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PENSION SIMPLIFICATION AND EXPANSION

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 SECOND CONGRESS

FIRST SESSION

ON

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PENSION SIMPLIFICATION AND EXPANSION

FRIDAY, SEPTEMBER 27, 1991

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 10:05 a.m., in room SD-215, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Also present: Senator Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H-39, Sept. 13, 1991]

HEARING PLANNED ON PRYOR-BENTSEN PENSION SIMPLIFICATION BILL; MORE PENSION PLANS SHOULD BE ENCOURAGED, PRYOR SAYS

WASHINGTON, DC—Senator David Pryor, Chairman of the Finance Subcommittee on Private Retirement Plans, Friday announced a hearing on the Pryor-Bentsen bill to encourage pension plans for more American workers.

The hearing will be at *10 a.m. Friday, September 27, 1991* in Room SD-215 of the Dirksen Senate Office Building.

Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, introduced the legislation with Pryor (D., Arkansas) on June 25.

"While recuperating in Arkansas from my recent heart attack, I was encouraged to learn of the growing interest in simplifying some of our most needlessly complex pension rules and helping businesses provide pension plans to their employees. I applaud these efforts. The time is long overdue to reverse the trend of increasing government regulation of pension plans," Pryor said.

"I want to thank Chairman Bentsen for introducing the Employee Benefits Simplification and Expansion Act of 1991, S. 1364, on my behalf while I was absent, and my 36 Senate colleagues who have cosponsored this legislation," Pryor said.

"The bill encourages employers to establish new pension plans, reduces administrative costs of providing these plans and encourages workers to preserve their retirement savings. I am committed to meeting these goals within budgetary constraints and I look forward to exploring new ways to achieve these ends. It is my hope the September 27 hearing will add a meaningful dialogue to this important debate," Pryor said.

S. 1364 allows small businesses to establish a Simplified Employee Pension that is similar to an IRA; makes a series of changes in pension laws to ease administration of retirement plans; and enables workers who change jobs to transfer funds from qualified pension plans directly into IRA's.

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

Senator PRYOR. Good morning, ladies and gentlemen. We are going to start our hearing now. I have a very brief statement. Then I am going to call on our friend, Senator Grassley. Senator Grassley has to go to the Judiciary Committee. There is a very important matter that is going to be awaiting his arrival there. I am going to make a few opening remarks about our issue today, then we will yield to him and then call on Senator Jeffords.

During the last couple of years the lion's share of this subcommittee's resources have been devoted to peeling off some of the unnecessary layers of complexity crippling pension law.

During this same period of time we met with small business, with big business, with taxable entities, with tax exempt organizations, the private sector, the public sector throughout the country. We talked with experts, lawyers, accountants, actuaries, and administrators, to try to find a consensus and a common sense approach to simplifying our retirement systems.

We held two hearings last year. We listened to a wide range of proposals during those hearings. We discussed the merits and the demerits of S. 2901, the Employee Benefit Simplification Act of 1990, which I introduced in the last Congress.

Every person involved and every group involved, in this continuing dialogue agreed on two things. One, the current pension laws are too costly; and two, they are too complex. Everyone agrees on these two principles.

On July 25 of this year, Chairman Bentsen introduced on my behalf, and I am indebted to him for doing so, the Employee Benefits Simplification and Expansion Act of 1991, S. 1364. I would like to thank Chairman Bentsen for his continued support of this legislation; and in addition, I would also like to thank the 36 of our colleagues in the Senate, including 13 of our fellow Finance Committee members for joining us in this effort of finding a simple and less costly way to increase retirement savings for the workers of America.

Several studies indicate that present pension coverage levels are alarmingly low. The Department of Labor and Employee Benefit Research Institute report that the gap in pension coverage for workers appears to be largely among the smaller employers. The Department of Labor estimates that only 30 percent of the employees of small business currently have employer provided pensions. This means that 25 million American workers have absolutely no pension coverage whatsoever and the futures they face are very uncertain and certainly gloomy.

The facts are in. The long range effects are frightening. We must act now. We must not delay. We think the first logical step is to make the rules simpler. We think S. 1364 is such a step.

Our bill helps small business provide generous pensions to their employees. It creates safe harbor alternatives to the current law's, complicated, expensive, nondiscrimination tests for 401(k)s and simplified employee pensions, which we call SEP's.

Another provision allows employees of tax exempt institutions—churches, museums, charitable organizations—to establish 401(k)s. There is no reason that they, too, should not be participating. There is simply no justification for denying these workers access to 401(k) plan benefits.

Another important segment of our bill simplifies the very controversial rollover provision rules. I would like to stress that our bill makes it simpler for workers who change jobs to take their pensions with them. The Department of Labor reports that $12 billion a year is distributed from pension plans before retirement and most of this intended retirement savings money is being spent rather than transferred into an IRA or other qualified plan.

One of the primary reasons for this premature spending of retirement savings dollars is the complexity of the rollover rules. Our bill eliminates most of those complex rules. It safeguards the long range nature of retirement savings by requiring trustee-to-trustee transfers. This makes it easier for workers to avoid unintended tax and penalties on their pension savings.

In addition, S. 1364 corrects problems in applying current law. It better focuses the law on abusive situations. It clarifies the law in certain areas, including minimum participation requirements, full funding limits for multi-employee plans, excess benefit plans for State and local government, and voluntary employee benefit association, known as VEBA's.

This morning we will also hear from a panel on S. 747, the Church Retirement Benefit Simplification Act. This legislation would modify existing law to bring greater consistency and clarity to pension policy as it applies to our churches. Current pension law simply does not work for them. S. 747 will correct these problems.

We look forward to our witnesses today. We thank our witnesses for coming. At this point we yield to Senator Grassley.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, first of all, thank you for holding this hearing. Secondly, I am glad to be back with you on this committee, more importantly to have you back in both a healthy state of both mind and body that you are, and looking so well, looking quite the same as you have always looked if that is okay for me to say it that way. Because I think that is the way you would want to look.

Senator PRYOR. Thank you, Senator.

Senator GRASSLEY. Also I have a statement from Bob Packwood, the Senator from Oregon, on this subject. I would like to have it included in the record.

Senator PRYOR. It will be made a part of the record. Thank you.

Senator GRASSLEY. And also another reason why I want to be here for a few minutes, even though the Thomas confirmation vote is going on in the Judiciary Committee at this time, is that there are two people from my State who are exports in this area who are on the list to testify. I thank you for calling for them to testify.

Mr. Chairman, our overall policy goals in this area must be to help maximize the retirement income of American workers. Anyone who has concentrated on public policies for older Americans as I have over the years realizes that the problems that some of them face are often caused by insufficient income. Often this is true even though they worked all their lives prior to retirement.

Private employment based pensions are very important means of ensuring that workers have adequate income in retirement. Unfortunately, we do not seem to be making progress in this area. Private pension coverage, once over 50 percent, has now slipped to 46 percent of our work force. According to the Congressional Research

Service there has been almost no growth in the number of participants in defined pension benefit plans since ERISA took affect in 1975. Terminations of defined benefit plans outnumbered new plans by three to one in 1989.

Providing pension plans for workers is particularly difficult for small employers. According to the Employee Benefit Research Institute only 18 percent of employers with less than 25 employees have plans and only 53 percent of employers with 25 to 99 employees have such plans.

It is clear that we have a consensus among interested parties to the affect that one important source of the decline in pension plan growth lies in the overly complicated pension law. It also seems clear that this complexity in particular discourages smaller employers from offering pension plans.

As we will hear today from one of my constituents, Larry Zimpleman, of Principal Financial Corporation, most of the small employers with which the principal company works simply cannot administer their pension plans without outside expert help, which can be very expensive. This is just plain unreasonable. If we are passing laws around here to help people we should not do those things which discourage employers from having plans.

Much of this complexity is caused by rules designed to prevent discrimination in favor of highly compensated employees. As we move ahead in our simplification project we do need very definitely to keep this in mind. I think all of us will agree that tax favored pension plans should not discriminate against non-highly compensated employees.

In any case, we have moved to the point in this debate at which we have some very good legislation to consider and perhaps we can make the legislation even better. I hope that this committee will be able to move this year on this legislation, Mr. Chairman. I hope that we get a vehicle to do that with.

If we cannot do it this year it should be one of our highest priorities next year.

Before I finish, I just want to introduce two of our witnesses, both from Iowa, both very knowledgeable in the pension area. One I have already mentioned, the second vice president for pension operations of the Principal Financial Corp. Mr. Zimpleman will be able to tell us about a survey conducted among some of their small business clients and the problem of pension complexity.

The second is Tom Walker, the president of Associated Benefits Corp., who is representing the Association of Private Pension and Welfare Plans. He is here today on our third panel. Mr. Walker has a lot of experience in the pension field. His firm represents over 200 small agricultural employers with over 8,000 participants in defined benefit and defined contribution plans. I think that this gives him a good perspective in pension simplification.

Mr. Chairman, I thank you for allowing me to go ahead and for understanding that I must go to the Judiciary Committee for the Clarence Thomas vote.

Senator PRYOR. Senator Grassley, thank you. I want to thank you for long being a constructive voice in this issue of trying to simplify these plans and make them more available to more employees across the country. We appreciate your contributions very much.

Senator GRASSLEY. Mr. Chairman.

Senator PRYOR. Yes.

Senator GRASSLEY. I will also have some questions if I am not able to come back from the hearing that I would ask participants to respond to in writing because of my absence.

Senator PRYOR. Very good.

We also have another very constructive voice here who we are going to hear from in a moment, Senator Jeffords of Vermont. Senator Jeffords has attempted to help us shape and mold this legislation. He has given some very good suggestions to us. In fact, I think he might have a couple more this morning.

Senator Jeffords, we appreciate your being here and look forward to your comments.

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

Senator JEFFORDS. Thank you, Mr. Chairman. It is so good to see you back.

Senator PRYOR. Thank you, sir.

Senator JEFFORDS. We all missed you and having you back, especially on this legislation, makes me excited for another reason, the fact that it may be my last time that I will have to testify before your committee on this issue. I am enthusiastic about the opportunity this year and the support of the administration which we have not always had.

This is my sixth year of appearing before committees, the fourth time before a Senate committee, I believe, pursuing the goals of portability and simplification. So I am excited that things are looking pretty good this year.

Not many legislatures, nor many citizens focus on this area of the law. However, I can assure you that a few years down the road pension issues will grow increasingly important to everyone. Right now all our focus is on health care and what we have to do about health care. But there is also going to be a question after that question hopefully is solved, what will the quality of life of our senior citizens be like, assuming and believing that they will reach retirement age.

If we do not have adequate pension plans in this country, the quality of life which they have sought so highly to have by a better healthy life will not be there. So I think it is important that we keep that in mind and that we remember that having a healthy life is not too good unless you have a quality of life with the money to spend to enjoy it.

Time is running out, however, for us to enact important changes in the law to enable the baby boom generation the pension portability necessary to assure that pension money is safe for retirement.

We need to improve the likelihood that a worker will participate in a pension plan. Unfortunately instead we have watched pension participation decline to less than half of all the workers over the last few years and I will not repeat the statistics that both you and Senator Grassley went through.

Our Nation's changing demographics, combined with changing corporation benefit structures make it critical that S. 1364 become law. Certainly, we are all aware that more retirees are living longer than ever before. By the year 2040 26 percent of the population will be over the age of 60. There will be 118 million Americans between 60 and 70 years of age; and 54 million Americans over the age of 70.

These future retirees will be more likely to participate in a defined contribution plan or even participate in a pension plan at all if we do not make some changes.

We must remember that the benefit an employee receives from a defined contribution plan, such as a 401(k) plan, is much less secure and often smaller in size than the benefit an employee will receive from a defined benefit plan. In order to maximize the value of this benefit, as well as the value of current tax expenditures for pensions, workers must save their money for retirement purposes. Yet distressingly the statistics show that a majority of workers who receive lump sum benefits do not put them back into the system as you have mentioned, but spend them.

Because of the high likelihood that an employee will spend his pension distribution, I am especially supportive of the rules in S. 1364 that require rollovers of distributions into qualified plans or IRA accounts. These rules should go a long way towards pension preservation. The bill also changes the current law to expand an employer's ability to use salary reduction simplified employee pensions. This should help to encourage plan formation and increase the participation in pension plans.

In addition to testifying that this bill is a significant step forward, I would like to make a couple of suggestions for improvements which I believe should be made. S. 1364 in its present form does nothing to protect the rights of spouses when distributions from a plan are rolled into an IRA account. It is very important that Congress seriously consider the need for spousal consent for all distributions from pension plans and pension type IRA's made other than in a joint survivor annuity type of form.

This is the current law rule for defined benefit plans and certain defined contribution plans, like money purchase plans. Other defined contribution plans, like 401(k) plans, allow distributions to be taken and the pension money to be spent without a spouse's consent or knowledge. I believe this is unfair.

The spouses should be granted sufficient protection from unanticipated changes in pension benefits. Even in today's society, many women are largely relying upon their husbands for the vast majority of their pension benefits. There are several reasons for this. On the average, women earn less than men. In addition, they are more apt to accept part-time employment that offers no employee benefits; and they are more likely to be in small businesses.

In fact, 45 percent of all women employed outside the home work in companies with less than 100 workers where pension coverage is usually very, very lacking. When women do receive pension benefits they are likely to be in small amounts.

Although shortening the vesting period for defined benefit plans did help women somewhat, the reality is that benefits provided for between 5 and 10 years of service, even in defined benefit plans, usually do not amount to much money. This is especially true when one considers the impact of inflation on these benefits.

I would like to point out that nearly three-quarters of the elderly poor, over age 65, are female. Also, women are five times more likely to be widows than men are to be widowers. Studies of the elderly, such as one by the Commonwealth Fund Commission have found that elderly people living alone are more likely to live in poverty.

In addition to lacking sufficient spousal protection, that we need some help in a sense of after tax contributions. S. 1364 retains the current law rule prohibiting employee after tax contributions from being rolled over into IRA's. I would urge this subcommittee to consider a change to the law to allow these after tax employee contributions to thrift plans to be rolled over and treated similarly to after tax contributions to IRA accounts.

Employee after tax contributions to pension plans were extremely popular with workers prior to 1986. By not permitting these contributions to be rolled over into IRA's, Congress is in fact forcing employees to spend money they conscientiously set aside for retirement purposes in spite of limited tax advantages. Such a policy makes no sense, given the nondeductible contributions to IRA's are permitted and must be accounted for separately under current law. So we do not believe it really creates any administrative burden.

As public policy makers we should be encouraging people to save their after tax money for retirement instead of nullifying their efforts once a rollover distribution occurs. My understanding is that this provision was not included due to revenue considerations. If this is so, I would suggest that allowing after tax contributions to be rolled over perhaps only for certain people within restricted income limits.

I might also mention that the Joint Tax Committee originally estimated that the revenue impact of this would be minimal.

I appreciate being able to testify before the committee today and I would hope you would seriously consider the suggestions I have which I think would improve the bill substantially.

Senator PRYOR. Thank you, Senator Jeffords.

Senator JEFFORDS. Thank you, Mr. Chairman.

Senator PRYOR. I appreciate that, and those suggestions will be well taken. We appreciate your being here this morning.

We are going to call our first panel now. We have a panel of five witnesses who are going to lead off. If you would please come. Michael Roush, Joseph Perkins, Larry Zimpleman, Paul Smith, and Matthew Fink.

Mr. Roush is the director for Federal Government relations for the National Federation of Independent Business, Washington, DC; Joe Perkins, from Danvers, MA, board of directors, AARP; Larry Zimpleman, second vice president, pension operations, the Principal Financial Group, Des Moines, IA; Paul Smith, president and chief executive officer of Fringe Benefits Design, Overland Park, KS, and he is appearing today on behalf of the National Association of Life Underwriters; Matthew Fink, senioı vice president and general counsel, Investment Company Institute of Washington, DC.

Mr. Roush, we will call on your first.

Let me, if I might, just interject a thought. We are going to limit testimony to 5 minutes. In the last several months I have had the opportunity, I did not seek this opportunity, but I have had the opportunity to engage in a lot of C-SPAN watching, and I have decided that most hearings are very, very boring. [Laughter.]

In fact, I do not even know if hearings are the format we are going to be using around this place much longer. But I hope we will liven this up. I hope you will talk in terms that not only the people in this room understand, as I am sure they all will, but let's try, as they say, to put the hay down where the calves can get to it so those people out in the country will understand not only what we are talking about but what we are attempting to do, in their terminology. I think it would be very instructive if we would do that.

So at the end of each 5-minute segment we are going to have the light system, and the lights will be on a few seconds before the expiration of your time. We hope that we will all abide by this. All of the remarks, all of the statements, will be placed in the record.

Mr. Roush, we look forward to your statement.

STATEMENT OF MICHAEL O. ROUSH, DIRECTOR, SENATE, FEDERAL GOVERNMENT RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. Roush. Mr. Chairman, I second those comments about testimonies, having to do this quite a bit. So I will try to abide by your requirements.

On behalf of the 550,000 small business owner members of the National Federation of Independent Business, I do appreciate the opportunity to testify this morning on the subject of pension simplification.

With your permission, Mr. Chairman, I would like to submit for the record in addition to my written statement some things I brought with me, including the testimony of one of our members recently given to the Senate Small Business Committee on this same subject and the relevant results of an employee benefit study by NFIB conducted in 1985.

[The information appears in the appendix.]

Mr. Roush. Mr. Chairman, as you are well aware, relatively few, probably less than one in four, small businesses offer retirement plans to their employees. While there are a number of reasons for this, foremost among them is that employers simply cannot afford retirement plans and the smaller the firm the more likely that reason is given as the overwhelming reason for failing to establish retirement plans.

Small firms offer employee benefits with a clearly defined frequency according to the study that I have submitted. Most frequently offered is paid vacations. It may surprise some to learn that not all small firms offer even paid vacations.

Next most frequent is health insurance. Then a cluster of benefits show up together, such as paid sick leave, life insurance and employee discounts, and then retirement plans. We believe that this is also pretty much the sequence in which an individual firm offers generic kinds of benefits to its employees: as the firm is able to afford them, and as their employees request them.

The point is, employee benefits do not grow on trees, just like money does not, and the government cannot change that despite what some people appear to believe about Government mandated benefits and their supposedly magical no cost properties.

The Government can, however, affect the ability of small business owners to offer retirement plans. First and foremost by helping to ensure a healthy business climate so that firms can become profitable enough to be able to afford benefits such as retirement plans.

