the employee's accrued benefit must be actuarially increased to take into account the period after age 70 in which the employee was not receiving benefits under the plan. Thus, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70 and begun receiving benefits at that time. It appears that this provision could have the effect of preventing plans from suspending benefits for employees who work after attaining age 70.

Multiemployer plans are supported by fixed, negotiated contributions and, therefore, have limited resources. Typically, these plans are able to provide only very modest benefits to relatively low-income people. The percentage of multiemployer plan participants who work beyond age 70 may not be great. However, a requirement to provide benefits to these participants while they are still working and receiving a paycheck, would diminish somewhat the plan's ability to provide adequate benefits to retired participants who have no other source of income.

We suggest that you clarify that neither this section of the Bill, nor any provision of Code section 401(a)(9), will prevent a plan from suspending benefits upon reemployment of a retiree, in accordance with Code section 411(a)(3)(B), ERISA Section 203(a)(3)(B) and regulations thereunder.

If you have any questions, or if we can be of further help, please call Vivian H. Berzinski of our professional staff at (202) 872-8610.

NATIONAL POSTAL MAIL HANDLERS UNION,
Washington, DC, July 31, 1990.

Senator DAVID PRYOR, *Chairman,*
Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service Subcommittee,
U.S. Senate,
Washington, DC.

Dear Chairman Pryor: On behalf of our Union I want to thank you for your leadership in sponsoring S. 2901, "The Employee Benefits Simplification Act."

Please be advised that we will mobilize our membership to support this critical legislation.

Fraternally yours,

GLENN BERRIEN, *National President.*

STATEMENT OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

On behalf of the National Telephone Cooperative Association (NTCA), we are pleased to provide you with our comments on the Employee Benefits Simplification Act (S. 2901).

NTCA was established in 1954 with the goal of providing member services and benefit programs to telephone cooperatives that would help them attract skilled per-

sonnel and provide quality phone service to rural Americans. NTCA membership is available to telephone cooperatives and independent commercial companies nationwide; we now have approximately 500 members located in 45 states.

NTCA sponsors both a defined benefit pension plan and a defined contribution plan for employees of its participating members. These plans are among the largest multiple employer plans in the nation with combined assets exceeding $400 million. In addition to these qualified plans, NTCA sponsors a group health program that provides medical, life and disability benefits to employees of participating members and their dependents.

NTCA strongly agrees with the goals of S. 2901 and the urgent need to simplify current pension laws. Complexity unnecessarily increases administrative costs, makes it difficult for employers and employees to understand how their plans work, and creates traps for the unwary. We commend you for the efforts you are making in this important area.

We comment and, in a few areas, recommend further simplification with respect to the following provisions of S. 2901.

- *Section 101: Definition of Highly Compensated Employees*

The elimination of the rules regarding officers and the top-paid 20% of employees would greatly simplify the administrative burden of determining an employer's HCEs. In addition, we support the streamlining of the family aggregation rule, and the use of the prior year's compensation to apply the $50,000 rule. These steps will avoid needless complexity that currently exists.

We also support the exception to the one-HCE requirement for purposes of sections 401(k) and (m). We further believe that the one-HCE requirement is unnecessary because there is no demonstrable need to ensure against discrimination in situations where the employer has no employees who are 5% owners or earn more than $50,000.

- *Section 102: Definition of Compensation*

The addition of base pay as a "safe harbor" definition of compensation would provide greater flexibility to employers and allow many employers to administer their plans consistent with their established practices. Any discriminatory impact that might result from the use of base pay would be outweighed by the reduction in administrative costs associated with testing a plan's use of this alternative definition on an annual basis. These administrative cost savings could be better spent providing participants with increased plan benefits.

- *Section 105: Nondiscrimination Rules for 401(k) and 401(m) Contributions*

The use of a design safe harbor for 401(k) and 401(m) contributions is a reasonable alternative to the existing annual discrimination tests. The annual tests are difficult and costly to apply, and considerably lessen the attractiveness of these plans by creating considerable uncertainty for higher paid participants.

The use of safe harbor to satisfy the discrimination rules is fully consistent with the recently issued IRS nondiscrimination regulations under code section 401(a)(4). Those regulations encourage employers to structure their plans to fit within one of the available safe harbors. This will provide certainty as to plan qualification and allow the IRS to conserve its examination resources. We also believe that the alternative minimum matching and nonelective contribution requirements of the safe harbor are sufficiently attractive to prevent a real decrease in participation by NHCEs.

- *Section 202: Qualified Plan Transfers*

We support the general goals of improving pension portability and retirement income preservation. However, we believe that this section, as now drafted, adds unnecessary complexity to a bill that is intended to simplify existing pension rules and will accomplish relatively little preservation that would not otherwise occur. We, therefore, recommend that these provisions be dropped.

At a minimum, if some provision for mandatory transfers is maintained, we believe that $500 threshold for transfers should be coordinated with the $3500 threshold for "cashouts" under code section 411(a)(11)(A). Under this alternative approach, cashouts of $3500 or less would not be subject to the transfer rules, but could be paid directly to the participants. If, however, the participant's benefit exceeded $3500 and the participant requested a distribution, the benefit would be subject to this section's transfer rules.

• *Section 305: Voluntary Employees' Beneficiary Association ("VEBAs").*

Present law generally requires that, to be tax-exempt, a VEBA must be maintained by "affiliated" employers. The bill would treat employers, unaffiliated by ownership, as "affiliated" as long as the participating employers are in the same line of business and demonstrate sufficient joint activity. We strongly support this alternative provision. Because of the urgent need to control rising health costs, it is imperative that such affiliated small employers, regardless of their geographic locale, be allowed the opportunity to pool their resources so that they can provide health care coverage to their employees at competitive rates. This is particularly true at a time when most commercial insurers are unwilling to provide reasonable coverage to smaller employers or will do so only at excessive cost.

• *Section 308: Contributions for Disabled Employees*

The bill would permit nonforfeitable contributions to be made on behalf of disabled HCEs if contributions were made on behalf of all disabled participants. We strongly support this change. Any concerns that such contributions might be discriminatory (e.g., coordinated with the disability of the highly compensated employee) can be dealt with under the proposed IRS nondiscrimination regulations (which simply reflect current and prior law with respect to limitations on this type of operational discrimination).

• *Section 414: Limits and Cooperatives*

S. 2901 also provides us an opportunity to bring to your attention another pension simplification matter of great importance to NTCA and other organizations with cooperative members. Section 3 of S. 2901 would simplify certain provisions of code section 415 as they apply to governmental plans. As explained below, section 415(b)(2)(F), which applies alternative early retirement limits to government employees and employees of tax-exempt employers for post-1986 years, is also an excellent candidate for simplification.

A. Background

Code section 501(c)(12) provides that a cooperative telephone company meeting the requirements of that section is a tax-exempt organization. One of these requirements is that 85 percent or more of the cooperative's income consists of amounts collected from members for the purpose of meeting losses and expenses. If the cooperative fails to satisfy the 85 percent test, then tax-exempt status is not available for that year. However, the cooperative may be tax-exempt for other years for which the 85 percent test is met. Whether the test is met in a particular year depends on a variety of factors, some of which are not always clear. For example, the determination of whether certain income is considered collected from a "member" is an issue open to different interpretations.

Under current law, a cooperative's tax-exempt status has an impact on the maximum retirement benefits which its employees may receive from a qualified pension plan. Under code section 415(b), the current maximum annual pension payable at the employee's "social security retirement age" may not exceed the lesser of $102,582 (or 100 percent of the employee's average compensation for his high 3 years), but substantially lower dollar limits apply at early retirement. After the Tax Reform Act of 1986 ("TRA 86"), different reductions for early retirement apply to plans maintained by tax-exempt organizations and to plans maintained by other employers.

Under code section 415(b)(2)(F), these more favorable early retirement provisions apply to "a plan maintained by an organization . . . exempt from tax under this subtitle." Neither the legislative history of TRA 86, subsequent technical corrections, nor IRS rulings elaborate on this language.

Employees of tax-exempt employers pay a price for more favorable treatment under the section 415 limits in the form of relatively strict limits on the amount of deferred compensation they may receive from "nonqualified" plans. Specifically, under current law (Code section 457), the maximum amount that may be deferred in any year is limited to $7,500; higher-paid employees of taxable employers are not subject to similar limits on nonqualified deferred compensation.

B. Proposed Solution

Telephone cooperatives are operated for the mutual benefit of their member-patrons. Consistent with this obligation, members of the cooperative are credited with amounts in excess of operating costs and expenses so as to reduce the cost of future service. The fact that a cooperative may not meet the 85 percent test for tax-exempt status in a particular year does not affect its fundamental nature as a cooperative organization. We also think it should not affect its pension plan.

Applying different pension limitations based on a cooperative's tax status for a particular year is not administrable from the plan's viewpoint because neither the amount that may be funded, nor the amount of the benefits to be paid, can be accurately determined. In addition, the uncertainty as to which early retirement benefit limitation applies makes it difficult for affected employees to plan for their retirement and creates the potential for complex lawsuits against plan administrators and trustees.

A reasonable way to simplify this technical problem would be to amend code section 415(b)(2)(F) to make the less restrictive qualified plan limitation available based on whether the organization continues to be a telephone cooperative, rather than on whether the 85 percent test for tax exemption happens to be met for a particular year. Under this proposal, higher paid employees of telephone cooperatives would remain subject to the strict limitations on nonqualified deferred compensation—again, regardless of the organization's income tax status for a particular year.

This change would allow plan sponsors to administer the pension rules with certainty. It would benefit the employees of telephone cooperatives who compete for quality employees with commercial telephone companies that are usually larger and often have greater financial resources. Because the higher qualified plan limits would remain available, telephone cooperatives would continue to emphasize the provision of employee pension benefits through broad-based tax-qualified plans instead of through nonqualified plans that benefit only a narrow segment of the workforce.

Significantly, this change should not result in any revenue loss because its impact is quite limited, and because restrictions on nonqualified deferred compensation under code section 457 would remain fully applicable.

We appreciate this opportunity to review the legislation and look forward to working with this subcommittee to ensure that S. 2901 is enacted into law.

STATEMENT OF NOBLE LOWNDES

We are pleased to offer comments and recommendations on S. 2901, the Employee Benefits Simplification Act. Noble Lowndes is one of the largest employee benefits consulting firms in the United States with offices in 10 cities. Over 700 employees provide welfare and retirement plan services to more than 3,000 corporate clients.

First and foremost, we applaud the current proposals as a first step towards simplifying rules in the employee benefits arena. Although more comprehensive changes to streamline qualification and individual income tax rules would be welcomed if carefully structured and clearly stated, the areas targeted in the current proposal would ease many compliance problems and should be given immediate consideration.

We would like you to consider three specific modifications to the current proposal, as follows:

1. In conjunction with your plans to modify the Section 401 (k) and (m) rules, hardship withdrawal restrictions should be dropped. Sponsors utilizing the new safe harbors should be required to offer in-service withdrawals to plan participants.
2. The revised definition of "highly compensated employee" should recognize data and employee status solely during the year preceding the testing period. The revised definition should be adopted on a uniform basis for all benefit plan purposes in lieu of current highly compensated and key employee definitions.
3. The dual plan restrictions of Code Section 415(e) should be repealed.

Our arguments in support of these suggestions follow. In general, our aim is to eliminate certain problems which have been the source of a disproportionate amount of confusion and concern. Lingering controversy in each area translates into uneven compliance attempts and enforcement.

SECTION 401(k) AND (m) NONDISCRIMINATION RULES

We fully support the option of safe harbor plan designs as an alternative to utilization testing. The current nondiscrimination tests generate problems largely due to the timing of the tests. Plan sponsors cannot be assured that they are in compliance until after the end of the plan year at which time correction becomes a complex exercise. Testing based on availability or utilization testing based on elections at the beginning of a plan year with restrictions on increases for highly compensated employees could also be considered in order to relieve the timing problems inherent in the current testing process.

With regard to the safe harbor proposals, we are concerned that opponents of the proposals will note that plan sponsors will no longer feel compelled to offer loans and withdrawals as a device to encourage participation by nonhighly compensated employees. As a result, such employees may be less inclined to squirrel away funds for retirement. In addition, it should be noted that the premature distribution penalty of Section 72(t) serves as an adequate disincentive against early withdrawals. The Section 401(k) hardship withdrawal restriction is an unnecessary duplication.

In order to address accessibility concerns, to eliminate the considerable attention and involvement surrounding hardship withdrawal details, and to achieve parity with IRA distribution rules, we propose that the hardship withdrawal restrictions be eliminated. Plan sponsors should be allowed to offer withdrawals using simple and direct limitations which focus on antimanipulation and administrative concerns. We would suggest that provisions permitting the withdrawal of funds one time each year after the fifth anniversary of initial participation and/or in an amount not in excess of the account balance two years prior to the withdrawal would be two reasonable options. Note carefully that we do not endorse the longstanding "two years from deposit date" rule simply because it adds complexity to the data collection and retention process.

In the case of plans which adopt design-based safe harbors, in-service withdrawal options should be mandatory so as to encourage participation by nonhighly compensated employees.

Why not require loans? Although we would not suggest that they be barred, we do not believe loans are necessary where withdrawals are available. Given that the accessibility concern lies generally with nonhighly compensated employees, it must be noted that for these individuals, loans are merely withdrawals against future elective deferrals without the benefit of employer matching contributions. Generally, only a fixed dollar amount is available from each paycheck. Deductions for loan repayments will reduce the amount available for contribution as new money. In addition, loan administration adds complexity; requiring loans runs contrary to the objective of simplification.

HIGHLY COMPENSATED EMPLOYEES

The elimination of the "top-paid group" determination and the use of prior year compensation data will appreciably simplify the identification of highly compensated employees. A further simplification could be achieved operationally and in the manner in which the definition is expressed if highly compensated employees are identified in full based on their status and compensation during the year preceding the year to be tested.

As currently drafted, the proposal uses prior year status and compensation to determine highly compensated employees and, in addition, brings in "5% owners" during the current year who were not 5% owners during the preceding year and did not earn the specified compensation level during the preceding year. Since it is unlikely that many individuals would fall into this latter group, a clearly stated prior year basis will eliminate confusion which could be presented by the circuitous definition included in S. 2901 without significantly changing the ultimate result. In the unlikely event that an individual is not viewed as highly compensated due to this refinement, the breach would only prevail for a single year.

Once there is agreement on an appropriate simple definition, there would seem to be little reason to restrict its applicability. Since these individuals are to be singled out as the favored few for qualified plan discrimination tests, it would be helpful if the same individuals were targeted in other areas as well. Thus, the Section 414(q) definition should replace all other highly paid and key employee definitions in welfare plan discrimination tests and in the top-heavy determination of Section 416.

To further streamline the benefits environment, consideration should be given to providing a specific definition of "select group of highly compensated employees" under ERISA in order to finalize the controversy with regard to nonqualified plans. The use of the Section 414(q) highly compensated employee definition would not only deliver administrative simplicity, but would also resolve the bias against middle management employees who are restricted in qualified plans and excluded from nonqualified plans. If this approach is not adopted, consideration should be given to expanding the ERISA Section 3(36) "excess benefit plan" definition to reflect additional qualified plan limitations such as the $200,000 limitation on compensation, the $7,000 limit on elective deferrals and the Section 401 (k) and (m) nondiscrimination test limits.

DUAL PLAN LIMITATIONS

Code Sections 415(e) and 4980A both address the accumulation of excessive benefits under qualified retirement plans. The first deals with benefits provided by a single employer under both a defined benefit and a defined contribution plan while the second deals with the totality of benefits provided to any single employee. There were indications at the time Section 4980A was enacted that it was an experiment to ultimately replace the Section 415(e) limit, universally viewed as a complex and unwieldy calculation.

Indeed, theories on the application of the Section 415(e) limit abound. When attempted, the calculation requires a great deal of historical data which is not universally available. Layers of transitional adjustments complicate the process, especially in the case of the most recent TRA '86 adjustment which, some practitioners suggest (with informal IRS staff agreement) varies based on each individual's actual retirement date and form of benefit payment—both factors unknown at the time the adjustment is to be made!

As a result of this complexity, voluntary compliance and enforcement is uneven, thus casting doubt on any revenue estimates attributed to the Section 415(e) limit. The repeal of Section 4980A which has been suggested by others to eliminate the duplication complaint would not deliver as great a simplification as the repeal of Section 415(e). We strongly encourage that the Section 415(e) limitation be eliminated as part of the current simplification drive.

Noble Lowndes is honored to have the opportunity to participate in the development of simpler responses to employee benefits issues. We would be pleased to answer any questions you may have regarding this letter.

STATEMENT OF THE PACIFIC TELESIS GROUP

Mr. Chairman and Members of the Subcommittee: Pacific Telesis Group is pleased to offer comments on the simplification of present-law tax rules relating to qualified pension plans.

Pacific Telesis Group is a diversified telecommunications corporation based in San Francisco, offering telecommunications services to domestic and international customers. The Corporation was formed as a result of the court-ordered divestiture of the Bell System on January 1, 1984. The Corporation comprises the holding company, its telephone subsidiaries, and its diversified subsidiaries.