But for our purposes today, the Government can increase pension offerings by reducing the costs it, itself, imposes on these plans. The costs of pension plans can be broken down to the costs of administration, including start-up costs, and the costs of contributions. The strings that the Congress attaches to its offer to employers to defer taxes on pension contributions in order to get more people to save for their retirement affects both types of cost to the employer.

The rule is simple, reduce complexity, reduce administrative costs, and maintain the tax advantages of pension plans and more small firms will offer them. Maximizing the opportunity for individuals to save for their retirement should be Congress's primary policy object here, not trying to equalize the benefits within individual retirement plans.

The more people who are offered the tax advantages of employer pension plans, the more who will provide for their own retirement. To that end, we support your bill, S. 1364, and Senator Packwood's bill, S. 318. The reasons are that both bills reduce administrative and compliance costs and they both at least allow the focus of savings to be on the individual by providing for employer matching of contributions and not just required across the board percentage contributions by the employer.

We believe that across the board minimum required contributions will be viewed by smaller firms as more of a payroll tax than an incentive and that such a proposal would not dramatically increase the number of people offered retirement plans.

Mr. Chairman, I would be glad to answer any questions. Thank you.

Senator PRYOR. Thank you very much, Mr. Roush.

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

Senator PRYOR. We will call on Mr. Perkins now. Then we will have questions following the witnesses.

Mr. Perkins?

STATEMENT OF JOSEPH S. PERKINS, DANVERS, MA, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. PERKINS. Good morning.

Senator PRYOR. Mr. Perkins, I believe you are representing AARP this morning.

Mr. PERKINS. Representative on the board of directors of AARP, Senator. Yes.

Before my statement let me just say that on behalf of AARP, Mr. Chairman, we are very happy to see you back again in Washington. While your able staff has kept the torch lit in your office, your presence has been missed. We welcome you back.

Senator PRYOR. Thank you, sir.

Mr. PERKINS. AARP is pleased to appear here today to testify on the important issues of pension access and simplification. AARP believes the current pension system can and should be simplified. However, such changes should not undermine important retirement benefit protections in the law.

The Association commends this committee for recognizing the need to improve pension coverage, particularly among small businesses. Currently for small firms, as we all know, with less than 100 employees, pension coverage rates are only about 25 percent.

Improving plan sponsorship, however, must not be our only goal. Any pension change should also promote plan participation and plan equity. In particular, I will address one troublesome area in a number of the current proposals.

Most of the pending proposals attempt to expand pension access by amending the current rules for 401(k) plans and simplified employee pension plans—SEP's. Specifically, several safe harbors have been put forward that would allow employers to circumvent the nondiscrimination requirements. One type of safe harbor would eliminate testing if the employer offers a generous matching contribution to employees who first contribute to the plan. Such a safe harbor is included in your own bill, S. 1364.

AARP believes the required match is generous. However, we know from experience that regardless of the match there are those employees who cannot and do not contribute. These generally lower-income employees will receive no benefits from the plan whatsoever. If past experience is a guide, roughly one in three employees will receive no pension benefits.

In addition, because current law bases benefits for higher income employees on the amount of benefits of lower income employees, the employer has a built in incentive to encourage employees to enter the plan.

Under generous match safe harbors, the employer will actually have an incentive to keep people out of the plan since such action will save the employer money. Because of these reasons, AARP believes that safe harbors based on generous employer matching contributions are a fundamentally flawed approach.

Instead, if safe harbors are needed, the Association believes that a required minimum contribution of not less than 3 percent of compensation for all employees would be a proper tradeoff to avoid testing. This safe harbor has been proposed as an alternative in your bill as well as in H.R. 2730. The administration's so-called "POWER proposal" contains a similar approach.

As an example, a 3 percent contribution to avoid all testing would mean only a $600 contribution per year for an employee earning $20,000. This should be the minimum required in any safe harbor.

A second area addressed by the various bills are the current distribution rules. The Association generally supports the changes that will liberalize the current IRA rollover rules. In addition, the Association supports the direct trustee-to-trustee transfer requirement contained in your bill, S. 1364, which would require an employer to transfer pension funds at job change to either another plan or to an IRA.

This change will promote retirement savings and help preserve pension benefits until retirement. The minimal administrative overhead is far outweighed by the long-term pension savings.

One proposed change in the distribution rules has received much attention, the repeal of 10 year and 5 year averaging. Whatever the policy, AARP believes any change must take into account the expectation of individuals at or near retirement who relied upon the existing law in their retirement planning decisions.

Also we would like to voice support for extending 5-year vesting to multi-employer plans. We believe pension integration, or permitted disparity, should be added to the list of areas in need of overhaul also.

We are very glad to be here and we will be glad to answer any questions you have.

Senator PRYOR. Thank you very much, Mr. Perkins.

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

Senator PRYOR. We will have a couple of questions to follow on later.

Mr. Zimpleman?

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

Mr. ZIMPLEMAN. Thank you and good morning, Mr. Chairman. We appreciate your invitation to testify. I might also add it is good to see you back and hope you are feeling well.

The Principal Financial Group is a family of insurance financial service companies with over $30 billion of assets under management. We have over 22,000 pension customers with most of those looking to us for help with plan recordkeeping and administrative functions.

The majority of our business is in the small employer market, the under 500 employees. Unfortunately, their voice is not often heard in these debates on pension law changes. That is why we appreciate the chance to be here. In my few minutes I will try to highlight their concerns.

While pension simplification is needed overall, as you know it is an especially critical item for small employers. The administrative cost for a 50 life employer to sponsor a 401(k) plan is about double the cost of a 500 life employer. The administrative costs for a 50 life employer to sponsor a 401(k) plan is four to five times the cost for a 5,000 life employer. That is why pension simplification is a critical small plan issue.

Comments from some congressional staff have indicated there is no constituent interest in pension simplification. We would dispute that. We recently surveyed 150 of our customers to get their views on pension simplification and would ask, Mr. Chairman, that the information be included in the hearing record.

We thought you might be interested in hearing some of their comments. Overall 71 percent of these small plan sponsors favored simplification; 28 percent were neutral, not because they were opposed to simplification, but because they were skeptical that real simplification would result; only one plan sponsor was negative.

Many of these customers had 401(k) plans. Their main concerns about the difficulty of maintaining their plans was the amount of data reporting they have to do, the complexity of the 401 (k) and (m) tests and the task of determining highly compensated employees.

We asked them if they were in favor of some approach that might allow them to avoid 401(k) and (m) testing. Eighty percent of them said yes.

S. 1364 allows a design based safe harbor if there is either a 100 percent match of the first 3 percent and a 50 percent match of the next 2 percent, or a contribution of 3 percent are paid to all eligible non-highly compensated.

About 20 percent of our employers favored one of these design based safe harbors. There seemed to be more interest in an approach similar to H.R. 2730 where each highly compensated employee is limited based on the average deferral of non-highly compensated from the prior year.

There was strong interest in simplifying the highly compensated employee definitions and family aggregation rules. About a third of our small employers are affected by the family aggregation rule. S. 1364 requires the employer to transfer plan distributions to another qualified plan or IRA if the distribution is more than $500. There was strong opposition to the idea of requiring the employer to transfer these amounts. Eighty percent were opposed to this as a requirement. This item may need some further study.

And finally, they all understood that any simplification bill needs to be revenue neutral. We asked for their thoughts on which items might be subject to change to increased revenue. About 60 percent said that they thought that 10 percent excise tax on early distributions might be changed; about 40 percent favored eliminating 5-year and 10-year lump sum income averaging; and about 20 percent might even be willing to consider some adjustment in the current limitations on benefits or contributions in order to achieve simplification.

S. 1364 also calls for expansion of SEP's for employers with up to 100 employees. We believe that the proposal may not significantly expand pension coverage among small employers. Retirement plans must be sold in the small employer market. They are not bought. It is not lack of choice that prohibits pension coverage, it is lack of reasonable regulation and design based safe harbors that inhibit coverage. This will bring the administrative cost for the small employer more in line and will increase pension coverage.

In closing, we want to express our strong support for pension simplification and many of the proposals of S. 1364. Over 60 percent of our customers believe these proposals will simplify the administration of their plans. We look forward to working with this

Subcommittee, staff and other groups to improve pension coverage and I, too, would be happy to answer any questions you may have at the close of this panel.

Senator PRYOR. Thank you, Mr. Zimpleman. We appreciate the support that you have given us in endeavoring to craft legislation that would be acceptable.

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

Senator PRYOR. Paul Smith, from the National Association of Life Underwriters. Mr. Smith, we appreciate your being here this morning.

STATEMENT OF PAUL M. SMITH, SR., C.L.U., PRESIDENT AND CHIEF EXECUTIVE OFFICER, FRINGE BENEFITS DESIGN, OVERLAND PARK, KANSAS, ON BEHALF OF NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. SMITH. Good morning, Mr. Chairman. I am Paul Smith, treasurer of the National Association of Life Underwriters, a member of the Association for Advanced Life Underwriting and President of a firm specializing in the design, implementation and administration of pension employee benefit plans.

NALU and AALU thank you and compliment you for your efforts to simplify the pension law. We also thank you for this opportunity to comment on your bill.

NALU represents almost 140,000 full-time life and health insurance sales people all over the country. Over 1,200 of our people are from Arkansas. AALU is a conference of NALU. AALU's membership of 1,500 includes specialists in pension plan design.

Mr. Chairman, NALU and AALU support the simplification effort generally and in particular the Pryor/Bentsen bill. We believe it is an important first step towards simplification of an area of law that has grown increasingly complex over the last decade. We know that this escalating complexity has caused many small firms to avoid implementing pension coverage for their workers. We also know that many businesses, big and small, that do have qualified plans in place are terminating those plans or downscaling the plan benefits.

This is because of administration costs caused by the complexity of pension plan rules. We believe that your simplification proposal will help reverse the trend towards fewer and/or smaller pension benefits for our Nation's workers, especially those employed by small businesses.

Particularly, we urge the adoption of your bill's safe harbor, design discrimination based options for a 401(k) plan. These provisions will do much to encourage employers, especially smaller ones, to implement retirement plans. Further, the availability of your proposed safe harbors with their generous benefit for rank and file employees will result in greater benefit for workers in companies that already have 401(k) plans in place.

Mr. Chairman, the optional safe harbors would allow employers to meet nondiscrimination requirements with a plan design that is generous to rank and file employees but does not require annual comparative testing of actual dollar amount contributions among employees.

This ability to meet nondiscrimination obligations is particularly helpful and important to smaller businesses who sometimes decline to implement 401(k) plans solely because of the unaffordability of the annual testing requirements. Current law discrimination tests were designed to assure that highly compensated employees do not disproportionately benefit as compared to rank and file workers.

Proponents of current law discrimination tests argue that part of that assurance comes from the incentive effect on highly paid to promote participation in the plan by the rank and file workers. While employer encouragement of employee participation may result in greater level of employee participation, we believe it is overstated when it is used as a reason to oppose the safe harbor proposal.

In our experience, the incentive effect of 401(k) plans is primarily due to the employer's matching contribution. To get the employer's contribution the employee must contribute. Thus, there is little justification for requiring plans to incur the administrative expense of annual calculations demanded under current law.

This is especially true in the context of the safe harbor provided by your bill's requirement that employees be notified of the plan's benefits.

Also worthy of note is the potential for greater benefits for rank and file employees as a by product of the safe harbor options.

Many of the employers with whom we work would prefer to provide the richer benefits provided by the safe harbor plan designs than to spend the significant administrative money required to combat annual testing. This is especially true for somewhat larger employers who already have established 401(k) plans.

Many of these businesses are spending substantial amounts to comply with the annual testing requirements. Their benefit contribution levels are generally below those required by the proposed safe harbors, but the combinations of contribution and administrative costs are not far from the cost of the safe harbor plan design. These businesses would certainly opt to spend the money on more benefits for their employees if the safe harbor options were available to them.

Thus, the safe harbor provisions not only make 401(k) plans more attractive to more employers, they would also provide a more generous benefit for rank and file workers of employers who already have these plans in place.

In conclusion, Mr. Chairman, NALU and AALU strongly support your bill and especially its safe harbor provisions. Thank you for this opportunity to comment. I will be glad to answer any questions you might have.

Senator PRYOR. Thank you very much, Mr. Smith.

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

Senator PRYOR. Mr. Matthew Fink who is general counsel for the Investment Company Institute. We appreciate you being here, Mr. Fink.

STATEMENT OF MATTHEW P. FINK, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. FINK. Thank you, Mr. Chairman. I will do my best to beat the yellow light.

Senator PRYOR. Thank you, sir. By the way I compliment all of you. You have really been swell with that.

Mr. FINK. Mutual funds have over $211 billion in retirement assets as the end of 1990 and are increasingly serving as the investment medium of choice for retirement savings plans.

I am pleased to be here today to express our very, very strong support for S. 1364. The bill would simplify the complex and burdensome requirements applicable to employment benefit plans. The complexity of these requirements has frustrated the attainment of the two principal policy goals. First the expansion of retirement plan coverage to cover as many American workers as possible; and second, preserving those American's retirement plan assets for their intended purpose, retirement.

The provision in the bill that would make salary reduction SEP's available to employers with 100 or fewer employees represents a very significant step towards the first goal of increased plan coverage. The salary reduction SEP is a very attractive vehicle for small employers not currently providing coverage; those employers amount to roughly 57 percent of all employers with 100 or fewer employees.

Second, we support the proposed simplification of the nondiscrimination rules. Easing their burdens should promote greater plan coverage. In particular, the matching contributions proposed under the bill should assure nondiscrimination in benefits without requiring burdensome periodic testing.

Our testimony notes a recent GAO study of 401(k) plans found that "for plans where the employer matched employee contributions dollar-for-dollar, the average participation rate was 99 percent of those eligible."

We applaud the sponsors of the bill for recognizing this very simple and effective means for ensuring retirement plan participation by employees of all income levels.

We believe that if you enact the first two provisions, expanded salary reduction SEP coverage and the nondiscrimination safe harbors, financial institutions such as mutual funds, banks and insurance companies will be encouraged to more actively market salary reduction SEP's. The potential impact of such an increase in marketing activity on pension plan coverage must not be underestimated.

Third, we support the bill's requirement that employees must transfer all pre-retirement distributions to an IRA or another plan upon separation of service. This should significantly reduce the level of premature consumption of retirement distributions.

In this connection, we note that the IRA is an existing, simple portability vehicle which can be used to accomplish the objectives of portability and thus the key second goal, the preservation of retirement plan assets for retirement purposes.

Finally, the unrestricted ability to rollover a pre-retirement distribution to a retirement plan or an IRA is also critical to the portability of retirement plan assets. Existing rules, unfortunately, encourage current consumption rather than savings for retirement.

Thus, we support the provisions that would maximize rollover opportunities and thus encourage the preservation of pre-retirement distributions.

Thank you.

Senator PRYOR. Thank you very much, Mr. Fink.

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

Senator PRYOR. Let me start off with a question, if I might, for Mr. Roush. I want to go into a school of thought, Mr. Roush, on the matching.

There is some people who feel that the employer in addition to the match should be making a minimum contribution to all the employees that they employ. Now what about small business here, how many of the small businesses would utilize this particular safe harbor?

Mr. ROUSH. Well, Mr. Chairman, it is difficult for me to quantify something like that. I think that in general though it is safe to say the costs are overriding in the concerns of small business employers and that whatever can be done to reduce their costs of establishing and maintaining a plan is one that is going to encourage them to offer plans to their employees.

Equity and participation are fine goals. As the gentleman from AARP asserted, one out of three employees would fail to participate if there was a matching requirement. From my perspective one out of three is better than three out of three if an employer fails to offer a pension plan. So that while I cannot quantify the answer to your question, I think it is a relatively simple matter of reducing costs.

Senator PRYOR. Mr. Perkins, do you have a comment on that? I think your organization supports not only the match, but also the additional contribution.

Mr. PERKINS. Yes. I have a very personal experience with a very generous match from a very large corporation which instituted a match for 401(k) which gave dollar-for-dollar for the first $250 that a person saved during the year. We were actually able to boost it as "$5 a week, and we will match it dollar-for-dollar."

I guess I have to dispute the 99 percent participation rate that one of the panelists said because our experience was that there were still approximately 30 percent of people that did not participate—and they were all in the low paid area. Even with that generous and easily understood match, lower-paid employees found it difficult to participate.

So the 3-percent contribution for everyone seems to be a very simple thing to do. It does not mean there would have to be very, very stiff rules, pure and simple. As I mentioned in my statement, $600 for a $20,000 per year employee does not seem to be something that would be too burdensome.

Senator PRYOR. Now if I might ask, you talked about your own plan, your own employer's contribution, and your contribution. How large an employer was this, if I might ask?

Mr. PERKINS. At that point in time there were about 12,000 employees.

Senator PRYOR. All right. What does the firm do with 12 employees or 100 employees? How does a small business afford this?

Mr. PERKINS. I hear you, Mr. Chairman. I understand the concern. But AARP really is concerned about the flagrant abuse that could result.

Very definitely if a plan comes in for small employers and it basically only helps those who are of higher income levels we do not think it is a level playing field. Basically the concern for retirement income security is more with low-income employees than those that are medium and high income. They do have savings plans now and other means to enhance their retirement, whereas the low paid workers do not.

We do know that Social Security is a marvelous plan, but it is basically a base from which to start.

Senator PRYOR. I had the opportunity recently to go into a small business operation in my home State. I had a ceiling fan that needed to be repaired. It was an old antique fan and I was talking to the owner of the shop and he had said he had gotten out of World War II, came back home, and set up this little machine shop and had nine employees. He said, "Senator Pryor, I am the owner of this place. I have operated it since about 1946 or 1947 and today of my nine employees I am the lowest paid of all the employees in this place." He said, "I am really working for them. I am trying to keep them up it seems."

He talked about it. He said if I could do two things, I would like to be able, as I used, to participate in a retirement plan for my workers, and I would like to be able to pay their health insurance. He said both of those are beyond my ability. He said "I know these people, I know their families, I know their children and it breaks my heart everyday to come to work knowing that they have no retirement plan, knowing that they have no health insurance, and knowing that I cannot do anything about it to help them."

Now there is a group of people out there without retirement plans, and we have to look at ways to make it easier for employers to provide retirement plans to these employees. That is what we are attempting to do with this legislation.

Mr. PERKINS. I hear you. It just appears, and in fact we can see it in any one of our towns wherever we live, we can see the difficulty the very small employer has had getting coverage, especially in health care which we are not covering today, but in retirement benefits too. But creating a system which does not have participation equity we also question.

Senator PRYOR. Mr. Smith, from NALU, if I might engage you for a moment. I have heard for years about how much money we could save if we had these safe harbors and did away with these expensive tests for 401(k) plans.