Pacific Telesis Group applauds this example of Congressional attention to an important employee benefit issue—pension simplification. This legislation could be an important first step on the road to meaningful reform of the extraordinarily complex rules which govern administration of private pension plans. The current situation serves no one well; neither plan sponsors nor plan participants benefit from the ongoing accumulation of more confusing rules. The Treasury does not benefit as more complex rules are not required in order to yield more tax revenues. Indeed, we believe that simplifying the administrative guidelines will encourage the continued growth of private pension plans.

Accordingly, Pacific Telesis Group supports Titles I and III of the proposed legislation. In Title I, we are most pleased to see the safe harbor relief for nondiscrimination testing of 401(k). While many plans will probably not be able to afford the "rich" safe harbor, the provision is an important step toward the elimination of the ADP test for these plans. We also believe the redefinition of "highly compensated employees" and the modification of the minimum participation rules in IRC Section 401(a)(26) are beneficial. In Title III, we are pleased to see the modification of the leased employee rule.

We are, however, disappointed that the "portability" provisions in Title II are included in "simplification" legislation. Pension portability is an important issue which deserves debate, but it adds administrative complexity and should be considered apart from this legislation. In addition, Section 202 as drafted would not necessarily improve portability; employees currently have the option of rolling qualified plan distributions into IRAs in many instances. This provision would make employers act as agents in setting up IRAs for former employees, who would then be free to withdraw money from their IRAs at will.

In summary, we support the Committee's effort to simply present-law rules governing private pension plans and would be glad to work with the Committee as it moves forward.

Statement of the Practice Service Corporation

HISTORY

Today, in fulfilling the goal of the National Retirement Policy, Practice Service Corporation is in the forefront of providing its employees with meaningful retirement and welfare benefits. Practice Service Corporation, also know as PSC, is the founder of the employee leasing industry. Despite the common assumption that employee leasing began as a way to avoid providing employee pension benefits, PSC began operations in 1972 by providing leased employees with a 100% Defined Benefit Pension Plan and a full benefit package, including health, dental and life insurance.

In order to attract and retain personnel, PSC provides its leased employees retirement benefits through a Defined Benefit Pension Plan. Under the PSC plan, at retirement age, each participant (and his or her spouse) will be entitled to a joint and survivor annuity equal to 100% of his or her final high three-year average salary. This 100% of final average final salary pension is *not integrated with social security.*

Thus, the PSC plan benefit is the maximum retirement benefit allowable under section 415(b) of the Internal Revenue Code. (References to the PSC plan benefit will be "the maximum 415(b) benefit). The PSC plan has many other favorable provisions affecting our employees, including among others:

1. No age restriction on participation;
2. Six-year top-heavy vesting;
3. Predecessor employer years of service credit;
4. An additional insured death benefit; and

STATUTORY BACKGROUND

The true employee leasing structure of true employee leasing is simple.

PSC does not employ or lease any recipients, in other words, any owners of our clients. Our personnel are generally highly compensated employees as defined in Section 414(q), but again they are not recipient owners.

Under the employee leasing rules of Section 414(n), our employees are *deemed* to be employed by our clients, the recipient, and the benefits earned by our employees under the PSC plan are *deemed* provided by the recipient. The proposed employee leasing regulations implement this rule by treating our client/recipient as if they maintain two qualified plans; one actually maintained for the recipient owner and one *deemed* maintained for the employees we lease to the recipient. Accordingly, each recipient plan must satisfy the minimum participation rules of Section 401(a)(26) as well as the participation rules of 401(a)(4).

To accomplish this result, the qualified plan actually maintained by the recipient includes our employees who are leased to the recipients benefiting under this plan. As participants, they are entitled to all rights and privileges of participation including the accrual of benefits and allocations of contributions.

Please note that the owners of the business entities to which we lease employees, that is the recipient, while participating under a plan actually maintained by them, *do not participate under the PSC plan.* The reason is obvious. Such owner/recipient is not an employee (or deemed employee) of PSC, and therefore cannot participate as a matter of law.

Because the PSC Plan provides for the maximum 415(b) benefit, any accrual of benefits by our employees under a defined benefit plan actually maintained by the client/recipient is entirely offset because of Section 415 and the proposed employee leasing regulations; and any allocation under the client's defined contribution plan is entirely offset because we believe that the provision of a maximum 415(b) benefit under the PSC Plan is the greatest retirement benefit we or the client can provide. In fact, it is the best qualified benefit provided to any employee in the United States. To assure that our client/recipient's qualified plans comply with this structure, we require them to adopt a special amendment to their plans which is consistent with this benefit structure.

We believe that this offset structure and treatment is mandated by the specific statutory statement of Sections 414(n)(1)(A) and 414(n)(1)(B). We further believe, and can demonstrate actuarially, that the maximum 415(b) benefit provided by the PSC Plan is greater than (or at least the equivalent of) the benefit provided under the qualified plans actually maintained by our clients.

Because of this, *it is our opinion that the structure we have established is free of all of the abuses that Congress intended to remedy when enacting Section 401(a)(26).* Our client/recipient's cannot receive a greater benefit under their own plans as a matter of law.

PROPOSAL

At the end of these written comments, you will find a proposal for amending Section 414(n) to simplify the testing and policing procedures for recipient's utilizing leased employees. The first part of the proposed amendment detailed an addition to the safe harbor currently existing under 414(n)5. The proposed safe harbor would add the ability for a leasing company to provide either a maximum 415(b) or 415(c) pension plan, without any restriction on the percentage of employees leased to the recipient. The establishment of these maximum type plans for rank and file employees will clearly help prevent abuse and policing by the IRS.

The proposed safe harbor plan would provide a leased employee with either of the following:

A. A Defined Benefit Pension Plan which provides:

1. 100% of pay benefits subject to Section 415(b) based upon a participant's highest average three years compensation;
2. For full benefits without offset for social security benefits;
3. A joint and survivor annuity for all participants;
4. A 6-year top heavy vesting schedule;
5. Vesting credit for past years of service with the recipient organization; and
6. For no age elimination, or

B. A Defined Contribution Pension Plan which provides:

1. A maximum contribution subject to Section 415(c);
2. For full benefits without any offset for social security benefits;
3. A 6-year top heavy vesting schedule;
4. Vesting credit for past years of service with the recipient's organization; and
5. For no age elimination.

The second part of the proposed amendment deals with standards for establishing true employee leasing arrangements While temporary services, off-site benefits administration and contract personnel most definitely have their place in our business atmosphere, it is important for unsuspecting recipients to know what risks attach to these type arrangements, including, but not limited to, co-joint employer liabilities. This will also help insure protection to the Federal government for those companies representing themselves as employee leasing in that the leasing company's assets will be available for payment of unpaid taxes. Additionally, leased employees will be insured that their benefits have been paid for by implementation of this proposal.

Once again, we stress that the goal of the National Retirement Policy is simplified and enhanced by allowing the unrestricted provision of maximum 415(b) and 415(c) pension plans to rank and file employees. The elimination of abuses by crafty practitioners and elimination of policing by the IRS makes this proposal meaningful for the thousands of employees covered under these plans.

Thank you for your consideration.

Attachment.

AMENDMENT TO SECTION 414(n)

SEC. 1. EMPLOYEE LEASING.

Section 414(n) is amended by adding the following:

"(5)(A)(ii) leased employee[s] (determined without regard to this paragraph) do not constitute more than 20% of the recipient's nonhighly compensated workforce, or

(iii) the leasing organization maintains a Defined Benefit Pension Plan which provides:

(a) A 100% of pay benefit subject to Section 415(b) based upon a participant's highest average three year's compensation;
(b) For full benefits without offset for Social Security benefits;
(c) A joint and survivor annuity for all participants;
(d) A six-year top-heavy vesting schedule;
(e) Vesting credit for past years of service with the recipient organization;
(f) For no age elimination, or

(iv) the leasing organization maintains a Defined Contribution Pension Plan which provides:

(a) A maximum contribution subject to Section 415(c);
(b) For full benefits without any offset for Social Security benefits;
(c) A six-year top-heavy vesting schedule;

(d) Vesting credit for past years of service with the recipient's organization;

(e) For no age elimination.

"(7) Leasing organization as sole employer.—A leasing organization shall be deemed to be the sole employer of the leased employee if—

"(A) the leasing organization retains the sole and exclusive right to—

"(i) hire, terminate, and transfer the employee,

"(ii) pay the employee from its own accounts, and

"(iii) direct, control, and evaluate the manner and means of the employee's performance of services provided to the recipient;

"(B) the leasing organization is responsible for paying its employees, through the duration of their employment, regardless of receiving reimbursed payroll and/or fees from the recipient;

"(C) the leasing organization provides universal fringe benefits among all its employees without discrimination; and

"(D) the leasing organization bills the recipient on a total fee rather than a direct cost pass-through basis.