Now let's say we are going to save a lot of money in not putting people through this loop. Can that money actually or will that money actually be passed on to the employee or will the companies just absorb that in additional profits? How is that going to really work out for us?

Mr. SMITH. Mr. Chairman, I think there is really two parts to your question there. First, the employer if the simplification bill is adopted will save about 25 percent on administration.

Senator PRYOR. The employer is going to save that.

Mr. SMITH. The employer will save about 25 percent.

Senator PRYOR. What is going to happen to that?

Mr. SMITH. The second part of your question, the employer will rather put that money into benefits for the employees than spend it on doing the testing, required by current law. The employer has love and consideration for the workers, not unlike the employer in your home State that said he would like to do something for his employees.

Employers would rather give the money to the employees to supplement their retirement than to pay it to us as administrators. They will do that. We have about 1,800 plans that we work with, and I have talked to my staff, and they feel, and we have proof of this, that about 90 to 92 percent of employees would participate under the safe harbor plan design, because of the employer match.

However, if you require minimum employer contributions, these small employers will say if my employees are not willing to walk down the line with me towards retirement then I am not going to put the plan in; I cannot afford it. It has to be a win/win situation for the employees and the employer.

Another factor contributing to high levels of employee participation in 401(k) plans is the fact that employees have the opportunity to direct their investments. They have ownership in the plan. I have no problem standing in front of 40 or 50 employees explaining matching contributions. Most of the time what happens is that when the employer is willing to put in dollar for dollar up to the first 3 percent the employee's compensation, the employees start to figure how many dollars the employer will put in, and then they start to figure how they will find their own money. And they do find that money.

We all find money for something that we believe in. The young employees making $20,000 to $25,000 will contribute, to get the matching contribution from the employer.

Plus you have another situation. There are some employees that are 50, 55 and 60 who have not been in a retirement plan, and the employer wants to help them. If they could reduce their costs through simplification. In summary, with this simplification proposal, the employer could help those people. You would have more rank and file employees being covered under pension plans.

Senator PRYOR. Mr. Smith, and all the panelists, I would like to make a request, I think you referred to some studies that you have done. We are building a record this morning. We are not allowing everyone to speak over 5 or 6 minutes. But we are building a record. We are going to utilize this record. What we would like to have as made a part of that record is those studies, those facts and figures that you have gathered together over the past months or years. It would be very helpful to us in shaping this legislation and hopefully in going forward with this proposal.

Mr. Fink, you mentioned the impact of marketing SEP. I wonder if you could elaborate on the impact of this legislation on the marketing of that.

Mr. FINK. Yes, Mr. Chairman. One of the other witnesses made the point that pension plans, particularly for the small employer, are not bought but are sold. Mutual funds, banks, and insurance companies, actively "market" plans to small employers. But mutual funds have been discouraged by the salary reaction SEP because of the very small 25 or fewer requirement.

If you enlarge the number to 100, we think there will be a lot more marketing activity. One example where marketing was a factor was the individual retirement account. We were involved in the legislation in 1981 that produced the universal IRA. I remember the government made a guess as to the level of contributions; the result was vastly underestimated. I think the missing element in the contributions predictions was the unanticipated marketing component by banks, mutual funds, and insurance companies.

Conversely when the IRA was curtailed in 1986, even though a lot of people remained eligible, financial institutions, such as those I represent, pulled back from marketing and contributions fell.

The last thing I will say is that Professor Skinner, in his 1991 study on IRA's, pointed out that nonscientific, noneconomic factors, like advertising campaigns, probably were a very important factor in producing the dramatic growth of the IRA and in creating the great curtailment in contributions to the IRA.

The changes proposed by the legislation would, our members tell us, really lead to more marketing and, based on history, to more plan installation.

Senator PRYOR. I think it was Frederick Engalls who many years ago said that human greed is the chief motivator of civilization. [Laughter.]

I am not sure that is exactly correct., but something like that.

Now what is going to happen if we grant all these safe harbors, do away with all these nondiscrimination tests in an attempt to do good in getting employees involved in this program and employers to participate if there is abuse? How does the system catch that abuse before that abuse goes so long that it becomes a situation that cannot be corrected?

Mr. Zimpleman, how do we catch that abuse out there soon enough?

Mr. ZIMPLEMAN. Thank you, Mr. Chairman.

Let me first respond to your question about the abuse by sharing some statistics that we gather for last year from the 401 (k) and (m) testing that we did last year, taking the present model and looking at the issue of is there abuse. We have about 6,200 401(k) plans. Most of those are in the under 100 life group.

Last year we found, this would be now 1989 calendar year, we found about 20 percent of those plans failed the current test, which perhaps on the surface sounds like a relatively high number. But what we found on that group was that the refund that needed to be made was only on average about $400 per employee and there was only about four or five employees that needed refunds.

So the actual refund going back or the excess abuse if you want to think of it in those terms, was relatively small. The fact that there are refunds is more indicative of the current operation of the (k) and (m) tests in that you do not know where you are until the end of the year, and because of census data changes during the year you find yourself on 12-31 needing to make some small refunds. But they are not large in amount and I would argue that there may not be the level of abuse that might appear on the surface.

Senator PRYOR. Sometimes it is harder to turn the spigot off than it is to turn it on. There may be some analogy in our weapon system procurement of the last 15 or so years. We build the weapons and we find out once we have built, say, 100 B-1 bombers, that, my gosh, they do not work. And after we have spent about $100 billion in the process over 30 years.

I am just trying to say is there a way before we do all this, is there a way that we can monitor it effectively so that we can keep up with the program and make certain that our intention is being carried out.

I would like to thank the members of our panel. We do have some questions from Senator Grassley for this panel. We are going to ask the hearing record to stay open a period of 10 days, not only for questions from Senator Grassley, but perhaps from Senator Packwood, possibly some more from myself. We would appreciate your prompt response to them.

We thank you for participating this morning. Thank you all.

[The questions appear in the appendix.]

Senator PRYOR. We will call our second panel. Elaine Church, Robert Fox, Kie Hall, Lt. Mike Mohler, Anthony Williams, and Carol Campbell.

Well, we want to thank this panel this morning for coming. Some of you have come from a long distance and we appreciate so much your participation.

Elaine Church is going to be the first person that I call on this morning. Let me first introduce our panel a little more. Elaine Church, the Employee Benefits Committee. I believe accompanied by Lewis Mazawey; is that correct?

Mr. MAZAWEY. Yes.

Senator PRYOR. The chair of the Subcommittee on Pension Legislation, the American Bar Association, Section on Taxation. Robert Fox, the executive director of the Cultural Institutions, New York City, representing the National Assembly of National Voluntary Health and Welfare Organizations. Mr. Kie Hall is certainly no stranger. As the executive director, Arkansas Public Employees Retirement System, from Little Rock, he is going to talk about the effect of this bill on public employees. Lieutenant Mike Mohler, Fairfax County Fire Department. Lieutenant Mohler, let's see, there you are in your uniform. Thank you for being here.

Anthony Williams, director of retirement, Safety and Insurance Department, National Rural Electric Cooperative. Mr. Williams, thank you for being here. Carol Campbell, vice president and treasurer of Carleton College, Northfield, MN, speaking today on behalf of the American Council on Education. We thank you very much.

So first let us call on Elaine Church.

STATEMENT OF ELAINE CHURCH, CHAIR, EMPLOYEE BENEFITS COMMITTEE, ACCOMPANIED BY LOUIS T. MAZAWEY, CHAIR, SUBCOMMITTEE ON PENSION LEGISLATION, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Ms. CHURCH. Good morning, Mr. Chairman. First, I would like to express the apologies of Peter Faber, chair of the section, who is unable to be with us today. His misfortunate is my fortune. After all the hearings I attended as a member of the Joint Committee staff I must say it is a pleasure to appear for the first time on this side of the dias on such an important issue as this.

Senator PRYOR. We are glad you are here.

Ms. CHURCH. The American Bar Association, and the Section of Taxation, wholeheartedly endorse the concept of pension simplification. As you know, Mr. Chairman, we worked with you and your staff last year on your pension simplification bill. We will work again on an ongoing basis with you this year and as long as it takes to achieve pension simplification.

In that regard, we will be submitting additional detailed, technical comments on various pieces of the bill. For that reason and in the interest of time today, my comments this morning will be more general.

First, as to the importance of pension simplification. We all know that the Tax Code is marvelously complex and convoluted, but this complexity bears a particular price in the area of pension law. Because unlike other areas of the Tax Code which affect few employers, pension complexity affects all of us. It affects employers of all sizes and employees of all income levels.

The complexity not only dissuades employers from establishing plans but also imposes costs on administering the plans and often, all too often, those costs reduce the amounts available to provide benefits to individuals.

In addition, the complexities on the distribution side make it very difficult for even the most informed participant to make appropriate decisions with respect to the taxation and distribution of their pension income.

And finally, the complexity makes it difficult for the Service to administer the pension law. It is now 1991, almost 5 years since the enactment of the Tax Reform Act, and notwithstanding the best efforts of the Service and the dedication of all of their resources to issuing guidance under those provisions we have yet to see the final package of regulations.

All of this indicates a system badly in need of reform. If we were all to make a wish list of the many areas of pension simplification that should be addressed we would certainly include those in your bill and others. We all have our favorites—the 401(a)(9) distribution rules, the 415 rules—and I use those Code Sections by the way not to talk in code speak, but to reinforce the credentials of the Section of Taxation as being technical experts. [Laughter.]

Senator PRYOR. Now you know if we make this really simple we are going to put all the lawyers out of business. Are you aware of this?

Ms. CHURCH. No, Senator, when I first got into this area in the late 1970's I was told that we would do final plan amendments before 1980 and I would not have a job. I am not terribly worried at this point. [Laughter.]

Senator PRYOR. I think you are on sound footing and ground.

Ms. CHURCH. With respect to the distribution rules, the current law includes a number of overlapping rules which at inception had good policies. We have rules to lock money up until retirement or separation from service. We have rules to dissuade people from consuming amounts that they get when they change jobs. We have rules at the other end of the spectrum that say once you retire you should start receiving and consuming retirement income rather than transfer it to your heirs at death.

But the overlap of those rules and the different rules for the taxation of such distributions is an imponderable burden for employees who are trying to determine the best way to use their retirement savings.

The bills all address these issues, taking different approaches, and we commend your efforts, recognizing that there are a lot of difficult issues here. We urge you to focus on those distribution issues, on the 401(k) issues and on efforts to make plans more accessible, particularly to small employers.

We would like to work with you. We urge you to provide reasonable transition and lead time so that any changes can be implemented in an orderly fashion.

Lastly, we urge you not in the guise of pension simplification to make these problems worse by trying in the law to anticipate and prevent every conceivable abuse.

Thank you.

Senator PRYOR. Thank you very much, Ms. Church.

[The prepared statement of Ms. Church appears in the appendix.]

Senator PRYOR. I remember when President Reagan one night held up a sheet of paper about this size, speaking at a big banquet somewhere, and said we are getting ready to have a tax form for Americans that you can fill out on one piece of paper and mail it to the IRS and all your problems will be over.

I think about 26,000 pages later after work in this committee and Ways and Means we produced that simplified tax code of 1986 that you made reference to. So I hope we are not off on the same road on simplification for our retirement programs. I think that we certainly need to be aware of that.

Mr. Fox, we appreciate you being here today. It is your turn up to bat.

STATEMENT OF ROBERT M. FOX, EXECUTIVE DIRECTOR, THE CULTURAL INSTITUTIONS RETIREMENT SYSTEM, NEW YORK, NY, CHAIRMAN, PENSION PLAN COMMITTEE, THE NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, INC.

Mr. Fox. Thank you. Good morning, Mr. Chairman.

Some of the country's largest charitable organizations that are members of the National Assembly of National Voluntary Health and Social Welfare Organizations are is pleased to join me in supporting your efforts to simplify the rules for plan sponsors to administer retirement plans as well as expand the availability of pension plans. We are encouraged by this first step towards simplification and appreciate the leadership role you have taken in this process.

I will try to use the time that has been allotted to review the highlights of the bill that are of interest to us as plan sponsors for human service organizations.

The changes outlined in S. 1364 to reduce the cost to plan sponsors of administering retirement plans are sorely needed. These will help our organizations in two ways. First, it will enable us to offer our dedicated employees sensible, cost effective retirement plans without needlessly burdening our administrative staffs. And second, it will enable us to shift dollars we end up spending in administration into the program areas of our organizations which are our primary mission.

Let me just briefly describe the areas of the simplification bill that we are supporting. First, the minimum distribution rules. The common sense approach contained in the bill is long overdue. The current rules are very complex and difficult to communicate to plan participants. The National Assembly's human service organizations are made up of many non-highly compensated employees. Requiring minimum distributions after age 70½ forces these employees to receive now the pension anticipated to be needed at retirement. Combine low salaries and short service and it is hard to rationalize the forced payment of accrued pensions from our organizations under the 70½ rules. We are very pleased that these minimum distribution rules as proposed in the bill will strengthen the retirement protection our plans were intended to provide.

The access to 401(k) plans is a second area we support. We we are pleased to see that the simplification bill will finally permit all tax exempt organizations to maintain qualified cash or deferred arrangements. This change will eliminate the inequities of the current law. We did not understand why the Tax Reform Act of 1986 prohibited 401(k) plans from being established by tax-exempt organizations and we are glad that this has now been clarified.

A third area of support is the definition of highly compensated employee. We feel that your simplification bill will provide relief for many nonprofit organizations who have a difficult time working with the current nondiscrimination requirements of the law. Some of our organizations have branches throughout the United States. The branches are run by directors who we believe are not "officers." In the event an organization has an officer, plan sponsors will have to implement costly discrimination testing at multiple locations. The outcome of such testing could result in cutbacks of benefits for so-called highly compensated employees. Your proposal to exempt tax exempt organizations from the one highly compensated employee rule for non-discrimination testing is a valid exception due to the unique employment structure of our organizations.

The fourth area we support is portability. The provisions in your bill that allow a participant or surviving spouse to rollover any portion of a taxable distribution from our plans to an IRA or another qualified plan are welcomed. We support every effort to enable our participants to continue to save for retirement. We hope this change will encourage them to put all of their distributions from our plans into other retirement vehicles and the rules should be simplified so they can do just that.

We would like to suggest that the simplification bill look at this legislation as an opportunity to expand the goal of portability and permit qualified plans to accept transfers or rollovers from other savings and retirement vehicles. The simplification bill could rationalize the confusing rules for keeping retirement money separate and distinct. Distributions made from plans under sections 401, 403, and 457 should be transferred into other savings and retirement plans.

The other area that we would like to suggest the simplification bill look at is to clarify that Section 457 will not apply to nonelective deferred compensation for tax exempt organizations. We believe employees of tax exempt and taxable employers should be treated the same in the area of nonqualified, nonelective retirement pay plans.

And finally, we realize this simplification bill marks the beginning of the process to fashion the best possible simplification legislation. We are available to be of any assistance to you and your colleagues during this process. I hope this testimony has been of some help. I will be happy to answer any questions.

Senator PRYOR. Thank you, Mr. Fox. Right on the nose.

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

Senator PRYOR. Mr. Hall is all the way from Little Rock, AR, here today and I think, Mr. Hall, you are testifying on behalf of the Government Finance Officers; is that correct?

Mr. HALL. Yes, sir.

Senator PRYOR. Thank you, Mr. Hall. We welcome you before the committee.

STATEMENT OF KIE D. HALL, EXECUTIVE DIRECTOR, ARKANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM, LITTLE ROCK, AR, ON BEHALF OF GOVERNMENT FINANCE OFFICERS ASSOCIATION AND OTHERS

Mr. HALL. Thank you, Mr. Chairman. I am the executive director of the Arkansas Public Employees Retirement System. The system has over 48,000 members, of which 10,000 are retired. They represent State and local public employees. The average monthly retirement benefit in this system is $424.

There are several items of interest to State and local government plans contained in the legislation. Perhaps none is as important as the provisions contained in S. 1364 that addresses public pension plan compliance with Section 415 of the Internal Revenue Code.

Section 415 of the Internal Revenue Code places both a dollar, as well as a percentage of pay cap on the amount that an individual can receive annually in the form of an employer provided pension that has been accumulated in a tax deferred setting.

Section 415 was adopted as part of the Employee Retirement Income Security Act of 1974, with the goal of limiting the ability to accumulate retirement income on a tax-favored basis. Section 415 was aimed at a very specific problem, the use of tax deferrals and deductions by a few highly compensated individuals and their employers in the private sector to finance extremely large benefits.

There is no indication in the legislative history of Section 415 that this was an abuse that was also taking place in the public sector.

Unlike the private sector where the employer and the highly compensated employee can sit down and privately sit down and negotiate the terms and the amount of the employer provided benefit package the plans of governmental employers are sponsored and maintained by State and local government with all of the constitutional regulatory apparatus, vote accountability that this implies.

In a defined benefit plan, which is the kind of plan used by the vast majority of public employers, the retirement benefit is based on a formula that is based in part to salary. It is therefore virtually impossible for a public employee to receive an abusively high employer provided retirement benefit in relationship to his or her salary.

Private sector employers receive a significant tax subsidy for the contributions they make to their retirement plans. This tax advantage is a major factor in the funding decisions made by private sector plan sponsor and has a direct impact on Federal revenues.

State and local governments must comply with Section 415 or face severe penalties. If a pension plan permits even one of its participants to earn a pension that exceeds by any amount however small the lower of the two Section 415 limits then the Internal Revenue Service is authorized to disqualify the entire plan.

Changes in our plan benefit formulas and other design feature require a lengthy public process and possible modifications of important State policies who are often constrained by our constitution or case law for reducing a benefit once it is promised an employee due to prohibitions on impairment of contracts.

Approximately 21 States, including Arkansas, in numerous localities have either constitutional or statutory restrictions prohibiting the diminishment of benefits. It is for these reasons that the four-part remedy to our unique problem with Section 415 is so important and necessary.

Part 1, the definition of compensation for the purposes of Section 415 testing, will be expanded to include employer pension contributions as well as employee contributions to salary deferral plans. These amounts are often included as annual compensation in the public pension plan's computation of an individual's pension benefit, but are required to be excluded when 415 percentage of pay limit is determined.

Part 2, public sector employees tend to be longer tenured and lower paid then their private sector counterparts. Because public plan benefit plans often reward this length of service the consequence that can be a pension benefit that while not large in absolute dollar terms can exceed 100 percent of the individual's high 3-year average compensation. Therefore, the bill provides that the percentage of pay component of the Section 415 limit test will not apply.

ERISA provides private sector employers with the ability to maintain excess benefit arrangements. Public pension plans have no similar safety valve to avoid disqualification. However, its use would be limited solely to providing benefits in excess of the 415 caps.

I will finish there, Mr. Chairman.

Senator PRYOR. Thank you, Mr. Hall.

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

Senator PRYOR. I just really applaud all of you in being so diligent in going by the bell system. I have a couple of questions there in just a minute.

Lieutenant Mohler, we appreciate you being here. Now are you the Fire Chief in Fairfax County? Is that correct?

Lt. MOHLER. Not quite, Mr. Chairman. I am just a Lieutenant on an engine company.

Senator PRYOR. All right. We appreciate you coming today and speaking on behalf of your people.

Lt. MOHLER. I appreciate your having me here.

STATEMENT OF LT. MIKE MOHLER, FAIRFAX COUNTY FIRE DEPARTMENT, FAIRFAX, VA

Lt. MOHLER. Again, my name is Mike Mohler and I am a lieutenant with the Fairfax County Fire Department, as well as a member of the International Association of Firefighters. I have been a firefighter for 15 years. I am here today to ask for this committee's help in resolving some of the pension related problems facing State and local government employees, especially for those of us in the fire service.

I would like to spend a few minutes this morning explaining these issues from the point of view of a rank and file firefighter. Like most of my co-workers I became a firefighter because it offers me the opportunity to help the community. I wish the members of this committee could see the look on faces of people who are trapped in a burning building when they see firefighters come through the flames to rescue them.

While this job has many rewards, the compensation and benefits are not high among them. I do not know a single firefighter who entered the profession because they thought the pension benefits sounded attractive. [Laughter.]

I am, therefore, at something of a loss to understand why my pension plan could be disqualified by the Internal Revenue Service because our benefits are alleged to be too high.

As I understand it, Section 415 of the Internal Revenue Code is the provision designed to assure that taxpayers are not asked to subsidize pensions paid to top corporate executives. Why, then, am I being penalized?

Allow me to offer one simple example of how the Fairfax County Fire Department's pension plan could exceed this limitation. In Fairfax County, the disability retirement benefit for total disability is a modest two-thirds of salary at the time of injury.

Yet if I had become disabled shortly after I was promoted to Lieutenant my disability benefit could have technically exceeded the Section 415 limitation, which caps benefits at 100 percent of compensation. The reason a 66.66 percent benefit can exceed 100 percent of compensation test is where this gets somewhat confusing.

When I was promoted to Lieutenant from firefighter, I received a pay raise. I had also been participating in our 457 plan, a deferred compensation plan offered to State and local government workers.

In addition, our plan has an employer pick-up provision on employee contributions. None of these things makes me at all exceptional.

When the Internal Revenue Service computes the 100 percent of salary limitation they do certain things which significantly reduce the amount of allowable benefit. First, they average the three highest consecutive years. In this example, that means they would have counted my Lieutenant's salary as only a small part of the equation.

Second, the IRS does not count as salary the money I contribute to my 457 plan, and the contributions made on behalf by the employer, even though that money is counted for computing my retirement benefit. Taken together, these items reduce the allowable benefits so much that 66.66 percent of my actual salary at the time of disability would be greater than 100 percent of my compensation as defined by the IRS.

That means my disability pension would place the entire pension plan in jeopardy and this plan which covers 1,150 firefighters could have lost its tax exempt status.

I chose to discuss how the Section 415 limitation is unfairly applied to disability benefits largely because disability retirement is especially important to firefighters as well as police officers. As the Nation's most hazardous profession, firefighters see more than their share of disability retirements and sustaining an injury within a year of a promotion is not an uncommon scenario.

It must be noted, however, that the disability benefit issue is only one of the ways that a public employee pension can exceed the Section 415 limit. I am sure others will point these out to you.

Finally, I would like to comment on the relationship of individual cases to the pension system as a whole. Under Section 415 if one person receives a benefit in excess of the limitation, the entire pension system could lose its qualified status.

In regard to the example I just gave you, that means that just because I was not injured during the year after my promotion, that does not mean the scenario no longer applies to me. If even one firefighter gets injured shortly after making lieutenant or battalion chief or chief, I will be affected by it, even if the injury occurs many years from now. As long as I am affected by my pension system, either as a contributor to it or as a recipient from it, disqualification of our pension system will have a direct, adverse affect on me and my family.

Senator Pryor, I understand that your pension simplification legislation would correct this inequity and several others, and would ensure that Section 415 limitations are applied fairly to the public sector workers while not violating the policy it was established to govern. On behalf of all my brother and sister firefighters, I want to express my deep appreciation for your interest in this important issue, and urge you to move as quickly as possible to see that your bill becomes law.

Firefighters give a lot to American, unfortunately, including their lives, and ask for little in return. All we are asking for right now is fairness, so that the application of the Internal Revenue Code provision be applied fairly to public sector employees so that no pension plan loses its exempt status.

Thank you.

Senator PRYOR. Lieutenant, thank you. Right on the nose. [Laughter.]

[The prepared statement of Lt. Mohler appears in the appendix.]

Senator PRYOR. Lieutenant, one question. It is not a very heavy question. I saw a movie recently, Backdraft. Have you seen Backdraft?

Lt. MOHLER. Yes, sir, three times. [Laughter.]

Senator PRYOR. Three times. Well I saw it once and I walked out and I don't know if that encourages people to become a firefighter or discourages them. I don't know. It is a pretty scary movie.

What do firefighters think of that movie, by the way?

Lt. MOHLER. We have critiqued that movie a number of times around the firehouse. We have some problems with the way Kurt Russell handled himself in certain ways. [Laughter.]

Senator PRYOR. I am sure you could have done a better job.

Lt. MOHLER. Absolutely.

Senator PRYOR. We appreciate you being here.

We are going to go to our next witness here now, Mr. Anthony Williams, National Rural Electric Cooperative. Thank you, Mr. Williams, for being here.

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

Mr. WILLIAMS. Thank you, Senator. My name is Anthony Williams. I am the director of the Retirement, Safety and Insurance Department for NRECA. NRECA is a national service organization of approximately 1,000 rural electric cooperatives operating in 46 States. The system serves over 25 million farm and rural individuals in 2,600 of the 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 these localities.

We at NRECA believe that there is a critical need for simplification of the laws affecting qualified retirement plans. Accordingly, we applaud the leadership shown by Senator Pryor in holding these hearings and in introducing legislation that would significantly reduce the complexity of retirement plan rules.

We are also appreciative of the leadership role being played by Chairman Bentsen in cosponsoring this legislation.

Our testimony today is in enthusiastic support of the Pryor/Bentsen bill. We believe that the enactment of this bill would provide historic simplification of the rules regarding qualified retirement plans. We view simplification as the elimination of modification of rules that have been created through the cumulative affect of years of legislation and that it poses administrative burdens that are not justified by tax policy or retirement policy.

The need for this type of simplification is particularly acute with respect to small employers. NRECA's 1987 survey of small employers in rural areas revealed that less than 19 percent maintained a retirement plan and that the primary reason they did not was because of the cost.

A simplification bill that would reduce the cost would have a major affect in raising the number of employees of small employers who can retire with dignity and security. We believe that the Pryor/Bentsen bill if enacted would achieve precisely this type of simplification.

A prime example is the modification of the Section 401(k) Plan nondiscrimination rules. NRECA supports the policy objectives of the nondiscrimination rules. However, we believe that these policy objectives can be achieved without the administrative burden of present law.

The Pryor/Bentsen bill accomplishes this by creating a safe harbor with respect to the nondiscrimination rules. Under this safe harbor the nondiscrimination rules are deemed to have been satisfied when an employer provides a significant contribution to the plan that could be expected to satisfy or substantially satisfy those rules. Thus there is little justification for requiring such a plan to apply the burdensome nondiscrimination rules.

We also support the provisions of the Pryor/Bentsen bill that would permit nongovernmental tax exempt employees to maintain Section 401(k) plan.

The clarification in the Pryor/Bentsen bill of the VEBA rules is another provision we would like to comment on specifically this morning. In general, the VEBA 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 VEBA's provide small employers with a means of pooling their buying power and thereby reducing their health insurance costs.

The reduction in cost of health insurance is crucial to expanding health insurance coverage for small employers, especially in rural areas. The Pryor/Bentsen bill clarifies that small employers may ban together to maintain the common VEBA if they are in the same line of business and are closely related as measured by the joint activities. We believe that this provision would serve as an important health policy objective.

Based on the only court case to address this key issue we also believe this provision is simply a clarification of current law.

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

Thank you, sir.

Senator PRYOR. Thank you very much, Mr. Williams.

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

Senator PRYOR. Ms. Campbell, we appreciate you being here this morning.

STATEMENT OF CAROL N. CAMPBELL, VICE PRESIDENT AND TREASURER, CARLETON COLLEGE, NORTHFIELD, MN, ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION

Ms. CAMPBELL. Thank you.

Good morning, Mr. Chairman. On behalf of the American Council on Education I commend you, Senator Pryor, and Senator Bentsen for your efforts to simplify pension plan administration and to expand pension coverage to more American workers.

During the last decade we have coped with numerous changes in the Federal tax requirements for pensions. The most significant resulted from the Tax Reform Act of 1986, which applied nondiscrimination rules to our 403(B) retirement plans. NACUBO, CUPA and TIAA-CREF have helped all plan administrators understand these new complex and confusing requirements.

Let me stress that the higher education community believes that equitable pension benefits for all employees is an important public policy goal. Our pension plan coverage is virtually universal. However, complicated micro management of retirement plans, burdens and frustrates employers and reduces the resources available to provide benefits to employees.

The vast majority of employees in higher education are covered by defined contribution plans as their primary source of retirement income. Defined contribution plans effectively deliver more dollars in benefits, yet the costs of administering even these plans has escalated in the last decade.

As a financial officer of a small college any increase in cost concerns me greatly. We in higher education are held accountable for tuition increases. We are striving to hold costs down. Excessive administrative burdens create the need for additional staff or expensive consulting which runs counter to our efforts towards efficient delivery of education.

Since 1970 Carleton College has contributed 7 percent of salary for an employee who contributes 3 percent. We vest 100 percent and allow immediate participation for all eligible employees. Because we offer the same plan to all employees the college should easily comply with the 600 plus pages of nondiscrimination regulations recently issued by the IRS.

The Employee Benefit Simplification and Expansion Act targets areas that are ripe for simplification and effectively reduces the burden of plan administration. We encourage the Finance Committee to adopt design based safe harbors for matching plans because they offer a simple method of compliance and yet assure equitable treatment for lower paid workers.

The majority of higher education's 403(B) plans are contributory, fully vested plans that match each employee's contribution by 100 percent or more. Since the passage of the Tax Reform Act of 1986 colleges have had no guidance on how the 401(m) matching test applies to 403(B) plans. Indeed, the IRS recently put off issuing regulations for 403(B) plans until 1992.

Many of the academic plans pass the 401(m) test. For example, Carleton matches more than 200 percent of the participant's contribution. Yet to ensure that our plan is nondiscriminatory we must work our way through payroll data and various numerical tests several times during the year. And we have no margin of comfort for the future. A sudden turnover could cause the college's plan to fail the test. As hard as we try it is difficult to convince young employees to save for retirement. Some colleges even offer an across-the-board base contribution of 3 percent or more to all employees.

The employer contributions required under S. 1364 provide meaningful benefits. Full and immediate vesting of matching contributions is significant to employees who make frequent job changes. Higher education welcomes the comfort that design based safe harbors provide and the corresponding reduction in administrative burden.

The goal of providing pensions to faculty members is to ensure a life long income. Nevertheless, in recent years some colleges have allowed plan participants to cash out all or part of their pension benefits at retirement. Last May Carleton's Board of Trustees acted upon request from faculty members to allow lump sum distributions under our plan. We hoped to allow cash for only the employee portion of contributions which amounts to about 30 percent of each participant's account, but partial rollover rules require a 50 percent distribution. Thus, the Tax Code forced us to offer full cash after age 55 to ensure that our employees would be eligible for a tax exempt rollover.

Thank you.

Senator PRYOR. Would you go forward one more minute. I want to hear on the rollovers. I may have a question for you.

Ms. CAMPBELL. Okay. S. 1364 greatly simplifies the complicated rollover rules. While a lump sum transfers control over pension assets to the retiree it also passes on a responsibility. DOL statistics suggest that workers may take this responsibility lightly. The proposed direct transfer mechanism addresses this concern.

S. 1364 does not prevent a terminating employee from cashing out, but it does add an automatic delay which gives lump sum recipients more time to consider the full implications of their actions.

[The prepared statement of Ms. Campbell appears in the appendix.]

Senator PRYOR. You are the Treasurer of a small college?

Ms. CAMPBELL. Yes.

Senator PRYOR. What is the enrollment of this college?

Ms. CAMPBELL. The enrollment is about 1,800 students.

Senator PRYOR. All right. Let's say that someone, one of the professors, well, let's say one of the maintenance workers decides to leave and he is going to move to another State. Let's say he is moving to Arkansas and he is retiring to Arkansas and sometimes that happens.

Ms. CAMPBELL. It is a little warmer.

Senator PRYOR. Now he comes in and he says I am retiring and I want my money. Do you write him a check then at that time? When he leaves do you write him a check?

Ms. CAMPBELL. No, we do not.

Senator PRYOR. What happens? Tell me how this works.

Ms. CAMPBELL. All right. That employee, through contributions and matching under the defined contribution plan has established and has built up a retirement account. That account is held in his name. He cannot cash that out or obtain those benefits under our plan as it stands until he reaches retirement or age 55.

Senator PRYOR. All right. What do you do with this employee's money?

Ms. CAMPBELL. It is maintained through our pension administrator and it continues to accumulate benefits and to grow until that employee reaches age 55.

Senator PRYOR. All right. If he is not paying benefits and if he is working in Arkansas and maybe he works for a small business person that does not extend these benefits, how does his benefit plan grow?

Ms. CAMPBELL. Through the wonders of compound interest it continues to grow.

Senator PRYOR. All right. So compound interest would be the only real contributions.

Ms. CAMPBELL. That is right.

Senator PRYOR. If we could use that end to this situation.

Ms. CAMPBELL. He may have an equity participation, depending on his plan. So there is also that element as well. But essentially, I think of it as compound interest over time.

Senator PRYOR. At what time then are you divorced or is the college divorced from any relationship with this employee? When he reaches a certain age, is that right?

Ms. CAMPBELL. In your example, Senator, our close dealing with that employee would terminate upon his termination, if I understand your example correctly.

Senator PRYOR. But you still hold in trust, basically, his funds.

Ms. CAMPBELL. Through TIAA-CREF, his funds would be held.

Senator PRYOR. Right.

Ms. CAMPBELL. Our faculty looked very seriously at the matter of providing cashouts of our plan at the point of termination and decided that the need and the importance to build benefits during the entire working career were more important. Therefore, we decided to make the recommendation to our trustees to provide the cash out only at age 55 or retirement.

Senator PRYOR. We really have a problem with this growing figure that when they cash out their money and they do not rollover, they go out and they have this check in their hand. They have not seen that much money. I mean I would do the same thing. I think I would walk out and probably buy a bass boat. [Laughter.]

Or a new set of golf clubs, you know. And before I know it I would fritter it away and have nothing for my retirement. I think though that your program is doing something that we would like to see done sort of universally. And I compliment you for it.

Any other comments that any of our other panelists would like to make? The reason I would like to kind of hurry us along, we are anticipating shortly a vote on the Senate floor. Once that occurs I will have to be gone for about 20 minutes, by the time I go over there and get back.

So if we could, I would dismiss this panel. I thank you very much. For studies or any facts and figures, we have 10 days for those and there may be some questions for you. Thank you very much.

We will call our third panel. Meredith Miller, Robert Stone, Thomas Walker, Edward Able. In a moment I will present Meredith Miller, who is the assistant director of employee benefits, AFL-CIO; Robert Stone, who is the associate general counsel, IBM Corp., on behalf of ERISA Industry Committee; Thomas Walker, the president and chief executive officer of Associated Benefits Corp., who is appearing today on behalf of the Association of Private Pension and Welfare Plans of Washington, DC; Edward Able will then follow, CAE, executive director of the American Association of Museums, on behalf to the American Society of Association Executives from Washington, DC.

We welcome this panel. I would like for the record to reflect, and also our audience to be aware, I think I am correct in saying this, that we had some 67 requests to testify this morning not only from individuals but also from national organizations and associations. We tried to do our very best to get an overall viewpoint, a composite of the country, and we certainly appreciate all of you being here this morning to participate and to add your constructive thoughts and advice.

Meredith Miller.

STATEMENT OF MEREDITH MILLER, ASSISTANT DIRECTOR OF EMPLOYEE BENEFITS, ACCOMPANIED BY ERNIE DUBESTER, LEGAL COUNSEL, AFL-CIO, WASHINGTON, DC

Ms. MILLER. Good morning, Mr. Chairman. We very much appreciate being here this morning. The AFL-CIO commends your leadership on these critical pension issues and for holding this hearing today to focus national attention on these matters.

In particular we would like to express strong support for the legislation's rollover provisions, the exemption of multi-employer plans from the full funding limitation and changes contained in the bill for public employee pensions. We do, however, have concerns that we would like to share with you about this and other pension simplification bills.

With respect to provisions we support, I would like to start with rollovers and transfers. The liberalization of the rollover provisions and the transfer requirement do much to advance the goal of pension preservation. We do, however, object to prohibiting after-tax employee contributions to be rolled over, especially if the intent of this proposal is to enhance and ensure pension savings.

We also are concerned that these same provisions do not extend to public sector plans except in limited circumstances or provide for spousal consent for distribution.

We strongly support the bill's provisions which protect public employee plans from potential disqualification by lifting limits on Section 415 pension distributions and by exempting benefits attributed to qualified excess benefit arrangements from Section 415 limits.

The unique plan, design features and local legislative authority for such plans warrant special consideration for public employees. State and local government workers also would benefit from the bill's proposal to reinstate public workers entitlement to 401(k) plans.

We also strongly support multi-employer exemptions to the full funding limitation and the annual evaluation requirement. Multiemployer plans provide benefits through prenegotiated contribution rates that are stipulated for the term of the collective bargaining contract. This funding stream cannot properly cover future benefits when subject to a full funding limit which fluctuates with interest rates.

With respect to provisions of concern, I would first address the repeal of income averaging for lump sum distributions. While we understand that the intent of this provision is to discourage retirement savings from being used for nonretirement purposes, this change may adversely affect future retirees not covered under the transition rule in your bill.

First, the financial crises in the banking and insurance industries make this an inopportune time to be pushing workers and retirees not included to put their money in IRA's to keep their pension assets in annuities since the PBGC is currently contesting its current obligation to ensure such annuities.