"(E) the leasing organization does not lease the owner of the recipient.

"(F) the leasing organization complies with the requirements of 3121(d).

"(8) Leasing Organization Defined.—For purposes of this subsection, a 'leasing organization' is an organization which—

"(A) fills job function positions for a recipient, pursuant to a written agreement with the recipient, which are not short term in duration or which are not for a defined period of time,

"(B) meets the requirements of paragraph (7), with respect to at least 1 leased employee,

"(C) is registered with the Internal Revenue Service pursuant to paragraph (9),

"(D) together with the recipient, does not constitute a controlled group of corporations, as defined in section 1563(a), or an affiliated service group, as defined in section 414(m), and

"(E) pays all taxes and benefits costs from its own account and under its own name.

"(F) allows the recipient to be responsible for the direction relative only to the operational duties of the assigned employees.

"(9) Regulation of leasing organizations.—The Secretary shall prescribe such regulations as are deemed necessary to ensure prompt reporting and depositing of withholding and employment taxes by the leasing organization, and to maximize timely monitoring of such reporting and depositing by the Internal Revenue Service. Such regulations shall include—

"(A) assigning a Standard Industry Code (S.I.C.) to identify leasing organizations;

"(B) establishing a procedure for registration of leasing organizations with the Internal Revenue Service, which shall include the registration of all officers, equity owners, and other responsible persons, within the meaning of section 6672;" and

"(C) establishing a procedure requiring annual payroll tax reporting by recipients utilizing an employee leasing organization as defined herein.

SEC. 2. EFFECTIVE DATE.

"(10) Except as otherwise expressly provided in this Act, the amendments made by this Act shall become effective January 1, 1991."

STATEMENT OF THE PROFIT SHARING COUNCIL OF AMERICA

Since 1947, the Profit Sharing Council of America (PSCA) has represented companies that sponsor profit-sharing and 401(k) plans. PSCA represents approximately 1,200 companies that employ more than 1.75 million plan participants. Located throughout the United States, PSCA members are diverse businesses that range in size from family-owned fledgling enterprises to Fortune 100 companies.

A fundamental purpose of the Profit Sharing Council of America is to encourage American companies to use profit sharing, both cash and deferred. Yet, the ongoing changes in the laws and regulations governing retirement plans have greatly increased the complexity of administering deferred profit-sharing plans over the last few years. At the margin, where a small or medium-sized employer is trying to determine if a retirement program is feasible, any complexity can only discourage

plan formation. For employers who already sponsor plans, additional administrative burdens can only increase the number of plans terminated because the employers and employees determine that retirement coverage is not as valuable as current compensation. The effect of administrative complexity is to deny the benefits of deferred profit sharing to millions of workers and thousands of companies. It is a priority of the Council that the regulatory complexity of plan administration be simplified. Therefore, the Council commends those who have begun the quest for simplification.

Nevertheless, it is important that proposals to simplify the provisions of the tax code affecting qualified plan regulation do not reduce the benefits of the current system, do not reduce the flexibility that employers need to develop programs which meet the special needs of individual companies and workers, or add complexity to plan administration. Any of these will result in reduced participation in the qualified plan system and defeat the purpose of simplification efforts.

S. 2901 should not be enacted in its present form. While it contains several constructive changes, it also contains changes harmful to the qualified plan system, especially as it affects deferred profit-sharing and 401(k) plans. Following are the Council's specific comments on those sections of the legislation most important to Council members.

SECTION 102. DEFINITION OF COMPENSATION

S. 2901 amends all three definitions of compensation.

There is no need for this section because recent Internal Revenue Service regulations have greatly simplified the application of current law while retaining employer plan design flexibility. This section should be removed from the legislation.

SECTION 104. MODIFICATION OF ADDITIONAL PARTICIPATION REQUIREMENTS

S. 2901 exempts defined contribution plans from the minimum participation requirements and reduces the minimum participation requirements for defined benefit plans to the lesser of 25 employees or 40 percent of the employer's workforce.

Congress never intended to apply section 401(a)(26) to defined contribution plans. Clarifying that defined contribution plans are exempt from this section is a significant simplification and the Council strongly endorses its adoption.

SECTION 105. NONDISCRIMINATION RULES FOR QUALIFIED CASH OR DEFERRED ARRANGEMENTS AND MATCHING CONTRIBUTION

S. 2901 provides that 401(k) and 401(m) plans meeting certain design and notice criteria would, in effect, be deemed to have passed either the ADP test or the ACP test, or both. The proposal also modifies the standards for determining which excess deferrals and matching contributions to distribute first if ADP or ACP tests are not passed.

The specific dollar limitations on contributions under sections 415 and 401(k) eliminate the need for ADP and ACP testing. Further, these tests are complex, time consuming and expensive to administer. They also discriminate unfairly against the lower end of the highly compensated group. The Council continues to support elimination of these tests.

In the event elimination of these tests is not possible, the Council supports the concept of a design-based safe harbor for 401(k) and 401(m) contributions. Such a safe harbor would ease an administrative burden that acts as a disincentive to plan formation and continuation. However, the legislation's proposed safe harbor is not a workable alternative. The Council is unaware of any profit-sharing plans that would meet this safe harbor without substantial and costly revision.

In addition, the notice requirement in the safe harbor imposes another administrative burden on plan sponsors. Such a requirement appears to contribute little or nothing to simplifying the law.

The Council recommends the proposed safe harbor be withdrawn and that a new safe harbor be developed.

SECTION 201. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST

S. 2901 eliminates most of the restrictions on distributions eligible for rollover treatment and eliminates 5-year forward averaging for lump sum distributions.

The rules for determining when a distribution can be rolled over into an IRA or into another qualified plan are unnecessarily complicated and constitute a burden on plan participants. The Council supports the liberalized rollover rules in S. 2901.

However, the Council strongly objects to the provision repealing 5-year forward averaging for lump sum distributions. A bill designed to make qualified plan imple-

mentation and participation more attractive should not include provisions reducing the benefits of such plans. Further, the elimination of 5-year forward averaging is bad public policy. The availability of five-year averaging should not be denied to plan participants for the following reasons:

- Without it the lower-paid receive unfair tax treatment.

Under the new rates established by the Tax Reform Act of 1986, five-year averaging provides little tax benefit for those taxpayers receiving a very large lump sum distribution. However, there is and should be a tax benefit for those receiving smaller lump sum distributions. Without the availability of special averaging, many non-highly compensated employees who take lump sum distributions will pay tax at the highest rate, even though their contributions and the employer's contributions were made when the employee was at a lower effective tax rate. For example, in a study of 115 companies, the Profit sharing Research Foundation found that the average retirement lump sum distribution for participants whose final salary was under $30,000 was $46,502. Under current law a recipient using averaging pays 15% on the lump sum. Under the proposal, the recipient would pay 28%. It is unfair to tax a distribution to an employee at the highest rate when his or her tax rate was 15% at the time the original contributions were made.

- IRA rollovers are not necessarily an option for smaller lump sum distributions.

The cost of maintaining an IRA rollover account is substantially the same for large and small rollovers. This means that for large rollover accounts the cost is acceptable but rollover IRA costs can be prohibitive for smaller lump sum distributions. Further, there is less investment flexibility with a small account, making it financially less attractive to roll over a smaller distribution.

- Special averaging for lump sum distributions is part of the overall fabric which makes defined contribution plans viable.

The availability of special averaging helps make defined contribution plans attractive to younger and lower-paid employees. They will be less likely to make voluntary contributions to plans if they know that their own money will be taxed at a higher rate coming out than going in. The same holds true for employer contributions. Employees, especially those in deferred profit-sharing plans, which make up the vast majority of defined contribution plans, will want their benefits in cash now rather than wait for a benefit later that will be taxed at a higher rate.

SECTION 202. QUALIFIED PLANS MUST PROVIDE FOR TRANSFERS OF CERTAIN DISTRIBUTIONS TO OTHER PLANS

S. 2901 requires qualified plans to make "applicable distributions" in the form of direct trustee-to-trustee transfers to "eligible transferee plans."

The Council opposes the inclusion of this provision in the proposed legislation for the following reasons:

- It will add substantial complexity to the administration of qualified plans.

Present distribution procedures are straightforward and manageable to both employers and participants. Current law also allows a clean break between the company and terminating employee. The proposal will require extensive ongoing communication between the employer and terminated participant as rollover vehicles are identified and arrangements are made to transfer account balances. This will present difficulties especially in the event the termination was not cordial. Certainly this proposal adds considerable complexity to plan administration.