Second, this provision would disrupt the vast number of collectively bargained contracts that have lump sum payment options for both defined benefit and defined contribution plans.

Our second concern is modification to SEP's. We support the bill's effort to encourage small businesses to offer pension coverage to their employees. Nevertheless the simplification measures could be counter productive if they considerably reduce coverage of part-time workers who now enjoy participation under existing SEP rules.

We also believe that reduced administrative complexity alone may not provide sufficient incentives for small employers to offer coverage when costs are the real barriers.

Our last concern is modification of 401(k) plans. The new design based safe harbors for 401(k) nondiscrimination testing raises concerns about adequate participation of lower paid employees. Under current rules plan sponsors must aggressively market the 401(k) plan to lower paid workers in order to get sufficient participation necessary to pass the test.

We urge the sponsors to include more stringent requirements for employers to market the 401(k) safe harbor plans and for Congress to authorize pilot studies to determine differences in participation rates of low paid workers between the current plan and the proposed 401(k) safe harbors.

With respect to proposals we oppose I woulu like to address modification to the definition of leased employees. To avoid health and pension responsibilities many employers are seeking to change the status of traditional permanent employees to either leased personnel or they are employing independent contractors.

In 1982 Congress developed a rule to ensure that leased employees would have the same pension benefits provided to other employees of the same employer. The new provision provides for a change in the definition of leased employees. It removes the historically performed test by substituting a looser control test. We believe it will encourage employers to change the status of their present leased employees to independent contractor status.

We are opposed to this conversion of leased employees to independent contractor status since the benefit responsibilities fall on the workers and bargaining unit rights may be eliminated.

Senator, I would just like to add that the other provisions that we do oppose include the death benefit exclusion, the repeal of the unrealized appreciation of employer securities exclusion and the repeal of the multi-employer 10-year vesting. The last two are not in your bill. We have laid out the reasons in a written submitted testimony.

Thank you very much.

Senator PRYOR. Thank you, Ms. Miller. Thank you very much.

[The prepared statement of Ms. Miller appears in the appendix.]

Senator PRYOR. Mr. Robert Stone.

STATEMENT OF ROBERT S. STONE, ASSOCIATE GENERAL COUNSEL, IBM CORP., ARMONK, NY, ON BEHALF OF ERISA INDUSTRY COMMITTEE

Mr. STONE. Mr. Chairman, about 2 hours ago you asked for the hay to be put down to the level that the calves could handle it. I am going to try to do that. The ERISA Industry Committee, on whose behalf I am testifying, has as its members approximately 120 of America's largest employers. With nothing more than a factual statement meant, our plans probably cover more participants in defined benefit and defined contribution plans than are covered under the plans of all the other people who are testifying here today combined.

We are, in that respect, interested in several important items of the proposed legislation and not in others. But to make this clear, we have a bill which is entitled simplification, and I will talk briefly on the issues which in our opinion are simplification and which we support wholeheartedly.

The bill also is a pension expansion bill, and that point really needs to be made in order to have everyone understand where we are with this proposal. Then, it has provisions regarding who will pay for the pension expansion. So we are really looking at three different items within one bill entitled pension simplification.

With regard to simplification, we are very much in favor of the proposal to simplify the leased employee provision and S. 1364 does it well. The provision would prevent abuse. It meets common industry practice, and it provides a needed retroactive effective date.

We also support the simplification provisions which eliminate the requirement that distributions begin before an employee retires, simplify the definition of highly compensated employees, provide more timely notice of cost of living adjustments, and allow coordination of normal retirement age with Social Security retirement age.

Then there are the provisions to simplify the 401(k) nondiscrimination tests. That is a rather complicated issue. As you heard from many special interest groups, it applies in a different fashion for the major employer community than it applies in another community.

But if that is all we had, and that is pension simplification, I dare say we could have a bill that could be passed very quickly and simply. In addition to that, however, we have several provisions for expanding pension access and coverage. We are in no way at odds with those proposals. We are concerned that in order to find the revenues to cover the shortfalls from the expansion proposals there are provisions in S. 1364 and in the companion House bills and in the administration's "POWER" proposal which would break promises that have been made to many of the employee plans sponsored by our members.

For example, S. 1364 would eliminate 5-year averaging and would extend the 15 percent excise tax to retirees who have received lump sum and other distributions that exceed $150,000. It would not be unusual for a plan participant after a life time of work to receive a $150,000 lump sum distribution. They may have planned for the use of the net amount of those funds, after having paid full income tax on the $150,000, only to find that the government bites another 15 percent into that distribution, something that they have been participating in, waiting for 30 years, and all of a sudden we change the dice on them.

Similarly, other bills would eliminate the net unrealized appreciation on employer's stock. When a distribution is made to a retiree, the retiree may well be planning on the dividends from that stock to help pay either the cost of a new business venture or their daily living expenses, and those dividends will be fully taxed. Okay? But when that employer stock is delivered under this change, the recipient would have to sell some of that stock, not have it available for the dividend flow, in order to pay a tax which up until now would not have been on the books and which he or she would not have been expecting.

So the final point I wish to make is that, in all of the proposals, effective dates are so important to employer and employee alike in order to plan and implement properly. We believe it is unfair to take longstanding provisions of the Internal Revenue Code and change them as they apply to people who have been planning in reliance on those provisions for some time.

Thank you.

Senator PRYOR. Mr. Stone, thank you. In a moment I am going to ask you a rollover question or two.

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

Senator PRYOR. Mr. Thomas Walker.

STATEMENT OF THOMAS C. WALKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATED BENEFITS CORP., ON BEHALF OF ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, DC

Mr. WALKER. Good morning, Senator. My name is Tom Walker and I am the president of Associated Benefits Corp. from Des Moines, IA. Contrary to what our name would imply we are a plan sponsor, not a consultant. We sponsor field prototype plans that are adopted by agricultural cooperatives throughout the Midwest and we do in fact truly understand hay and calves.

I am here today representing the Association of Private Pension and Welfare Plans whose members directly sponsor or administer pension and health plans covering over 100 million Americans. We are very proud at the APPWP that we were able to help launch your efforts on pension simplification, last year's bill, S. 2901, and grateful that many of the 29 issues that we identified in a work called "Gridlock" in September 1989 were included in your bill and are included in S. 1364.

Time will not allow a complete discussion of our views, but there are a few of the points covered in our written testimony that I am compelled to address specifically.

Earlier this year, our review of the proposed nondiscrimination rules written to implement the Tax Reform Act of 1986 revealed eight specific areas that we consider problems. But they were problems that could be fixed without undermining Congressional intent.

A description of those problems and our proposal for fixing them are contained in gridlock revisited which I would like to request be accepted for the permanent record.

[The information appears in the appendix.]

Mr. WALKER. In addition, in response to a request you made earlier, the Wyatt Company has conducted a survey which demonstrates the participation levels are directly related to the generosity of the employer match and we will provide a copy of that as well for the permanent record.

[The information appears in the appendix.]

Mr. WALKER. When the Treasury Department testified in July before the House Ways and Means Committee they specifically asked Congress not to legislate on the eight issues I just talked about but rather to wait for the final regulations. We now have those regulations and they only address some of the problems that we identified, and then in very modest ways.

With one exception, and that exception actually made the final regulations more onerous than the proposals. This is the case of the general nondiscrimination test. The final regulations say that an employer cannot have even one single highly compensated employee accrue a benefit at a rate greater than a nonhighly compensated employee.

This moves very dramatically away from the currently allowed averaging of highly compensated against the average of nonhighly compensated. What this means is that one person in a plan with tens of thousands of participants could cause the plan to be disqualified. Nowhere known to us has this ever been expressed as the intent of Congress.

I am holding up a sheet of paper and it is highlighted in yellow. These three lines are all that you legislated in the Tax Reform Act of 1986 on nondiscrimination in pension plans. For dramatic effect, here are the 609 pages of regulations that those three lines generated.

Real pension simplification as well as simplification of all other areas of law could probably occur if you legislated that regulations could never exceed by 20 times the number of lines of actual legislation. [Laughter.]

Seriously. We do have a request for you today. The final separate line of business rules are truly needed before the real impact of these 609 pages can be determined. The final separate line of business rules are not expected until early next year, which is after the current effective date for these 609 pages.

We would ask that you accompany us in a formal request to the administration to postpone the effective date of this 609 page stack until the final separate line of business regulations are promulgated.

The yellow light is on. We appreciate very much, Senator Pryor, your interest in pension simplification and we urge you to pursue your bill and help us if you can to delay the implementation of these nondiscrimination rules.

Thank you.

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

Senator PRYOR. By the way, I am just trying to get a clarification, when does that 600-page set of regulations go into effect?

Mr. WALKER. 1-1-92.

Senator PRYOR. It is January of next year, isn't it?

Mr. WALKER. Yes.

Senator PRYOR. Thank you. That was a very, very sound request. I appreciate the drama by which you demonstrated the problem. [Laughter.]

Now let's go to Mr. Able. Mr. Able, we appreciate you being here.

STATEMENT OF EDWARD H. ABLE, JR., C.A.E., EXECUTIVE DIRECTOR, AMERICAN ASSOCIATION OF MUSEUMS, ON BEHALF OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, WASHINGTON, DC

Mr. ABLE. Thank you, Mr. Chairman. My name is Ed Able and I am the executive director of the American Association of Museums. I have been a volunteer leader in the Association community and the American Society of Association Executives (ASAE) for most of my 20 years in Association management.

ASAE is pleased to have this opportunity to present testimony regarding the extension of 401(k) plans to tax exempt employers, a provision of your bill—S. 1364.

Mr. Chairman, ASAE is a professional society of over 20,000 Association executives, representing more than 9,000 national, State and local associations. Most of our members work for associations with less than 10 employees. ASAE members represent tax exempt organizations, mostly under Internal Revenue Code Sections 501(c)(6) and (c)(3).

Many of our members, Mr. Chairman, would like to sponsor some form of qualified retirement plan. The 401(k) plans for nonprofits have been prohibited since July of 1986 when Congress changed the eligibility requirements for 401(k) plans. In a recent survey of ASAE members we found only 17 percent of the associations in the sample have been able to offer 401(k) plans to their employees because of the ineligibility rules.

As a result of this inequity ASAE along with the U.S. Chamber of Commerce formed the 401(k)s for 501(c)s coalition which now has 3,350 members, including 3,000 Chambers of Commerce and 350 Associations. ASAE strongly supports permitting all tax exempt employers to maintain qualified cash or deferred arrangements also known as 401(k) plans.

Mr. Chairman, I am sure that you and the Subcommittee are aware that most employers may establish programs that allow their employees to save for retirement on a tax favored basis. For profit employers may offer their employees the opportunity to participate in 401(k) plans and for smaller employers salary reduction simplified employee pensions.

Code Section 501(c)(3) tax exempt organizations and certain other educational organizations may offer their employees tax sheltered annuities under Code Section 403(B). Employees of State and local governments may participate in eligible deferred compensation plan under Section 457. Even the Federal Government has provided its employees with a tax deductible salary reduction retirement savings program.

This public policy has been adopted unselfishly to promulgate public good, the income security of retired Americans. What better way to assure the quality of life during retirement than to encourage savings throughout an individual's working life. What better way to increase savings and capital formation so necessary to our economic well being.

Employees of 501(c)(6), trade and professional associations on the other hand are precluded from participation in a broad-based tax favored savings program. There seems to be no logical reason or justification for this discrepancy. The situation as it currently stands is grossly unfair to our members and it should be rectified.

To further compound the problem most individuals may not qualify to make tax deductible contributions to IRA's. The current situation is grossly unfair to our member associations and their employees because they are less able to provide the competitive benefits necessary to attract and retain a well-qualified work force.

Certain members of Congress have perceived the inequity of this situation and sought to rectify it. As has already been stated you have introduced the Employee Benefit Simplification and Expansion Act and included language that would allow all 501(c) organizations access to 401(k) plans.

Also on the Senate side, Senator Steve Symms has introduced Senate 448. On the House side Representatives Sander Levin and Bill Archer introduced H.R. 2327, which if enacted would allow tax exempt organizations access to 401(k) plans and this bill incidentally has strong bipartisan support, 98 co-sponsors, including 10 from the House Ways and Means Committee.

In addition, the language from H.R. 2327 has been included in two major pension simplification bills being discussed before the House Ways and Means Committee.

Mr. Chairman, ASAE believes that these legislative activities evidence continuing Congressional interest in fairness and tax policy and in the soundness of public policy regarding tax favored retirement programs for all employees. We appreciate the opportunity to present our views and sincerely hope that you will help us in providing some equity of employees of trade and professional associations.

Senator PRYOR. Mr. Able, thank you. Once again, you are right on the nose. You all are super witnesses this morning.

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

Senator PRYOR. One comment, Mr. Stone. You mentioned the repeal of the five times rule, I believe. Let me just say for the record, and I have just consulted with the staff, and staff advises me that this is a drafting error and will be corrected. So we appreciate you bringing that to our attention in public.

Mr. STONE. Thank you.

Senator PRYOR. We wanted also in public to make certain so there will not be additional confusion that is in fact a drafting error.

Now let me ask you a question. Are you against the mandatory rollover to the IRA's, I believe, is this correct?

Mr. STONE. Yes.

Senator PRYOR. Now I know this presents a lot of trouble for the employer, but would not the trouble justify, in some cases, protecting that retirement money for that employee who may go out like me and buy the bass boat or the golf clubs?

Mr. STONE. I think, Senator, it depends on how old you are and what your status is in life at the time you are eligible to receive the amount.

Senator PRYOR. You are never too old to catch a fish or swing a golf club. [Laughter.]

Mr. STONE. True. But if after a 30-year career at IBM, as I will achieve next summer, I decide that I really want to open a Chevy dealership, I would like to be able to take that lump sum at age 55 and do so.

On the other hand, if you have an employee who is maybe 35 or 40 years of age, you may have a different view as to whether or not the tax incentive money that has gone into their account, that has built up tax-free, has to go to another retirement account rather than go out for the bass fishing boat.

So I think it is a much more complicated issue than just a unilateral mandatory rollover or suffer a 10-percent penalty tax.

Senator PRYOR. Well, you know what we are trying to do. We are trying to protect that person's retirement fund. I guess also we are trying to be pretty paternalistic about it.

Mr. STONE. Well, I do not think so.

Senator PRYOR. We do not want them to get their hands on it until they retire.

Mr. STONE. Yes, the Profit Sharing Council in Chicago came out with some statistics which I saw in Pensions and Investments magazine about 2 weeks ago, which said that something like 80 plus percent of all people who receive $50,000 or more as a lump sum distribution rolled them over or continued their use for payout for retirement benefits. And that to the extent that there was a nonrollover of those funds it was generally one that was a much smaller amount that was coming out at a young age, where the person was going on to another employer, where they could probably build up another level of retirement income.

But again, it is a vastly different issue, depending upon the stage of life, the family situation, and a question as to whether being paternalistic with one plan for everybody is correct.

Mr. WALKER. Senator, could I interject something on this as well.

Senator PRYOR. Yes, go right ahead.

Mr. WALKER. My biggest concern in imposing the mandatory rollover lies not in the paternalistic approach that is involved, but lies in the fact that nowhere in the proposed legislation is there anything addressing the issue of the fiduciary responsibility of the plan sponsor.

One of the things that is required is that if an employee does not direct the employer as to where that rollover is to go, the employer is required to choose an IRA account for that employee's deposit. I believe that will, under the law, continue the fiduciary responsibility of the employer for those assets.

I have very serious reservations about my ability or any other plan fiduciary's ability to second guess a nonresponding employee as to how he would want his assets treated. If we choose to make a deposit that is not in accordance with what that individual may want, I question whether our fiduciary liability is relieved with the making of the deposit. I have some serious reservations in that area.

Senator PRYOR. Mr. Able, we have been listening, I guess, mostly to the private sector here with your colleagues on the left. Do some of these same arguments apply then to the groups you represent?

Mr. ABLE. I think they would if we had the 401(k)s and some of the other opportunities, Senator. [Laughter.]

We would probably be more vocal on some of these issues if we had the plan to start with. I might also mention I do endorse our colleague from the American Council of Education's comments about 403(b)s as well.

Senator PRYOR. Ms. Miller, this is a sort of broad, general question. Is the issue of the retirement funds a major area of negotiating with labor management contracts today? I know health care is. Where does this fit in the spectrum?

Ms. MILLER. I would say it is right behind health care within employee benefits. I think we have cash, health care, and perhaps pensions behind that. It has certainly been an area that we are very much concerned with and as one that money may be taken away from to pay for health care.

This is certainly an important area of concern for our members, not only just in bargaining, but as you know we have been very much concerned about the benefit security issues, especially about the PBGC standing on annuities and as I mentioned in the testimony about concerns with the banking industry as well.

Senator PRYOR. Any more comments in this area?

[No response.]

Senator PRYOR. I have a short statement here—I need to correct something. We want to point out for the record that the changes in the 15 percent additional tax on excess distribution in the Pryor/Bentsen bill was not intended. I want our audience to know this and the record to reflect it.

The staff tells me that in an error in a conforming amendment that has not been a proposal now for about 2 years, but no one has noticed it up until about 3 weeks ago, which I think is somewhat interesting. I will commit to you that we will fix it. But at least if this hearing served no other purpose we found an error that we are going to make certain is corrected. So we thank you very, very much.

I want to thank this panel. We appreciate your comments and any information you would like to additionally add for the record, it will be greatly appreciated.

We will call our final panel now. Mr. John Kapanke, the Rev. Robert John Dodwell, Rev. Perry Hopper, and Henry Shor.

Let me first for the benefit of our record identify who our distinguished panel is going to be. John Kapanke, President—am I pronouncing that correctly, sir?

Mr. KAPANKE. Kapanke, sir.

Senator PRYOR. Kapanke, president and chief executive officer of the Board of Pensions, Evangelical Lutheran Church in America, Minneapolis, on behalf of the Church Alliance. He is accompanied this morning by the Rev. Robert John Dodwell, the rector, St. Anna's Episcopal Church, New Orleans, LA, trustee, the Church Pension Fund of the Episcopal Church.

Now is that church on Jackson Square by the way?

Mr. DODWELL. No, sir, that is the Cathedral, the Roman Catholic Church. I am a little bit down the street.

Senator PRYOR. You are down the street a little bit.

Mr. DODWELL. Now I have been there almost as long, but I am down the street.

Senator PRYOR. All right.

The Rev. Perry Hopper, the assistant to the executive director, Ministers and Missionaries Benefit Board of the American Baptist Churches, assistant pastor, Canaan Baptist Church, New York, NY. Reverend, we appreciate you being here.

Henry Shor, Baltimore, member of the Joint Retirement Board, Rabbinical—what is that pronunciation, Mr. Shor?

Mr. SHOR. The Rabbinical Assembly of America.

Senator PRYOR. Rabbinical Assembly.

Mr. SHOR. And the United Synagogue of America.

Senator PRYOR. Jewish Theological Seminary and the United Synagogue of America.

Mr. SHOR. Right.

Senator PRYOR. Well, you are well qualified, all of you are to be here.

John, we look forward to your statement.

STATEMENT OF JOHN G. KAPANKE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BOARD OF PENSIONS, EVANGELICAL LUTHERAN CHURCH IN AMERICA, MINNEAPOLIS, MN, ON BEHALF OF THE CHURCH ALLIANCE, ACCOMPANIED BY REV. ROBERT JOHN DODWELL, RECTOR, ST. ANN'S EPISCOPAL CHURCH, NEW ORLEANS, LA, TRUSTEE, CHURCH PENSION FUND OF THE EPISCOPAL CHURCH; REV. PERRY HOPPER, ASSISTANT TO THE EXECUTIVE DIRECTOR, MINISTERS AND MISSIONARIES BENEFIT BOARD, AMERICAN BAPTIST CHURCHES, ASSISTANT PASTOR, CANAAN BAPTIST CHURCH, NEW YORK, NY; HENRY O. SHOR, C.L.U., BALTIMORE, MD, MEMBER, JOINT RETIREMENT BOARD, RABBINICAL ASSEMBLY OF AMERICA, JEWISH THEOLOGICAL SEMINARY AND THE UNITED SYNAGOGUE OF AMERICA

Mr. KAPANKE. Thank you very much, Mr. Chairman. It certainly is an honor for us to appear before your committee this morning. We are here to indicate our strong support for passage of S. 747, the Church Retirement Benefits Simplification Act of 1991.

Mr. Chairman, before I comment on S. 747, I would like to take this opportunity to congratulate you and Senator Bentsen on the introduction of your general pension simplification bill, S. 1364. Several of the provisions in this bill are of interest to us.

I am speaking on behalf of the Church Alliance, which is a coalition of chief executive officers of 30 mainline Protestant and Jewish denominations. The Church Alliance has worked very closely with the U.S. Catholic Conference in formulating this legislation and the U.S. Catholic Conference supports its passage and has issued a letter for the record in support of this bill.

The Church Alliance supports your goals for pension simplification. We believe that every provision in S. 747 will simplify the rules that apply to church retirement programs. Time does not permit me to go into detail on each one of these provisions, but I would like to comment very briefly about four of the primary goals.

(1) The legislation would simplify the rules that apply to the two different types of church retirement plans and make the rules that apply to qualified church retirement plans consistent with those that apply under current law to the Church Retirement Income Account Programs, the 403(b) plans.

(2) To locate the rules that apply to qualified church retirement plans in their own Section in the Code so that these rules can be easily identified and not be subject to inadvertent change.

(3) To promote access to pensions on the part of ministers and lay workers and;

(4) To clarify and resolve some technical issues.

Mr. Chairman, I would like to comment on one provision of S. 747 which is of particular importance to our denomination. A very vital aspect of our ministries is carried out by persons who serve in specialized ministries. I am talking about people that serve as chaplains in prisons and hospitals, in nursing homes, on college campuses and in social ministry organizations.

Under the current law there is a question as to whether or not these persons serving in those specialized ministries may continue to participate in their denomination's pension plan. For example, you might have a chaplain who is serving in a hospital. The hospital, for tax purposes, would consider that chaplain as an employee. But that chaplain because he or she is under call by the church, would like to continue to serve in the church's pension plan.

It is not clear under the current provisions that the chaplain could do so. And, in fact, if we are not successful with this legislation, we would have to inform our chaplains that they could no longer participate in our plan.

From time to time we are asked questions as to why laws applicable to church pension plans should be different from those of other employers. We believe there are several very unique characteristics that affect churches that are not applicable to other employers.

Mr. Chairman, I would like to conclude my remarks by noting that various members of the Church Alliance, together with the members of the U.S. Catholic Conference, have worked for over 4 years in developing this legislation. In view of the time that has been committed to this development and the immediacies of the problems which would be resolved by this legislation, I must emphasize the importance of its passage this year.

We are not revenue estimators but we believe that when the Joint Committee on Taxation issues its revenue estimate it will demonstrate that S. 747 involves virtually no revenue loss. We appreciate this opportunity to be before your subcommittee this morning. The Senate Finance Committee has been helpful in the past and we look forward to your support in the future.

Thank you for this opportunity to be here this morning.

Senator PRYOR. Thank you very, very much.

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

Senator PRYOR. Now do we have an up-to-date number or list of the Senators now supporting S. 747? I know we have a large number, but I do not have an up-to-date one.

Mr. KAPANKE. Yes. I believe I do. We have on the Senate side, we have 12 Senators on the Finance Committee; and a total of 22 Senators that signed on as co-sponsors.

I also should mention that we have on the House side—this bill has been introduced by Congressman Matsui—and we have 21 House members out of the 36 Ways and Means Committee members; and I believe we have about 90 members on the House side total that support this legislation.

Senator PRYOR. You have been doing a lot of good work getting those sponsors.

Mr. KAPANKE. Thank you.

Senator PRYOR. We appreciate that. That makes our job a little easier when you do that.

You know, I have had correspondence from time to time on many occasions with the head of the Rabbinical Board, I guess I am pronouncing that right, Mr. Shor.

Mr. SHOR. That is correct.

Senator PRYOR. That is Leo Landis, I believe.

Mr. SHOR. Yes, and he sends his well wishes.

Senator PRYOR. Yes.

We are sorry he could not be with us today, but we appreciate you coming. He has been really a constructive force in this whole effort and I certainly owe him a debt of gratitude for helping to educate me and all of our staff on the unique quality of the people that you represent.

We not only appreciate your support, we appreciate this group's blessings. That is what we might need. I think that we certainly have that today and certainly we need your help continuing as we proceed further.

Reverend Dodwell, Mr. Hopper, Mr. Shor, any comments? We are going to wind down our hearing at this point. But we would be glad to hear from you.

Mr. SHOR. Thank you, Senator. I will skip all the boiler plate which you already know. But I would like to comment on the fact that S. 747 will help us tremendously because many of our churches and synagogues are very small. They have a rabbi or a minister possibly and maybe one employee or no employees or part-time, and it is very difficult for them to understand what they have to go through in terms of administration in qualifying for a plan.

We think that this bill will help us tremendously in really solving that problem. We think it is very important and, of course, we support it wholeheartedly with the Alliance.

Thank you.

Senator PRYOR. Thank you very much.

Mr. DODWELL. Father Robert Dodwell, sir. If it is all right, I would like to make a few comments in addition to my written statement which will be in the record.

Senator PRYOR. All of your statements will be placed in the record. Thank you.

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

Mr. DODWELL. First off, as a Trustee of the Episcopal Church Pension Fund, but especially as the priest of the church, I want to thank you for your care for the welfare of the clergy of this country. Keep up the good work is what I am told to say to you by lots of people.

Secondly, not every bill I am sure but many of the acts of Congress in respect to pensions frankly are burdensome and onerous to the church's pension funds and the administration of them. It causes us lots of trouble and costs us enormous sums of money. If we concentrate, focus for just one second, on Senator Grassley's comment about maximizing the pensions of the clergy of this country, it is outrageous not to go ahead with simplification.

If we have simplification, then the pension funds of the churches and the synagogues of this country will be freed up literally, on an annual basis, from millions of dollars of expenses, particularly the reporting rules, but I think there are other rules also. So if we can be freed from this, it would permit this money to be used for making the pensions larger which, of course, as a recipient in a few years of this I approve of, and for the other missions of the churches and synagogues of this country.

Thank you very much, sir.

Senator PRYOR. Thank you.

Mr. HOPPER. Thank you, Mr. Chairman. As you can see, I am here in two capacities, both as a pension board executive for my denomination but also as an assistant pastor of a local parish in Harlem. In particular I simply wanted to echo Mr. Kapanke's concern over the issue of the coverage of ministers who during the course of their ministry may change jobs many times. For example, from being a pastor in a local church to being a chaplain in a prison or hospital or to being on the staff of a drug counseling center.

In all of these capacities the minister is pursuing his or her Baptist ministry. They should be able to participate in the American Baptist Church's retirement plan. If the minister is not in our denomination's plan he or she might never get a pension.

So due to the complexities and the restrictions of the present law, the minister may be denied coverage under our denominations pension plan. We simply want to urge you to approve the enactment of this bill, S. 747, which will remove these restrictions and simplify the operation of our plans.

Thank you for allowing us to be heard.

Senator PRYOR. Thank you very much.

Now this is on another subject, but it is about ministers. This subcommittee also has the oversight, among other jurisdictions, we have oversight of the Internal Revenue Service, if you can imagine any oversight that can be had over any agency, we try our best.

We have just gotten word a couple, 3 weeks ago that the Internal Revenue Service is auditing a large number of Methodist preachers in the Southern part of the country in the Memphis region of the IRS.

Do you have any such information? Are any of your ministries being inordinately audited by the IRS as a class? John?

Mr. KAPANKE. Mr. Chairman, if I could, I would like to call on Mr. Carl Mowery, who is the legal counsel for the United Methodist Church to comment on that, please.

Senator PRYOR. Sure.

Carl? By the way, this was unrehearsed and unplanned. But I was just wondering. I would like any information you have.

Mr. MOWERY. Senator Pryor, it is the view of the United Methodist Church that because of the denominations polity its ministers are self-employed and that its ministers should file as self-employed individuals. We do have an understanding that there is a growing audit of self-employed individuals as a whole.

However, we do not know of any specific instance where the IRS is focusing on United Methodist ministers. But I think that as a part of the audit program of self-employed people, our United Methodist ministers probably represent a larger share of that.

There has been information received from our ministers who live in the area serviced by the Memphis district of the IRS, that they feel that the IRS is focusing its attention on minister who file as self-employed. We do not know of any such focus at this time.

I am the general counsel for the Pension Board. We do have another area of the church that handles this specific matter, but we are always concerned about those issues with respect to the participation of self-employed ministers in our church pension programs.

Senator PRYOR. Well, I get upset when I hear things like this. I wish the IRS would concentrate its efforts on maybe the drug dealers and people like that. I just do not see a lot of sinister activity out there on behalf of the Methodist preachers. I wish they would sort of get their priorities lined up a little bit better.

We want to thank this panel and all our panelists this morning. This has been a very good hearing. I think we have built a very impressive record. It will be a record that will be utilized not only by this committee, but by other committees, I assume, in the House of Representatives. We appreciate so much you coming.

Like I have said, many of you have come from all parts of the country to be a part of this hearing. I will pledge you this morning we are going to do our dead level best in working with you in moving this legislation forward because it is of critical need and we need to get it done.

Thank you very much. Our hearing is adjourned. Thank you.

[Whereupon, the hearing was adjourned at 12:30 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Ed Able, Jr.

INTRODUCTION

Mr. Chairman, my name is Ed Able. I am the Executive Director of the American Association of Museums, and have been a volunteer leader in the association community and the American Society of Association Executives most of my 20 years of association management.

The American Society of Association Executives (ASAE) is pleased to have the opportunity to present a written statement for the September 27, 1991 hearing of the Senate Finance Committee Private Retirement Plans Subcommittee, regarding the extension of Internal Revenue Code ("Code") section 401(k) plans to tax-exempt employers, announced in Press Release No. H-39 issued on September 12, 1991.

ASAE strongly supports permitting all tax-exempt employers to maintain qualified cash or deferred arrangements (CODAS), also known as 401(k) plans. ASAE believes that employees of trade associations and other tax-exempt employers are entitled to the same opportunity to save for their retirement on a tax-favored basis as employees of charitable and educational organizations, federal, state and local government and the private sector. It is unfair and discriminatory to prevent one type of employer from being able to offer to its employees a particular type of employee benefit that is available in one form or another to employers in every other sector of the economy. It is ultimately the employees of those employers whose ability to save for retirement is being restricted.

The American Society of Association Executives is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005(202/626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 20,000 individuals representing more than 9,000 national, state, and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of hundreds of millions of people throughout the world. Many of ASAE's members work for associations which employ less than 10 employees. Approximately two-thirds of ASAE's members represent trade associations exempt from taxation under Code section 501(c)(6). Many of ASAE's member associations either sponsor or are contemplating sponsoring some form of qualified retirement plan, including 401(k) plans if they would be permitted by law.

BACKGROUND

It has long been recognized that an individual's retirement income should be derived from three sources: (1) Social Security benefit payments, (2) employer-sponsored retirement plan benefits and (3) individual savings. It also has been recognized that individuals in this country have not been saving in sufficient amounts for their long-term needs, including retirement. ASAE believes that the policy of providing tax-favored savings through employer-sponsored plans is an appropriate and efficient means of encouraging Americans to save.

As this Subcommittee is aware, most employers may establish programs that allow their employees to save for retirement on a tax-favored basis. For-profit employers may offer their employees the opportunity to participate in 401(k) plans and, if employing less than 25 employees, salary reduction simplified employee pensions

("SEPs"). Organizations exempt under Code section 501(c)(3) and certain educational organizations may offer their employees tax-sheltered annuities under Code section 403(b). Empl‸yees of state and local governments may participate in an eligible deferred compensation plan under Code section 457 (457 Plan). And within the past few years, even the Federal government has provided its employees with a tax deductible salary reduction retirement savings program. Only tax-exempt organizations other than those described in Code section 501(c)(3) are unable to provide all of their employees with an opportunity to save for their retirement on a tax-favored basis. To further compound the problem, many individuals may no longer make tax-deductible contributions to individual retirement accounts after the passage of Tax Reform Act of 1986.

Prior to the Tax Reform Act of 1986, all tax-exempt organizations could sponsor 401(k) plans. In 1985, the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (President's Proposal) proposed that private sector tax-exempt organizations and public sector employers no longer be permitted to establish and maintain CODAs. The President also proposed to establish rules for deferred compensation arrangements of private sector tax-exempt organizations similar to those found in Code section 457. In its explanation of reasons for change, the President's Proposal stated that private sector tax-exempt organizations may offer their employees tax-sheltered annuities under Code Section 403(b). This, of course, was and is not true for the vast majority of employees of tax-exempt organizations. As the Subcommittee knows, and as stated above, tax-sheltered annuities are available only to employees of Code section 501(c)(3) organizations and certain educational organizations.

Perhaps as a result of this misconception, Congress, in the Tax Reform Act of 1986, acted to prohibit all tax-exempt organizations from adopting 401(k) plans after July 1, 1986. ASAE was active in the unsuccessful attempt to preserve new 401(k) plans for non-governmental tax-exempt organizations during the development and passage of the Tax Reform Act of 1986. Congress also brought under Code section 457 unfunded salary reduction arrangements offered by private sector tax-exempt organizations to a select group of management or highly compensated employees. Accordingly, the only retirement savings plan now available to employees of tax-exempt organizations other than those described in Code section 501(c)(3) is the 457 plan which, as discussed below, is not an adequate replacement vehicle for the 401(k) plan.

Certain members of Congress were quick to perceive the inequity of this situation, and sought to rectify it. In 1987, Senator David Pryor introduced the Small Business Retirement and Benefit Extension Act (S. 1426), which would have extended the availability of Code section 403(b) tax-sheltered annuities to all tax-exempt organizations. Hearings were held before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Committee on Finance at which the particular inequities faced by employees of tax-exempt organizations, including trade associations, were thoroughly aired. ASAE presented oral testimony before the Subcommittee at a hearing held on October 23, 1987. ASAE strongly supported this legislation, which unfortunately was not enacted. The Ways and Means Committee, and later the full House of Representatives adopted H.R. 3545, the Omnibus Budget Reconciliation Act of 1987, which contained a provision that would have permitted tax-exempt organizations not eligible to offer Code section 403(b) tax sheltered annuities to establish 401(k) plans. Unfortunately, this provision as well as many others were removed as the result of the deficit reduction agreement between Congress and the administration. The Code was ultimately amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) to reinstate 401(k) plans for rural telephone cooperatives. More recently, in October, 1989, the Senate version of H.R. 3299, the Revenue Reconciliation Act of 1989, contained a provision to permit all tax-exempt organizations to again be able to sponsor a 401(k) plan. Although this provision was approved by the Senate Finance Committee, the version of H.R. 3299 submitted to the full Senate for a vote did not contain a provision to extend 401(k) plans to tax exempt organizations because most matters not germane to the budget were dropped from the bill. ASAE believes that these legislative actions evidence continuing Congressional interest in fairness in tax policy and in the soundness of public policy regarding tax-favored savings programs.

Certain members of Congress continue to fight against the inequity of this situation, and have sought to rectify it during the 102nd Congress. Senator Pryor has included language in the *Employee Benefits Simplification and Expansion Act of 1991*, S. 1364, that would reinstate 401(k) plans. In May 1991, Representatives Sander Levin and Bill Archer introduced H.R. 2327 which, if enacted, would allow all tax-exempt organizations to have access to 401(k) tax deferred retirement plans.

This bill currently has strong bipartisan support with 98 co-sponsors, including 10 from the Ways and Means Committee. In February 1991, Senator Steve Symms introduced a similar bill which also has strong bipartisan support with 25 co-sponsors, including 9 members of the Senate Finance Committee. In addition, the language from H.R. 2327 has been included in two of the major pension simplification bills: House Ways and Means Committee Chairman Dan Rostenkowski's bill—H.R. 2730, and Representative Ben Cardin's bill—H.R. 2742.

REASONS TO PERMIT TAX-EXEMPT EMPLOYERS TO SPONSOR 401(K) PLANS

The reasons why Congress should extend 401(k) plans to tax-exempt employers are rooted in the principle that employees of tax-exempt organizations should have the same opportunity to save on a tax-favored basis as employees who work in the private sector or for federal, state or local governments. ASAE believes that eliminating this inequitable treatment between taxpayers would result in a more equitable tax policy. It also would foster the objective of increased private retirement savings. ASAE's members support the extension of 401(k) plans to tax-exempt organizations primarily because it would benefit their employees and, by virtue of being able to hire the most qualified employees, the public which they serve.

As indicated above, it is unfair and discriminatory to single out one employer group and, thereby, one group of employees who may not sponsor 401(k) plans. Because the employers do not derive a direct economic benefit from sponsoring a 401(k) plan, it is their employees who are being penalized. This unfair and discriminatory treatment is especially inappropriate when the inequity results from incorrect assumptions regarding the availability of alternative tax-favored savings plans.