- It reduces the incentive value of deferred profit sharing.

Most defined contribution plans are profit-sharing plans. Studies by academicians at prestigious institutions like Harvard, Rutgers and Cornell have found that deferred profit sharing improves labor stability, increases profits and enhances productivity. Participants in profit-sharing plans believe that profit sharing contributions are their money. If participants perceive that the money has too many strings attached they will lose the feeling of ownership and many of the benefits of profit sharing will be lost. Some profit sharing companies will convert to cash payouts to avoid that loss.

- Voluntary contributions will diminish.

Because of the restrictions and penalty tax imposed on pre-retirement distributions by the Tax Reform Act of 1986, lower-paid employees already are hesitant about making voluntary contributions to deferred plans. Many with pre-1987 contri-

butions were angry that the rules were changed after contributions were made. The passage of this proposal will reinforce their concern that the rules operating today may be replaced by even more restrictive rules in the future. The uncertainty caused by continuous change affects participants as well as plan sponsors.

- The $500 minimum is too low.

It is economically inefficient to rollover small accounts into Individual Retirement Accounts. Administrative charges and inflation will substantially diminish the purchasing power of small rollovers in a relatively short period. There is little real benefit in forcing rollovers smaller than $3,500.

- This proposal changes the availability of in-service distributions from profit-sharing plans.

Currently, deferred profit-sharing plans may allow in-service distributions of employer contributions without requiring the presence of "hardship" as in a 401(k) plan. As drafted, the bill imposes the 401(k) "hardship" requirements on deferred profit-sharing plans. This is a fundamental policy change and should not be undertaken without extensive study. Typically, most profit-sharing plans do not require participants to meet hardship criteria when seeking withdrawals. Therefore, this change will significantly alter the relationship between the company and participants in many profit-sharing plans. At a minimum this change will add extensive complexity to the administration of deferred profit-sharing plans.

SECTION 203. REQUIRED DISTRIBUTIONS

S. 2901 eliminates required distributions for those employed except for 5 percent owners.

The current 401(a)(9) regulations impose immense complication and hardship on companies and on participants who work beyond the age of 70½. The Council supports the proposed change that eliminates required distributions to defined contribution plan participants as long as they are employed.

SECTION 301. TREATMENT OF LEASED EMPLOYEES

S. 2901 replaces the "historically performed" test with a test that determines if the individual is performing services under the control of the recipient.

The rules governing leased employees have been nearly unworkable. The Council supports the simplification on the 414(n) rules proposed in the legislation.

STATEMENT OF THE SMALL BUSINESS COUNCIL OF AMERICA

On behalf of the Small Business Council of America ("SBCA"), we are pleased to have the opportunity to provide comments regarding the Employee Benefits Simplification Act (S. 2901) introduced by Senator Pryor on July 26, 1990. The SBCA is a national non-profit organization that focuses on tax and employee benefits issues as they affect small business. As should be evident throughout this letter, SBCA strongly supports S. 2901, which we believe is the most positive pension legislation introduced since ERISA. Our comments regarding S. 2901 are intended to be constructive in nature, and to contribute to the debate regarding how best to simplify the private pension system. SBCA is committed to providing whatever assistance is requested or necessary to enact this important legislation.

Following are our comments regarding specific provisions of S. 2901:

SECTION 101: DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

The present law definition of highly compensated employee ("HCE") is too complex, especially for smaller employers. Accordingly, SBCA supports the amendment of Code Section 414(q) simplifying the HCE definition. However, SBCA respectfully suggests the following modifications to the definition:

1. Increase the $50,000 threshold amount in Code Section 414(q)(1)(B). An employee earning $50,000 is not considered highly compensated in many parts of the country. Furthermore, as presently drafted, the revised definition would expand the potential HCE group beyond that under current law, because it would classify as HCEs those who earn greater than $50,000 but who are not in the top paid group (i.e., in the top 20 percent group ranked by compensation). An increased dollar threshold would mitigate this problem.

2. Do not require an employee to be counted as a HCE merely because of his percentage ownership of the business if his income is below the $50,000 (or higher)

dollar threshold. If an individual is not earning significant compensation, he is not highly compensated regardless of how much of the business he owns.

3. Provide rules for employees who are hired or who terminate service during the year. For example, such employee's compensation during his first or last year of employment could be annualized for HCE testing purposes.

4. Code Sections 414(q)(6), 414(q)(7), 414(q)(9), 414(q)(10) and 414(q)(11) should be designated as 414(q)(4), 414(q)(5), 414(q)(6), 414(q)(7) and 414(q)(8), respectively.

SECTION 102: DEFINITION OF COMPENSATION

SBCA agrees that W-2 wages and base pay are appropriate methods of measuring compensation for qualified plan purposes. Both changes reflect an awareness of actual plan practices, and an acknowledgment that these practices are not abusive. Furthermore, sanctioning the use of W-2 wages for this purpose eliminates a trap for the unwary, since the use of W-2 wages is not currently a safe harbor definition of compensation under the proposed Code Section 414(s) regulations.

We believe, however, that the revised Code Section 414(s) should be coordinated with the definitions of compensation under Code Section 415 and the regulations thereunder. Regulations Section 1.415-2(d) authorizes the use of the following compensation definitions:

1. Compensation subject to FICA withholding.
2. Compensation subject to Federal income tax withholding.
3. The present Code Section 415(c)(3) definition of compensation.

We suggest that the first two of these definitions be included in Code Section 414(s) as amended by S. 2901 in order to specifically authorize the practices of many plan sponsors.

SECTION 103: MODIFICATION OF COST OF LIVING ADJUSTMENTS

SBCA supports the use of rounding to determine cost of living increases for pension plan dollar limitation purposes. Rounding is simple and practical, and would help eliminate the current preoccupation with detail currently plaguing the private pension system.

SECTION 104: MODIFICATION OF ADDITIONAL PARTICIPATION REQUIREMENTS

SBCA understands that the proposed changes to Code Section 401(a)(26)(A) would (1) limit the application of Code Section 401(a)(26) to defined benefit plans, (2) lower the number of employees that must benefit under a plan from 40 to 25, and (3) require a two person plan to cover both employees. While SBCA is in favor of limiting Code Section 401(a)(26) to defined benefit plans, we believe that these changes do not adequately limit the scope of Code Section 401(a)(26) to its original purpose: to restrict the use of individual defined benefit plans maintained solely for the benefit of highly compensated employees.

SBCA believes that the abuse potential with respect to individually designed plans will be eliminated when the comparability provisions of Revenue Ruling 81-202 are updated. If it is desired that individually designed plans be prohibited (in contrast to being used in nonabusive situations), this could be accomplished by prohibiting such plans from being aggregated with other plans for Code Section 410(b) purposes. For example, Code Section 410(b) (and the regulations at 1.410(b)-1(d)(3)) could be amended to provide that only plans with a specified number of employees (e.g., five) may be aggregated with other plan(s) for purposes of determining whether such plans satisfy the minimum coverage requirements. Because individually designed plans could be restricted or prohibited by other means, we believe that Code Section 401(a)(26) could be eliminated with no adverse affect to the private pension system. However, if Code Section 401(a)(26) must be retained, we believe that it should be amended to apply only to plans covering a nominal group of employees, such as five.

We must note, however, that in many cases, comparability even with one-participant satellite plans with a core staff plan, generated the greatest retirement benefits for staff employees. This principle seems to have been overlooked.

Finally, we should point out that the proposed change requiring a plan to cover two employees serves little purpose. A plan that covers only one employee will violate the minimum coverage requirements of Code Section 410(b) if the excluded employee is not a HCE. If both employees are HCEs, there is no abuse to correct. Therefore, the purpose for this additional restriction under Code Section 401(a)(26) is unclear.

SECTION 105: NONDISCRIMINATION RULES FOR QUALIFIED CASH OR DEFERRED ARRANGEMENTS AND MATCHING CONTRIBUTIONS

While SBCA would have preferred to see the complete elimination of the actual deferral percentage (ADP) test under Code Section 401(k) and the actual contribution test (ACP) under Code Section 401(m), SBCA strongly supports the use of designed based safe harbor rules to avoid nondiscrimination testing. Such safe harbors will make many 401(k) plans and plans with matching contributions easier and less expensive to administer, allowing many more small businesses to sponsor such plans on behalf of their employees.

SBCA notes that this new section would allow alternative plan designs to be used in order to meet the 401(k) safe harbor. This is an enlightened approach to safe harbor design, affording each employer the opportunity to provide the most appropriate matching structure for their employees while still being able to avoid unnecessary and burdensome nondiscrimination testing. SBCA strongly supports this provision.

With respect to the 401(k) safe harbor, SBCA would like to make the following suggestions, in hopes of improving an already excellent provision:

1. SBCA is concerned that S. 2901, Section 105(a) as presently drafted could permit a discriminatory matching contribution to exist in conjunction with the three percent nonelective contribution safe harbor. Accordingly, Code §401(k)(11)(C) should specifically state that the three percent minimum nonelective contribution is to be provided in lieu of a matching contribution.

2. It is our view that the notice requirement will be satisfied by distribution of the summary plan description to eligible employees. Therefore, this notice may be redundant and costly to produce and distribute. However, if the notice requirement is to be retained, there should be a notice provided to employees who become eligible to participate during the plan year.

3. The ability of the employer to provide the safe harbor contribution under another plan should be limited to qualified plans.

With respect to the 401(m) safe harbor, we have the following observations:

1. Because the 401(m) safe harbor requires compliance with the 401(k) safe harbor, which provides for matching contributions with respect to elective deferrals up to five percent of compensation, it is unclear why the 401(m) safe harbor should then prohibit matching contributions in excess of six percent of compensation. It seems more logical to either limit matching contributions to elective deferrals and employee contributions of up to five percent of compensation, or to provide no such limitation at all. We believe that no such limitation on matching contributions apply, because the other two components of the 401(m) safe harbor (i.e., the prohibition against increasing matching contributions and the limitations on the aggregate amount of matching contributions) adequately protect against discrimination in favor of HCEs.

2. An element of potential discrimination still exists under the 401(m) safe harbor because there are no limitations on employee contributions. One way to limit this potential discrimination would be to limit employee contributions to that percentage which would result in the greatest possible match (taking into account elective deferrals under the plan).

3. The 401(m) safe harbor should specifically state that the "multiple use" restrictions of Code Section 401(m)(9) will not apply if a safe harbor is used.

Finally, SBCA agrees with the proposed amendment to Code Sections 401(k)(8)(C) and 401(m)(6)(C) regarding the return of excess contributions. Determining excess contributions by reference to contributions and not the deferral percentages is logical. It also is fairer to the lower paid employees in the HCE group.

SECTION 201: PENSION DISTRIBUTION RULES

SBCA is pleased to see a legislative proposal that would simplify the Code Section 402 pension distribution rules. It is hard to imagine a Code Section with more complexity and traps for the unwary or even to the wary! Simplifying the distribution rules is a giant step in the right direction for pension simplification. This simplification would also result in more fairness to the many individual taxpayers who must cope with these rules.

SBCA generally supports the methods by which S. 2901 would simplify the pension distribution rules. However, SBCA respectfully requests that the following proposed modifications be considered in order to further enhance an already improved Code Section 402:

1. Retain five year forward averaging treatment. Five year forward averaging treatment primarily benefits non-HCEs with small benefit distributions. Also, from a simplification standpoint, we do not believe that the tax under the forward averaging rules is difficult to calculate. Even if the forward averaging calculation is perceived as difficult by the distributee, he could avoid this complexity by not electing such treatment.

Retaining five year forward averaging also requires no legislation change so as to permit distributees to continue to use an amount equal to five times the excess distribution amount (i.e., $112,500, indexed or $150,000) for purposes of determining whether the excise tax on excess distributions applies (the "five times" rule). S. 2901 as presently drafted would not permit continued use of the five times rule. We note that this is a major policy change significantly impacting many participants. See Section 201(b)(43) Even if five year forward averaging is repealed, we believe that Section 201(b)(43) should be eliminated, so that the five times rule would continue to apply. Of course, Code Section 4980A(c)(4) will need to be modified to refer to forward averaging prior to its repeal. To this end, regardless of whether forward averaging treatment is repealed, Code Section 4980A(c)(4) should be amended to provide that if the distributee receives the balance to the credit under a qualified plan, the excess distribution amount in Code Section 4980A(c)(1) will be multiplied by five for purposes of determining whether the excise tax on excess distributions would apply with respect to that distribution. This is more liberal than current law, but it is not clear why the five times rule should apply to only those recipients of lump sum distributions who are eligible for forward averaging treatment, and not other lump sum recipients.

Finally, if five year forward averaging is repealed, it may be appropriate to provide transition rules for individuals who were anticipating using five-year averaging.

2. With respect to rollovers of property, we suggest that the distributee be allowed to roll over cash into an eligible retirement plan instead of the property. For example, if property worth $5,000 were distributed from a qualified plan, the distributee could roll over $5,000 in cash into an IRA. This change would increase the number of eligible retirement plans available to the distributee, since all such plans accept cash, but not all plans accept property. The change would also simplify Code Section 402(d) by eliminating the need for Code Section 402(d)(6). Finally, the distributee would not be required to sell the property. We do not believe that retirement policy would be adversely affected by permitting cash to be rolled over instead of property, since assets of equal value would continue to be available for retirement purposes. It may, however, be necessary to characterize the distributed property as ordinary income property in order to avoid potential advantages should capital gains rates be lowered.

3. Allow employee contributions to be rolled over into IRAs. Since IRAs may accept nondeductible contributions, it seems illogical to prohibit individuals from rolling over employee contributions merely because they were distributed from a qualified plan.

4. Permit net unrealized appreciation on distributions of employer securities attributable to employer contributions to be excludable from income regardless of whether the securities were received as part of a lump sum distribution. This alternative would greatly simplify Code Section 402(e)(4) under S. 2901 by eliminating the complex lump sum distribution rules.

5. Code Section 402(d) should specifically provide that direct transfers from qualified plans to IRAs be treated as rollover contributions. (This change would effectively be made if new Code Section 417A were enacted).

6. The rollover notice provisions of Code Section 402(f) should refer to Code Section 403(b)(8) (regarding rollovers from tax sheltered annuities).

SECTION 202: TRUSTEE-TO-TRUSTEE TRANSFERS

SBCA supports improvements to the pension system which enhance the portability of plan benefits. Accordingly, SBCA supports the concept of Section 202 of S. 2901 requiring plans to make trustee-to-trustee transfers at the employee's request. By improving pension portability, this provision would increase the likelihood that an employee's benefits will be available to him when he retires. Also, excluding such transfers from income under new Code Section 402(e)(5) would effectively sanction trustee-to-trustee transfers from qualified plans to IRAs, a long overdue change. However, while SBCA agrees in concept with the availability of trustee-to-trustee transfers, we believe that several modifications should be made to improve the workability of the transfer rules.

1. Increase the minimum amount which must be transferred from $500 to $3,500, to coordinate with the other cashout provisions in the Code. See, Code §§411(a)(11), 417(e).

2. Explicitly state that IRAs are acceptable transferee plans.

3. Clarify Code Section 417A to make it clear that a trustee-to-trustee transfer will not be made unless requested by the participant or his beneficiary. This clarification will prevent the trustee-to-trustee transfer rules from conflicting with the immediate cashout restrictions of Code Section 411(a)(11).

4. Allow employers to directly transfer all accounts from a terminated qualified retirement plan to another qualified retirement plan maintained by the employer without participant or spousal consent. This will help keep retirement moneys in the pension system.

5. Code Section 417A should specifically state that it is applied after other applicable distribution rules (e.g., Code §§411(a)(11), 417).

6. Clarify that distributions of employee contributions are not required to be transferred even if some of the distribution is taxable under Code §72(e). Alternatively, for purposes of Code Section 417A, the employee contributions could be deemed to be the first distributions received under the plan (i.e. a basis recovery rule).

SECTION 203: REQUIRED DISTRIBUTIONS

While SBCA supports the liberalization of Code Section 401(a)(9) and the elimination of the half year rule, we respectfully submit that these changes do not go far enough. In our view, there is no longer a reason for Code Section 401(a)(9) to exist. Code Section 401(a)(9) was initially enacted to prevent wealthy individuals from using qualified plans as an estate planning device. However, the estate tax exclusion for qualified distributions was repealed. In fact, with estate tax rates higher than income tax rates, a wealthy individual should be disinclined to defer receipt of his plan distributions until death.

If Code Section 401(a)(9) must be retained, we suggest that it be modified in accordance with one of the methods suggested by the APPWP in its September, 1989 report, Gridlock, Pension Law in Crisis and the Road to Simplification. These methods include applying the minimum distribution rules to participants who are either 5% owners or who have a minimum benefit entitlement (e.g., $750,000), or even better, by simplifying the payout rules.