The first incorrect assumption is that Code section 403(b) tax-sheltered annuities are available to all tax-exempt organizations. They are not. They are available only to Code section 501(c)(3) charitable organizations and certain educational organizations. Trade associations and other Code section 501(c) organizations may not sponsor such plans for their employees. The other incorrect assumption is that 457 plans are comparable to 401(k) plans for retirement savings purposes. This assumption is incorrect for two reasons.

First, 457 plans do not provide the same level of retirement income security as a 401(k) plan. Qualified plan contributions and earnings, including those in a 401(k) plan, are held in trust for the exclusive benefit of participants and their beneficiaries. In contrast, a 457 plan must be unfunded, and amounts held under that plan are subject to the general creditors of the employer. This greatly reduces the retirement security of an employee who participates in a 457 plan because of the uncertainty of whether the employer will ultimately be able to provide the promised retirement income. In this regard, it would be wrong to assume that private sector tax-exempt organizations have the same ability to generate revenue as public sector tax-exempt organizations, since private sector tax-exempt organizations do not have the power to levy taxes to raise revenue.

Second, as a result of the interplay between the Code and the Employee Retirement Income Security Act of 1974, as amended (ERISA), 457 plans of private sector tax-exempt organizations may not be offered to all employees, as is the case with public sector organizations such as state and local governments. Again, Code section 457 requires the plan to be unfunded. However, ERISA does not permit a plan of deferred compensation sponsored by a non-governmental private sector organization to be unfunded unless it is maintained primarily for a select group of management or highly compensated employees. This interplay results in the exclusion from a 457 plan of virtually all rank and file employees. This is clearly inconsistent with the underlying purposes of the amendments to Code section 401(k) by the Tax Reform Act of 1986; namely, to broaden coverage to non-highly compensated employees and to limit the benefits of highly compensated employees, especially relative to non-highly compensated employees. By limiting the availability of broad-based tax-favored savings to highly compensated and management employees, current law limiting the availability of broad-based tax-favored savings plans for tax-exempt organizations runs counter to both sound tax policy and the objectives of the Tax Reform Act of 1986. ASAE is not suggesting that an exemption from the funding rules be granted. ASAE does not want unfunded plans to be extended to all employees because deferred amounts would be subject to creditors of the employer.

Another reason that tax-exempt organizations should be able to sponsor 401(k) plans is competitiveness. ASAE's members are particularly sensitive to the tax incentives for employee benefits, like 401(k) plans, because these incentives' affect the ability of the employers of ASAE members to attract and retain well-qualified personnel. Trade associations frequently compete within the same labor pool for employees as private industries that have 401(k) plans or organizations that have Code section 403(b) tax-sheltered annuities available to them. Not only must trade associations be competitive in relation to these employers, but they must also compete with the Federal government which now provides a funded salary reduction plan for Federal employees. Furthermore, it appears that 457 plans offered by public sector employers work reasonably well because they are available to a broad cross-section of employees, and because public entities generally have the power to tax to secure the promise. Because most of our members work for associations that are small tax-exempt employers, they are concerned about tax incentives that favor for-profit employers or other segments of tax-exempt organizations, or that create tax disadvantages for small tax-exempt employers. The change in the law to prohibit tax-exempts from establishing 401(k) plans has had a significant impact as evidenced by the fact that in 1990 only 17% of ASAE members currently maintained a 401(k) plan. It is estimated that 49% of employers in the population at large offer a 401(k) plan to their employees. These disparities create an often insurmountable handicap to attracting and keeping qualified employees. It is also unfair that our members, the employees of associations, have to do their savings for retirement on a different basis than the employees of virtually every other type of employer.

CONCLUSION

ASAE strongly urges Congress to extend the availability of 401(k) plans to tax-exempt employers.

This would allow all tax-exempt employers the opportunity to offer salary reduction programs to all of their employees. It also would eliminate the disparate treatment between employees of private sector tax-exempt organizations and all other employers. Most importantly, it would help these employees save for their retirement.

Alternatively, ASAE would support extending the availability of tax-sheltered annuities to all tax-exempt organizations. ASAE stands ready to provide any assistance to the Subcommittee that it can in order to achieve this fair and equitable result.

PREPARED STATEMENT OF CAROL N. CAMPBELL

Good morning, I am Carol Campbell, Vice President and Treasurer at Carleton College in Northfield, Minnesota. I currently serve as Treasurer of the National Association of College and University Business Officers' Board of Directors. On behalf of the American Council on Education (ACE), the National Association of College and University Business Officers (NACUBO), the College and University Personnel Association (CUPA), and the Teachers Insurance and Annuity Association and the College Retirement Equity Fund (TIAA-CREF), I commend Senator Pryor and Senator Bentsen for their leadership in introducing legislation to simplify pension plan administration and to expand pension plan coverage to more American workers. ACE and the other higher educational associations that support this statement represent the majority of the nation's colleges and universities and independent schools.

Carleton College is a small liberal arts college with 623 employees. One of the many areas I oversee in my role at the College is its employee benefit program. During the last decade we have had to cope with numerous changes in the federal tax requirements for retirement plans. The most significant changes resulted from the Tax Reform Act of 1986 which applied nondiscrimination rules for the first time to the 403(b) retirement plans of colleges and universities. NACUBO, CUPA and TIAA-CREF have helped plan administrators like myself to get up to speed on these new, complex, and I must admit at times confusing, nondiscrimination requirements.

Let me stress that the higher education community believes that equitable pension benefits for all employees is an important public policy goal. However, complicated micro management of retirement plans burdens and frustrates employers and reduces the resources available to provide benefits to employees. Unlike the profit-making sector where 401(k) plans supplement defined benefit plans, the vast majority of employees in higher education are covered by defined contribution pension plans as their *primary* source of retirement income. This approach to retirement dates back to the early part of this century when pensions were a novel idea. In fact, during the debates surrounding the passage of the Employee Retirement Income Security Act of 1974, the pension plans of higher education were cited by Senator Jacob Javits for their leadership in pension design issues, especially vesting and portability.

Retirement plans in higher education were initially created to meet the needs of faculty at colleges and universities and have, over the years, been expanded to include support staff. Based on surveys completed by TIAA-CREF, pension plan coverage is virtually universal in the academic community. Almost 99% of *all* employees at four year colleges are offered pension plans. Through defined contribution retirement plans, colleges have a cost effective way of delivering more dollars in benefits with modest administrative cost. In contrast, Jim Lockhart, the Executive Director of the Pension Benefit Guaranty Corporation, stated that the costs of administering a 500-participant defined benefit plan increased 12.9 percent per year in the last decade. Extensive nondiscrimination testing magnifies the administrative cost of offering even straightforward pension programs. As a financial officer of a small college, an increase in cost greatly concerns me.

Carleton established its 403(b) retirement plan in 1970. Under the plan, the College has always contributed seven percent of salary for any eligible employee who contributed three percent of his or her salary. Because we offer the same plan to all employees, the College should easily comply with the 600-plus pages of nondiscrimination regulations issued by the IRS on September 12, 1991. Needless to say, we still need to study the regulations to make sure there are no surprises lurking in the fine print.

The Employee Benefits Simplification and Expansion Act (S. 1364) targets areas that are ripe for simplification. Of the numerous bills introduced by Members of Congress this session, S. 1364 most effectively addresses the burden of retirement plan administration. In addition, the bill simplifies the tax code as it effects individual taxpayers, making it easier for workers to understand the law and act responsibly with their pension benefits.

SIMPLIFYING THE 401(M) MATCHING TEST

We encourage the Finance Committee to extend relief to pension plans in which employees share in saving for their future security and to which employers make a substantial matching contribution or a minimum contribution for all employees. Design-based safe harbors offer a simple method of compliance yet assure equitable treatment for lower paid workers. The majority of defined contribution 403(b) pension plans at colleges and universities are contributory, fully vested plans. All but a handful of these plans provide at least a dollar-for-dollar match of employee elective contributions. Many, like Carleton's, provide an even greater matching contribution.

These voluntary defined contribution pension plans are designed to provide basic retirement benefits to workers in education. The 401(m) matching test duplicates, in most aspects, the Average Deferral Percentage (ADP) test under Section 401(k) of the Internal Revenue Code. 401(k) plans primarily supplement the basic pension benefits provided through defined benefit plans. Recent trends in pension plan design show an increasing preference for defined contribution pension plans, especially among mid-sized and small employers. Design-based safe harbors that require employers to offer fully vested matching contributions as a trade off for relief from administrative complexity provide short-term employees "real" benefits and will enhance pension portability.

For example, Carleton offers the same pension plan to all employees after one year of service. The College matches more than 200% of each participant's voluntary employee contribution. Yet to ensure that this plan passes the nondiscrimination tests, we must work our way through payroll data and various numerical tests. We have passed the 401(m) test for the last two plan years. However, we have no assured margin of comfort for future years and are at the mercy of external forces. A sudden turnover could cause the College's plan to fail the test. As hard as we try, it is difficult to convince young employees to participate in a pension at an early stage in their career.

Since the passage of the Tax Reform Act of 1986, colleges, universities and schools have struggled with the matching test under Section 401(m), with no specific regulatory guidance on how these requirements apply to 403(b) retirement plans. The notices published by the IRS offering safe harbors for 403(b) plans addressed only noncontributory plans and suggested a "good faith" standard for other areas of compliance. In the recently released final regulations covering nondiscrimination testing under Section 401(m) the IRS prohibited the use of restructuring for matching plans. Based on the experience of the last two years, many of the academic pension plans met the 401(m) test's current parameters but we have yet to access the impact of these latest changes. Some colleges have increased participation in their plans by reminding employees about the many benefits of joining the pension plan and other colleges have offered an across-the-board, base contribution (acting as a qualified nonelective contribution) for all employees of 3% or more.

The employer contributions required under S. 1364 would provide meaningful benefits. The 100% matching safe harbor would result in a total contribution of at least 6% for participants. The other safe guards of S. 1364 would prevent these plans from favoring highly compensated employees. Full and immediate vesting of employer matching contributions represents a significant enhancement to nonhighly compensated employees who make frequent job changes. No doubt for employers with high employee turnover rates this may represent a significant cost. The 403(b) plans at colleges and universities already fully vest benefits for all plan participants. The bill's written annual notice requirement would guarantee that employers inform employees about plan benefits and would result in broad participation.

Employers in higher education welcome the comfort that design-based safe harbors provide and the corresponding reduction in excessive administrative cost and burden. The flexibility in S. 1364 allows an employer to satisfy the safe harbor by either offering a significant match or by making a minimum contribution for all employees. Complying through a safe harbor would eliminate the massive collection of employee payroll data every year, greatly reducing administrative costs. Already the new layer of complexity imposed by numerical nondiscrimination standards has forced a number of educational institutions to add staff to collect data and test or to pay substantial sums to benefit consultants on a yearly basis.

Importantly, the safe harbor approach allows employers who want more flexibility to still test under the existing rules. Representative Rostenkowski has suggested replacing the existing 401(m) matching test. His bill, H.R. 2730, would use the average contribution percentage (ACP) for the nonhighly compensated employees in the prior year and limit the current contribution for each highly compensated employees to two times that ACP amount. While this proposal reduces the year-end uncertainty and eliminates adjustments to satisfy the 401(m) test, H.R. 2730 still requires extensive data collection and testing. By replacing the existing test rather than offering a statutory safe harbor, H.R. 2730 would involve costly reprogramming of testing and payroll systems.

ROLLOVERS AND TRANSFERS

A recent report to Congress on mandatory retirement in higher education conducted by the National Research Council cautioned, "In the context of ensuring an adequate pension income over time, allowing faculty to withdraw pension funds at or before retirement is less desirable. The Committee believes the goal of providing pensions for faculty members is to ensure a continuing standard of living in retirement. It believes colleges and universities can best achieve this goal by providing payments over the course of a retirement." We agree that preserving pension assets and guaranteeing lifetime income are crucial aspects of pension plans. In fact, the higher education pension system has offered a model for pension portability.

In recent years, some colleges and universities have introduced flexibility to allow plan participants to "cash out" all or part of their pension funds at retirement or termination. Several weeks ago Carleton's Board of Trustees formulated our response to requests from faculty members to allow lump sum distributions under the retirement plan. Initially, we planned to restrict the cashability to only employee contributions which amount to approximately 30% of each participant's account. The current partial rollover rules require that at least 50% of the participant's funds be rolled over. Thus the complications in tax code forced us to offer full lump sums, otherwise employees who chose to take the lump sum would not be eligible for a roll over. Consistent with our Board's belief that pension funds be preserved for retirement, lump sums are available after termination of employment and the attainment of age 55.

While a lump sum option transfers control over pension assets to the retiree to reinvest or to spend as he or she desires, it also passes on a responsibility. Statistics from the Employee Benefit Research Institute and the Department of Labor analyzing what happened to the $48 billion workers received in 1988 as lump sum distributions from pension plans are disturbing. The numbers suggest that workers may take this responsibility lightly. Inadvertent cash outs from the nation's pension system could weaken footings of a sound national policy that provides income for workers when their careers are over. Premature use of these assets might exert pressure on Social Security just when the baby boom generation begins drawing benefits.

Simplifying the rollover rules would provide relief for the individual taxpayer. Participants are often unaware of or may be wrongly advised about the current requirements for a triggering event or at least a 50% distribution for a partial rollover. At times employees fall unsuspectingly into a tax-trap. Allowing rollovers of any pension distribution, except amounts required under the minimum distribution rules, would preserve pension assets for their important and intended purpose. The approach in S. 1364 greatly simplifies the complicated rollover rules.

The direct transfer mechanism that Senators Bentsen and Pryor propose in S. 1364 addresses the concern former Labor Secretary Elizabeth Dole expressed for employees who spend their lump sum pension distributions on BMWs rather than save the funds for their future security. The benefit of compounding these lump sums in an IRA or other pension plan is significant and difficult to replace. For example, an employee who saved $2,000 each year in a pension plan between the ages of 31 and 40 and then terminated employment at age 40 could receive a $26,045 lump sum. If he or she preserves the money and just lets it accumulate until age 65 he or she could have an accumulation of $178,366 based on earning 8% annualized investment return. Unfortunately for the individual who elected the lump sum and spends it, even if the employer contributes $2,000 every year from age 40 until age 65 he or she would only replace $152,473 assuming the same 8% interest rate.

While S. 1364 would not prevent a terminating employee who wanted cash from taking it, the bill would put the brakes on any rash or inadvertent action by requiring the plan to transfer the money to an IRA or other pension plan. This is not a perfect answer, but this step would add an automatic delay and would give lump sum recipients more time to consider the full implications of their actions.

MINIMUM DISTRIBUTION RELIEF

Employees of colleges and universities who decide to continue working beyond age 70 have a difficult time reconciling the conflict that exists between social policy and tax policy. While eliminating the half-year from the starting age criteria would help, the individual taxpayer has more significant problems with the minimum distribution rules. Faculty and staff over age 70 are totally confused when informed that while the Age Discrimination in Employment Act as amended encourages them to stay in the workforce, tax laws require employees over 70½ to start income from the pension plans to which they still contribute. The complicated calculations and adjustments are performed manually and may take several weeks to finalize. Each year the taxpayer must start over again and reflect the prior years' contribution. The proposal in S. 1364 to limit the minimum distribution requirement to active employees who are 5% owners and to IRAs would apply more consistent public policies to workers over age 70. With the uncapping of mandatory retirement for tenured faculty, the level of confusion will increase unless Congress provides some relief.

DEFINITION OF HIGHLY COMPENSATED EMPLOYEES

We believe that the proposals to simplify the definition of highly compensated employees based on one indexed salary level would reduce the administrative burden and not target middle income employees unfairly. S. 1364 relaxes the requirement that tax-exempt employers have at least one highly compensated employee. This would ease compliance for 74 colleges that, according to the 1990-1991 CUPA CEO salary survey, have presidents who earned less than $61,000. Among midsized four-year colleges, the average salary for the highest ranking full professors is $45,000 a year. Most importantly, this provision will help the majority of independent schools with compensation levels well below these figures.

LEASED EMPLOYEES

We agree that the current historically performed test to determine if leased employees should be included in nondiscrimination testing is unworkable. Some colleges and universities have always contracted out their food service activities and an increasing number have done so in the last ten or more years. Under this type of contract, the educational institutions have no control or information on these employees. We concur that a control test is a more practical standard.

SMALL EMPLOYER PLANS

If the experience of the education community is any guide, reducing the complexity for small employers should achieve the goal of all the simplification proposals: expanding pension coverage for the nation's workforce. Most nonprofit colleges and universities are very similar to small employers: they cannot spend large amounts of dollars on plan administration and they seek to maximize every dollar to provide benefits for employees. Based on surveys completed by TIAA-CREF, pension plan coverage is virtually universal in the academic community. By 1980, 97% of four-year colleges employing 99.7% of all full-time faculty and administrative staff had retirement programs. The coverage status of clerical-service employees was equally impressive. 90.2% of institutions which employed 98.9% of clerical-service employees at four-year colleges offered retirement plans. The statistics for two-year colleges are comparable. These figures are significant when compared to the fact that only 55% of the nation's workforce is covered by a pension plan.

The fact that the 403(b) plans were simple and very inexpensive to administer and easy for employees to understand, encouraged and made possible the broad expansion of pension coverage in higher education. Keeping it simple works. Expanding Simplified Employee Pension Plans (SEPs) to a broader range of small employees or offering PRIME accounts to small employers, should result in expanding the nation's pension coverage.

SECTION 457 AND NONELECTIVE COMPENSATION

In recent years, Congress has passed legislation designed to protect the rights of older Americans who remain active in the workforce. Amendments to the Age Discrimination in Employment Act have uncapped the mandatory retirement age for the general workforce but allow an exception for tenured professors until 1993. The Committee on Mandatory Retirement in Higher Education which studied this issue for Congress released its report on May 21, 1991. The Committee found that the evidence did not support continuing the exemption for tenured faculty. They recommended the use of early retirement incentives as an alternative and urged institutions to consider using this important tool to ease the impact of uncapping. Realizing that such incentives pose special challenges for the defined contribution plans prevalent in higher education they recommend that "Congress, the Internal Revenue Service, and the Equal Employment Opportunity Commission permit colleges and universities to offer faculty voluntary retirement incentive programs that: are not classified as an employee benefit, include an upper age limit for participants, and limit participation on the basis of institutional needs."