SBCA also believes that the actuarial increase for accrued benefits that have not commenced at age 70 is unnecessary. Code Section 411(b)(1)(H) already provides that employees who are employed past normal retirement age are entitled to continued accruals. Also, ERISA's suspension of benefit rules also permit actuarial increases of benefits which are suspended because of employment past normal retirement age. Adding the proposed actuarial adjustment would further complicate an area that is far too complex now. As an alternative, we suggest that participants who are still employed by the employer at age 70 be allowed (but not required) to begin to receive benefits at age 70. If the age 70 actuarial adjustment is retained, clarification is needed regarding whether it is intended to apply to defined contribution plans, and if so, how.

TITLE III: MISCELLANEOUS PROVISIONS

SBCA generally supports the miscellaneous provisions in S. 2901, particularly the provisions which (1) redefine leased employees to include a "control" test rather than a "historically performed" test, (2) eliminate the half-year requirements and (3) simplify the Keogh plan rules of Code Section 401(d). Regarding self-employed individuals, SBCA believes that S. 2901 provides an opportunity to amend the Code to provide complete parity between corporate sponsored qualified plans and plans sponsored by sole proprietorships and partnerships. In particular, the prohibition against plan loans by self-employed individuals should be eliminated.

SBCA suggests that with true simplification of the laws governing the private retirement system, SEPs serve no legitimate purpose. SEPs were created in response to the complexity of the pension system. They are strange creatures—hybrids of IRAs—which act as qualified retirement plans and are readily subject to abuse. The entire pension system will be strengthened by simplification of the major body of pension law and elimination of this ancillary system.

ADDITIONAL MEASURES

SBCA cannot state emphatically enough its support for pension simplification. We hope that this letter demonstrates our commitment to the cause. While S. 2901 goes

a long way towards pension simplification, we would like to take this opportunity to suggest certain other pension law changes that we believe would simplify the private pension system. Specifically:

1. Eliminate or simplify the redundant top-heavy rules.
2. Repeal either the Code §4981A excise tax on excess distributions or the combined plan limitations of Code Section 415(e). (SBCA prefers that the excise tax on excess distributions be repealed.)
3. Eliminate the family aggregation rules of Code Section 414(q)(6). This is an unfortunate throwback to the days when a wife's property was deemed to be the husband's. The family aggregation provisions demean the legitimate efforts of the owner's spouse and other family members in the business. There is no justification for hurting family-owned businesses.
4. Liberalize the rules regarding distributions upon the termination of a 401(k) cash or deferred arrangement.
5. Repeal or simplify the hardship distribution rules with respect to 401(k) cash or deferred arrangements.
6. Simplify the basis recovery rules of Code Section 72.
7. Eliminate the remaining distinctions between profit sharing plans and money purchase pension plans.
8. Simplify and coordinate the REA consent and notice requirements of Code Section 417 (relating to survivor annuities) and 411(a)(11) (relating to immediate distributions).
9. Eliminate the notice to interested persons and the summary annual report requirements. Simplify or streamline the Form 5500 annual report.
10. Eliminate the 150% full funding limitation of Code §412(c)(7).
11. Coordinate the excise taxes for nondeductible plan contributions, overstatement of pension liabilities and pension plan reversions.
12. Prohibit further pension legislation (other than purely technical amendments) for at least five years.

SBCA is pleased to have the opportunity to provide its views regarding the Employee Benefits Simplification Act. We would be pleased to answer any questions you may have regarding this letter. SBCA also stands ready to assist in any way possible to improve or refine this important legislation.

Statement of Tax Section of Los Angeles County Bar Association

The Tax Section of the Los Angeles County Bar Association generally applauds Section 201 of the Employee Benefits Simplification Act (S. 2901). We are hopeful that it will result in meaningful simplification of the unduly complex pension distribution rules. Other than the treatment of the rules on net unrealized appreciation ("NUA") in employer securities, we are in complete agreement with the approach to simplification taken in Section 201 of S. 2901. At this time, we are unable to comment on the other sections of S. 2901.

Turning to the NUA rules, it is the opinion of the Tax Section that these rules add an unnecessary layer of complexity to the distribution rules and should be eliminated. In case you have not previously seen it, we have enclosed a copy of a report prepared by the Tax Section prior to the introduction of S. 2901 that examines many of the problems with the current distribution rules, including the rules on NUA, and suggests a method for reforming these rules that involves the abolition of the NUA rules.[1]

As stated in pages 37 through 46 of the report, our objections to the retention of the NUA rules are twofold.

In the first place, there is no legislative justification for the retention of the NUA rules once an unlimited rollover rule has been adopted. When your Committee introduced the NUA rules almost 40 years ago, it stated that:

> "It is frequently the case [when a tax-qualified plan distributes stock] that the price the fund paid for the stock was substantially less than the current market price that is used in determining the taxable value of the employee's withdrawal. This results in the employee's being taxed on the amount of company contribution, the fund earnings, and any increase in the value of stock which was purchased for his account. Therefore, where companies select this method for providing for their employees' retirement

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[1] The report is in the Committee files.

rather than through the purchase of annuities, this accumulated value of the employer's contribution in the fund is bunched in one taxable year, thus subjecting it to tax and higher surtax brackets.

"Your Committee believes that the present tax on the stock appreciation in such cases substantially reduces the employees' profit-sharing accumulation and thus his retirement income. This is a discrimination against those employees who select this method of providing for their old age. S. Rep. 781, 1951-2 C.B. 493."

It is clear from this statement that the implicit rationale behind the NUA rules is the avoidance of income bunching through the deferral of income. A rule of unlimited rollover as proposed by S. 2901 solves the problem of income bunching and thus eliminates the rationale underlying the NUA rules. This is not a revelation. In Senator Pryor's statement introducing S. 2901, he states that: "liberalization of the rollover rules increases the flexibility of taxpayers in determining the time of the income inclusion of pension distributions, and eliminates the need for special rules to prevent bunching of income." Given this awareness, the Tax Section strongly believes that there is no justification for the retention of the NUA rules.

Turning to our second objection, the Tax Section believes that the goal of simplification is to reduce the distribution rules to a few simple rules that the public can understand. This goal is undermined by the retention of the NUA rules. Looking at the number of pages of text which make up Section 201, the NUA rules, which incorporate the rules on lump sum distributions, comprise about one-third of these pages. While the length of a statute may not be the most reliable measure of its complexity, no one can argue that Section 201 is not more complicated as a result of the inclusion of the NUA rules which represent one-third of its pages. This measure itself, however, understates the complexity added by these rules. What makes the NUA rules so pernicious are the difficult calculation and accounting burdens they impose. The Tax Section has addressed many of these complexities in pages 43 through 47 of its report. The Tax Section's report demonstrates that the retention of the NUA rules is totally inconsistent with a policy of simplification.

CONCLUSION

Other than the treatment of NUA, the Tax Section enthusiastically supports Section 201 of S. 2901 as an approach aimed at the simplification of the pension distribution rules. The Senate Finance Committee's retention of the NUA rules however, causes the Tax Section to question its commitment to simplification. The Tax Section strongly urges the Senate Finance Committee to remove an obvious impediment to that process.

TEACHERS' RETIREMENT BOARD, TEACHERS' RETIREMENT SYSTEM,
THE CITY OF NEW YORK,
New York, NY, August 23, 1990.

Senator DAVID PRYOR, CHAIRMAN,
Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service,
Senate Finance Committee,
Washington, DC.

Re: Employee Benefits Simplification Act (S. 2901)

Dear Senator Pryor: On behalf of the Teachers' Retirement System of the City of New York (the "System"), I am pleased to provide you with our comments on the Employee Benefits Simplification Act (S. 2901).

The System was established in 1917 and includes both a defined benefit plan and a tax-deferred annuity program (subject to Internal Revenue Code section 403(b)) for eligible employees of The Board of Education. These retirement programs have over 125,000 participants and combined assets of approximately $16 billion. System participants primarily include teachers and school support personnel.

The System strongly agrees with the goals of S. 2901 and the compelling need to simplify current pension laws. Complexity unnecessarily increases administrative costs, makes it difficult for employees to understand their benefit plans, and creates tax traps for the unwary. We commend you for your efforts in this important area.

We comment on the following three provisions of S. 2901 which are of particular interest to the System.

I. SECTION 201: TAXABILITY OF DISTRIBUTIONS

The current rules for distributions from retirement plans are overly complex and potential tax traps for the unwary. Much of this needless complexity is due to the current distinctions between, and the different rules applied to, "qualified total distributions" and "partial distributions." The bill would eliminate these distinctions, and expand the rollover rules to allow rollovers of almost all plan distributions (except required distributions and distributions of amounts deemed to involve after-tax employee contributions) to an eligible transferee plan. Similar changes would also be made to the rollover rules governing the distribution of benefits from annuity programs subject to Code section 403(b)—rules which the System was instrumental in supporting when they were enacted in 1978.

The liberalization of the rollover rules will decrease much of the tremendous complexity now associated with the tax rules for distributions. Moreover, this change would advance the goal of pension portability and retirement income preservation by providing employees with increased rollover availability and flexibility. For example, the System allows certain long-service participants to make limited in-service withdrawals of their after-tax employee contributions; the expanded rollover rules would allow the participant to roll over the portion of the withdrawal that is deemed to represent earnings on the employee contributions. Importantly, the bill would achieve these worth-while goals without placing additional burdens on plan administrators or additional restraints on participants' existing pension rights.

We also strongly believe that this section should be expanded to permit the rollover of distributions of after-tax employee contributions. Denial of rollover treatment for after-tax employee contributions frustrates the goals of both pension portability and retirement income preservation. Allowing rollover treatment of after-tax employee contributions would not add to the administrative burden of IRA sponsors because they must already account for nondeductible IRA contributions. Moreover, any revenue loss associated with this change may be offset by the favorable economic effects of continued investment of the funds involved.

Many governmental plans, like the System, require that employees make after-tax employee contributions towards their retirement benefits. While governmental plans now often "pick-up" future employee contributions on a pre-tax basis under Code section 414(h), most governmental plans (and many private sector plans) still contain large amounts of after-tax employee contributions. Often these after-tax employee contributions are a sizable portion of the employee's total retirement benefit. We strongly agree with Sen. Jeffords' statement on S. 2901 that employees "should not be forced to spend their after-tax distribution money because they can't put this money into an IRA account."

II. SECTION 202: MANDATED PLAN TRANSFERS

The general goals of pension portability and retirement income preservation are laudable; as noted above, we support simplification of the pension rules to achieve these goals. We believe, however, that this section of the bill would add unnecessary complexity to the plan distribution rules that otherwise would be simplified by section 201. Indeed, the complexity that would be added might even outweigh the simplification benefits of section 201.

In general, the bill would require the transfer—to either an IRA or another qualified plan—of all plan distributions greater than $500 that are made prior to the employee attaining age 55. We believe this requirement is likely to accomplish comparatively little additional retirement income preservation. An employee could merely remove the plan distribution from the transferee IRA. In addition, increased administrative burdens would be placed on the System because it would have to provide employees with an election to designate a transferee plan and, where no such designation is made, the System would have to select a transferee plan. We are concerned that many employees would make no designation or would make inappropriate designations. We are also concerned about the burdens and costs associated with the establishment and maintenance of a "default" transferee plan vehicle. We, therefore, recommend that this section of the bill be deleted.

The marketplace offers individuals an immense variety of IRA vehicles, most of which are quite easy to establish. We believe that increased awareness of these opportunities—together with simplified rollover rules—will enhance the use of rollover IRAs without imposing additional burdens on plan administrators.

III. SECTION 306: TREATMENT OF CERTAIN GOVERNMENTAL PLANS

This section would eliminate the restriction under Code section 415 that limits the annual benefit payable under a defined benefit plan to 100% of the participant's

average compensation. The System strongly supports the elimination of this restriction. First, it will allow long-service employees, the overwhelming majority of whom are not highly paid by private sector standards, to receive their full benefits under the System without regard to this restriction. Currently, some of these employees—who accept the tradeoff of a lesser government salary in return for a pension benefit more generous than that provided in comparable private sector employment—may be denied their full benefits upon retirement. In addition, fiscal austerity has required many governmental bodies to reduce their staffs. The availability of these full benefits will facilitate any efforts to reduce governmental payrolls (such as through the use of early retirement incentives) by assuring retirees that they may receive pensions commensurate with their retirement needs.

A second, and equally important, reason we support this provision is that it will eliminate the administrative burden of verifying that participants' benefits do not exceed this compensation limit.

We appreciate this opportunity to provide you with our comments. Please contact Lou Mazawey of Groom and Nordberg, Chartered, our Washington tax counsel (202-857-0620) or me if we can provide you or your staff with further assistance in the consideration of our suggestions.

Very truly yours,

DONALD S. MILLER, *Executive Director.*

UNITED CHURCH OF CHRIST—THE PENSION BOARDS,
New York, NY, July 26, 1990.

Hon. DAVID H. PRYOR,
U.S. Senate,
Washington, DC.

Re: The Church Benefit Simplification Act of 1990.

Dear Senator Pryor: I am the Chief Legislative Officer of The Pension Boards—United Church of Christ. The Pension Boards, a historic instrumentality of the United Church of Christ, is involved in the provision of retirement and welfare benefits to United Church of Christ ministers and lay workers. At the present tine, we serve about 11,000 ministers and 6,000 lay employers

We have carefully reviewed The Church Benefits Simplification Act of 1990, and enthusiastically and wholeheartedly support this legislation.

Over the past 15 years, since the enactment of the Employee Retirement Income Security Act of 1974, the Pension Boards has had to spend a significant amount of time and financial resources in complying with rules that we do not believe were designed with the church employee benefits community in mind.

The Act would greatly simplify those rules and result in significant cost savings to churches. These savings will of course be used in carrying out the ministries and missions of the church.

The cornerstone of this legislation is a provision that "wall-off" the rules that apply to church retirement plans from further change unless the Congress and the Treasury Department specifically decide that these rules should be made applicable to churches. If enacted, this is provision will mean that churches will no longer have to be heavily involved in employee benefits legislation as it moves through the Congress to explain why the legislation creates unique problems for the church employee benefits community.

Senator Pryor, we thank you for your willingness to sponsor this important piece of legislation, and we will do everything in our power to assist you in ensuring that it is enacted in 1990.

Sincerely,

JOHN D. ORDWAY, *Executive Vice President.*

UNITED METHODIST CHURCH, GENERAL BOARD OF PENSIONS,
Evanston, IL, July 27, 1990.

Hon. DAVID H. PRYOR,
U.S. Senate,
Washington, DC.

Dear Senator Pryor: I am writing to express appreciation for your sponsorship of The Church Benefits Simplification Act of 1990. My understanding it that the legislation was to be introduced this week.

Those on the General Board of Pensions of The United Methodist Church serve participants in ministry in 37,000 local churches containing about 9 million church members. The vast majority of churches are small congregations, and pensions are modest for the clergy who also serve at modest salaries.

In reviewing and supporting the concepts of simplifying and walling off the Internal Revenue Code rules regarding churches, our opinion is that there will be significant cost savings to the churches with the enactment of this Act. Churches will be spared from what heretofore have been onerous efforts to be involved with employee benefits legislation meant usually for corporations and which never seemed to fit church situations. Businesses are not structured like denominations with 37,000 "outlets" with one employee in each, often assisted by one or two part-time quasi volunteers (secretary and custodian).

Our heartfelt thanks and support as we sincerely attempt to assist you to ensure that this proposal will be enacted in 1990.

Sincerely,

JAMES F. PARKER, *General Secretary.*

UNITED STATES CATHOLIC CONFERENCE,
Washington, DC, August 2, 1990.

Hon. DAVID PRYOR, *Chairman,*
Finance Subcommittee on Private Retirement Plans
and Oversight of the Internal Revenue Service,
Washington, DC.

Re: S. 2902—"Church Retirement Benefits Simplification Act."

Dear Mr. Chairman: The United States Catholic Conference ("USCC") submits these comments with respect to S. 2902, the Church Retirement Benefits Simplification Act.

USCC is a nonprofit, tax-exempt organization whose members are all active Catholic bishops in the United States, representing almost 200 dioceses and over 50 million people nationwide. USCC commends your efforts in sponsoring this legislation to relieve church retirement plans from the complex provisions of current pension law, which were designed primarily to regulate retirement plans of business employers, and which are unnecessary and burdensome for church retirement plans.

As you are probably aware, Catholic pension benefits are not provided through a national pension board, but rather are provided at the diocesan level and through plans covering the ministries of Catholic religious orders. Catholic diocesan pension plans alone provide retirement benefits for an estimated 200,000 lay employees.

USCC believes that S. 2902 will reduce the administrative and compliance burdens of church retirement plans. As a result, churches will be able to redirect to traditional church ministries funds that have been diverted to pay plan attorneys and actuaries. Although S. 2902 does not go far enough toward reducing the administrative and compliance burdens on church plans, particularly with respect to church welfare benefit plans, USCC believes that it is a step in the right direction.

Accordingly, recognizing that S. 2902 is a good first effort, USCC supports your bill as introduced. However, any weakening of the relief provided church retirement programs by S. 2902 would diminish its beneficial effect, and would necessitate reconsideration of USCC's support. USCC looks forward to passage of S. 2902 and to your future sponsorship of additional legislation helpful to church plans.

Respectfully submitted,

DEIRDRE HALLORAN, *Associate General Counsel.*

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