Defined contribution retirement plans do not have the flexibility to incorporate early retirement incentives that defined benefit pensions offer. Because of the contribution limits under Section 415, there is no directly comparable action that a college's defined contribution pension can provide equivalent to adding five years of service to a defined benefit formula for early retirees. Generally, under a defined benefit plan additional years of service still fall within the limits of Section 415 while the actual funding for these incentive benefits is spread over several years. Defined contribution plans build-up retirement benefits by compounding contributions with interest over a working career. Funding an early retirement incentive under a defined contribution retirement plan typically involves purchasing an annuity. An increase in monthly pension income of $100 could easily cost $12,000 for an employee age 60. Even a modest incentive could exceed the 25% limitation $30,000 contribution cap under Section 415 for defined contribution plans. Colleges and universities cannot accelerate several years of contributions into their retirement plans as a voluntary incentive to encourage early retirement.

Prior to the Tax Reform Act of 1986 (TRA86), colleges and universities offered early retirement incentives as deferred compensation. TRA86 applied the limits under Section 457 to deferred compensation plans of nonprofit employers. In addition, the unfunded nature of Section 457 contributions prohibits private colleges and universities from using a 457 plan for the majority of their employees since ERISA requires funding for all but "top hat" plans. We suggest that the Finance Committee enact the provisions in H.R. 2641 that would amend Section 457 of the tax code so that the $7,500 limit does not apply to nonelective deferred compensation, as defined by the Secretary. We urge Congress, at a minimum, to specify that nonelective deferred compensation does not include early retirement payments.

PREPARED STATEMENT OF ELAINE CHURCH

Good morning. My name is Elaine Church. I am Chair of the Employee Benefits Committee of the Section of Taxation of the American Bar Association. I am testifying on behalf of the American Bar Association. Peter L. Faber, Chair of the Section of Taxation, regrets that he is unable to be here today. I am accompanied by Lou Mazawey, Chair of our Subcommittee on pension Legislation.

We are pleased to have been invited to testify on proposals to simplify the laws governing private pension plans. The American Bar Association has previously endorsed the importance of simplifying these rules and is pleased to cooperate with Congress in helping to reduce their complexity.

The Subcommittee has invited testimony on S. 1364, the Employee Benefits Simplification and Expansion Act of 1991. We commend you, Mr. Chairman, and Committee Chairman Bentsen, for your demonstrated interest in simplifying this important area of law and focusing the attention of Congress on the need to further expand pension coverage. In our testimony today, we review the overall objectives underlying these proposals. We will submit shortly technical and other comments on the specific proposals for consideration by the Subcommittee and staffs.

WHY PENSION SIMPLIFICATION IS OF PARTICULAR IMPORTANCE

There is widespread recognition that our tax laws are much too complex and that the provisions governing pens ions and other employee benefits are among the most intricate of all. Although there are legitimate reasons why the tax laws are complicated, the price of complexity in the pension area is particularly high. Some of the reasons are as follows.

First, the pension laws affect businesses of all sizes and Americans at all income levels. Many other areas of tax law complexity have a much narrower focus (e.g., the international tax area primarily affects large multinational corporations).

Second, complexity interferes with the achievement of the social policy objectives that underlie the tax incentives for retirement plans. Although the cost of added benefits is perhaps the major factor, there is a consensus that the difficulty in understanding the pension laws, and the need to hire various professionals and administrative service providers to establish and maintain a plan, is a significant impediment to the expansion of pension coverage among smaller employers.

Third, there is concern that covered workers often do not have a good understanding of their retirement plan and their rights and obligations under the plan. Although good communication is of obvious importance, the inherent complexity of the rules themselves contributes toward ill-informed participant decisions concerning enrollment in certain types of plans, the disposition of participants' accumulated retirement benefits, and other important matters.

Fourth, complexity makes it difficult for the Internal Revenue Service ("IRS") to administer the law and results in varying degrees of compliance by employers and individuals. This increases the administrative costs of employers, breeds disrespect for the tax laws, and undermines protections the laws were intended to afford covered workers.

We believe the tax and retirement policy arguments for pension simplification are compelling ones, and are pleased to strongly endorse your efforts.

RECOMMENDED FOCUS OF CURRENT SIMPLIFICATION EFFORTS

In our March 1990 testimony before this Subcommittee, we outlined a number of areas where it would be appropriate to focus statutory pension simplification efforts. The bill before the Subcommittee includes proposals in many of these areas. Our views on the scope of the pending proposals are briefly summarized below. We will submit technical comments separately.

Plan Distributions—Retirement plan distributions are subject to a variety of complicated requirements and limitations designed to achieve various tax policy goals. To encourage savings for retirement, the Code provides penalties for early distributions and encourages rollovers of such pre-retirement distributions. To encourage consumption during retirement rather than estate transfers, the Code includes minimum distribution rules which require payments to begin after age 70½. Overlaying these rules are a series of provisions which produce different tax treatment for different retirement distributions depending on the timing and form of distribution as well as the type of retirement plan making the distribution.

In our March 1990 testimony, we recommended scrutiny of the following five areas affecting the taxation of plan distributions: (1) the excess accumulations tax under section 4980A of the Code; (2) the basis recovery rules under section 72; (3) the rules regarding lump-sum distributions under section 402; (4) the rules regarding tax-free rollovers under section 402; and (5) the treatment of net unrealized appreciation in employer securities under sections 402(a) and 402(e).

All of the pension simplification bills address most of these issues, offering somewhat different approaches towards simplification. For example, H.R. 2370 would simplify the taxation of distributions by repealing 5 and 10-year averaging as well as the deferral of net unrealized appreciation. S. 1364, on the other hand, retains 10-year averaging and net unrealized appreciation. H.R. 2370 requires plans to offer a direct transfer option; S. 1364 requires that certain distributions be transferred to an IRA. Some of these provisions are controversial and we appreciate that revenue constraints as well as simplification objectives may force difficult choices. It is, however, important to ensure that these choices produce the desired result and ultimately permit the greatest possible flexibility for rollovers.

In addition, as we will discuss in our technical comments, we believe further simplification can be achieved with respect to minimum distribution rules.

Definitional Provisions—We agree that the definitions of "highly compensated employee" and "leased employee" need to be simplified. We believe it is possible to substantially improve the law in these areas without sacrificing the nondiscrimination goals that underlie these rules.

Nondiscrimination Rules—The backbone of the qualified plan provisions are the nondiscrimination rules for ensuring that qualified plans do not provide excessive benefits to highly paid employees. The bill proposes to simplify the nondiscrimination testing rules for section 401(k) and related contributions under retirement savings plans, primarily by providing alternative design-based tests.

This area highlights some of the difficult choices that confront policymakers in deciding whether the law should be simplified and how simplification should be achieved. For example, although complex, thousands of employers and administrators have incorporated the current nondiscrimination testing scheme of sections 401(k) and 401(m) into their plan documents and administrative systems. The IRS recently issued final regulations that generally impose workable requirements and provide a fair degree of flexibility to help sponsors pass the applicable tests. Any "safe harbors" that are layered on top of the existing scheme should be enacted only if consistent with the underlying nondiscrimination objectives.

Pension Access—Numerous studies indicate that millions of employees of small employers have no pension coverage. We believe that simplification in key areas will help expand coverage by making it easier for small employers to set up and run plans. The bill approaches this problem by modifying the nondiscrimination rules for salary reduction simplified employee pensions ("SEPs") to parallel the rules for section 401(k) and (m) plans (as they would be amended by the bill), and by removing the prohibition on section 401(k) plans for tax-exempt employers. We generally support efforts to expand pension coverage, although it is unclear whether SEPs are the most effective way to do so.

Revenue Neutrality—We appreciate that the tax-writing committees are constrained by the budget deficit and that changes in the tax law must meet "revenue neutrality" criteria. It is also important that pension simplification legislation not become a vehicle to raise revenues. It should be possible to address many areas of pension law within this framework.

RECOMMENDATIONS

We applaud your decision to make pension simplification a priority and urge that the Congress' efforts in this area continue on that basis. We think it is particularly commendable that the Finance Committee is examining this area without being confronted by a budget agreement that calls for more revenues. Past experience indicates that budget pressures have often resulted in troublesome benefits legislation—such as the pension funding limitations enacted as part of the 1987 budget legislation.

We understand that any simplification effort necessarily involves difficult choices. Simpler rules often are less responsive to particular, sometimes sympathetic situations. Everyone—the Congress, the Treasury, employers, employees and practitioners—must recognize the need to compromise. We also urge that any legislation in this area be kept as simple as possible. On numerous occasions, simple concepts have become needlessly complicated in an attempt to deal with remote abuses or narrow fact situations. The result has been added complexity, often without any offsetting gains in the fairness of the system. It would be extremely unfortunate if these commendable efforts were to make a bad situation worse.

Finally, in supporting pension simplification legislation, we are ever mindful of the need to avoid frequent changes in plan qualification rules. Assuming that meaningful simplification is produced by these efforts, we recommend that employers should have a reasonable amount of lead time for compliance, and that Congress resist the temptation to make further changes for a substantial period of time thereafter.

The Tax Section looks forward to working with you and your staff to help with the legislative process wherever our participation might be useful. Our goals are to maintain the essential soundness of the present system, while improving and simplifying it. We would be pleased to work with the Subcommittee to those ends.

Prepared Statement of Robert John Dodwell, D.D.

My name is Robert John Dodwell, and I have been a priest of The Episcopal Church for 32 years. I am Rector of Saint Anna's Episcopal Church in New Orleans, Louisiana, am a Trustee of The Church Pension Fund of The Episcopal Church, and have also served as President of the National Network of Episcopal Clergy Associations. I am proud of the Episcopal retirement program. We provide retirement benefits for all clergy and have recently mandated coverage of all lay employees.

I am grateful for the opportunity to testify in support of S. 747, the Church Retirement Benefits Simplification Act of 1991, and want to express my deep gratitude to Senator Pryor for sponsoring this bill, and also to Senator John B. Breaux of Louisiana, my Senator, for his help. For churches this is landmark legislation. It was developed over a period of more than four years, during which time representatives of Protestant and Jewish pension boards and the United States Catholic Conference spent countless hours examining and deliberating the needs of denominational retirement plans in the light of Internal Revenue Code provisions.

I was glad to see that you, Senator Pryor, and Senator Bentsen have made a significant beginning toward simplicity by the introduction of S. 1364, an important piece of legislation to reduce the unnecessary intricacy of the pension tax laws.

For many reasons the present complex rules in the Code do not fit church retirement plans. Much of the administration of Episcopal retirement plans is done at the local church level. Most churches do not have the funds to hire professionals to administer their retirement plans. The responsibility of administration lies with volunteer treasurers, who do not have the time or background to become familiar with complex pension tax lāw, which seems designed for large corporate conglomerates and not for churches.

We urge the passage of S. 747 as soon as possible. S. 747 would greatly reduce the administrative burden of complying with the tax law relating to church retirement plans. It would provide simple rules that are workable for churches. Thank you.

Prepared Statement of Matthew P. Fink

I am Matthew P. Fink, Senior Vice President and General Counsel of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 3,288 open-end investment companies, more commonly known as mutual funds, 214 closed-end investment companies and 12 sponsors of unit investment trusts. Its mutual fund members have assets of about $1.2 trillion, accounting for approximately 95 percent of total industry assets, and have over 36 million shareholders.

The Institute welcomes this opportunity to express its strong support for S. 1364, the "Employee Benefits Simplification Act."

I. INTRODUCTION

Mutual funds traditionally have served as vehicles through which investors channel their investment dollars into the nation's economy through a diversified, professionally managed pool of securities. Increasingly, mutual funds are also serving as 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 fund organizations provide ancillary services to retirement plans, such as recordkeeping and sponsorship of prototype retirement programs.

The Institute is pleased to express its strong endorsement of S. 1364, a legislative initiative that would simplify the complex and burdensome operational requirements applicable to employee retirement plans, including qualified retirement plans and SEPs. The complexity of these requirements has frustrated the attainment of two essential polfcy goals: (1) the expansion of coverage of retirement income plans to provide greater economic security for more Americans, and (2) the preservation of those retirement plan assets for retirement purposes.

In particular, the Institute applauds the provisions of the bill which would significantly enhance these policy goals through:

(1) expansion of the availability of salary reduction SEPs to small businesses;

(2) simpiification of the nondiscrimination rules applicable to 401(k) plans and salary reduction SEPs;

(3) promotion of pension portability through the use of the IRA; and

(4) liberalization of the current restrictions on rollovers of pre-retirement distributions to IRAs and qualified plans.

II. EXPANSION OF RETIREMENT PLAN COVERAGE

A. Expanded Use of Salary Reduction SEPs

Historically, the Institute has supported and encouraged the use of SEPs as the retirement plan vehicle through which employers not currently maintaining retirement plans could be encouraged to provide retirement income for their employees. Thus, the Institute actively supported the legislation first establishing the SEP in 1978, as well as legislation which simplified the SEP in 1986.

For this reason, we endorse the approach taken under Section 307 of the bill that would retain the basic structure of the SEP and the salary reduction SEP. Because of its simplicity and ease of administration, the current SEP is an attractive vehicle for employers not currently providing retirement plan coverage, who may be deterred by the complexity and expense involved in qualified plan adoption and administration. when combined with a salary deferral feature, the SEP is particularly attractive to such employers because of the additional flexibility and reduced costs offered by such a program.

Financial institutions marketing salary reduction SEPs can use a simple prototype form designed by the sponsor and preapproved by the IRS. Once an employer adopts a salary reduction SEP, covered employees can establish their own separate IRA accounts. Employees are free to choose any financial institution offering IRAs as the funding vehicle for their SEP account, and are free to move their accounts to another financial institution upon notification to the employer. Minimal reporting and disclosure obligations are imposed, and, because of the limited employer investment discretion, most of ERISA's Title I fiduciary responsibility provisions remain inapplicable.

Because the salary reduction SEP has substantial appeal to the market that is in most need of increased retirement plan coverage, Section 307(a) of the bill, which would make salary reduction SEPs available to employers with 100 or fewer employees, represents a significant step toward the goal of increased retirement plan coverage. The flexibility and ease of administration offered by a salary reduction SEP makes it most attractive to the small employer market.

According to a Bureau of Labor Statistics survey, one of the major distinctions between the small employer, one with 100 or fewer employees, and larger employers is in the retirement plan area. As of 1990, only 43 percent of these smaller companies offered a retirement plan, as compared with 81 percent of the larger companies.[1]

Moreover, the percentage of the total workforce employed by businesses with 100 or fewer employees is substantial. A Department of Labor study found that approximately 41 percent of the full-time private wage and salary labor force, an estimated 33 million workers at the end of 1991, are employed in firms with fewer than 100 workers. These firms represent 98 percent of American businesses.[2]

B. Simplification of Non-Discrimination Rules

The Institute also strongly supports the provisions of the bill (Sections 105(a) and 307(d)) that would simplify both the 401(k) and the salary reduction SEP nondiscrimination rules, respectively. The complexity of these rules has contributed significantly to the burden of plan administration, thereby discouraging employers from installing 401(k) and SEP plans. Easing these burdens will promote greater retirement plan coverage.

With respect to the nondiscrimination rules applicable to salary reduction SEPs, the Institute particularly welcomes the approach taken in the bill that would allow a design-based safe-harbor to satisfy nondiscrimination requirements. By contrast, current law seeks to achieve nondiscrimination in benefits under a salary reduction SEP through the use of minimum participation rules and the application of an average deferral percentage (ADP) test to ensure that highly compensated employees will not receive a disproportionately greater share of the plan's benefits than non-highly compensated employees. At least 50 percent of the eligible employees must participate in the plan, and employers must periodically ensure that the deferral percentage of each highly compensated employee is not more than the ADP of all non-highly compensated employees multiplied by 1.25.

In lieu of these often complex and cumbersome calculations, the bill provides alternative non-discrimination safe harbors satisfied through a mandatory employer matching contribution. An employer could simply provide dollar-for-dollar matching

[1] M. Rowland, "A Benefit Small Business Can Afford," *The New York Times,* June 23, 1991.

[2] Statement of Secretary of Labor Lynn Martin on the Administration Proposed Pension "Power" Plan, April 30, 1991 (hereinafter referred to as "Martin Speech").

contributions of up to 3 percent of compensation, with a 50 percent match for elective deferral contributions between 3 and 5 percent of compensation. Under another alternative, a plan could specify other design based safe-harbor matching contribution rates, provided certain conditions are met. In our view, there is good reason to believe that this matching contribution requirement, which may be incorporated as a feature of plan design not requiring periodic compliance testing, will result in sufficiently high participation rates to satisfy any nondiscrimination concerns.

Direct support for the nondiscrimination rules proposed by the bill can be found in a recent study of 401(k) plans by the General Accounting Office. The report is one of two comprehensive studies of 401(k) plans prepared by the GAO on the basis of a 1986 survey of 5,000 corporations. Respondents represented 9.9 million employee-participants in 401(k) plans. The report found that the participation rate for plans in which the employer provided contributions matching those of employees was 88 percent, while the participation rate for plans without matching contributions was less than 50 percent. The GAO concluded that "[f] or plans where the employer matched employee contributions dollar for dollar, the average participation rate was 99 percent of those eligible." [3]

In summary, we believe that if the expanded salary reduction SEP coverage and non-discrimination safe harbor provisions of S. 1364 are enacted, financial institutions, such as mutual funds, will be encouraged to more actively market salary reduction SEPs. The potential impact of such an increase in marketing activity should not be underestimated.

III. PRESERVATION OF RETIREMENT PLAN ASSETS FOR RETIREMENT

A. Portabi!ity of Retirement Saving

The portability of retirement plan assets is an important policy goal. Because of the increased mobility of the American workforce, few employees stay with any single employer long enough to build up adequate retirement benefits. According to a recent Labor Department study, one in five Americans changes jobs each year and one in ten changes careers. Some predict that the average worker will soon hold up to 10 jobs during his or her career.[4]

In addition to permitting employees to transfer assets from one retirement vehicle to another when job changes occur, portability helps to reduce pre-retirement consumption of retirement plan assets. Department of Labor statistics for 1987, the last year for which data are available, show that approximately 1 million individuals under the age of 55 received lump sum distributions from private and public pension plans during that year. Only 13 percent of these individuals rolled any part of their distribution into an IRA or other retirement plan.[5]

Moreover, recent statistics indicate that many future retirees will not have adequate retirement savings. Even though, a decade after they retire, most retirees will need more income than they earned while working to maintain their standard of living,[6] few are meeting this challenge.

For this reason, we strongly support the provision of the bill (Section 202) that would deter pre-retirement consumption of retirement benefits by requiring employees to directly transfer their pre-retirement plan distributions to an IRA or another plan upon separation from service. We believe that this provision will significantly reduce the level of premature consumption of retirement plan distributions that exists today.

We further concur enthusiastically with the bill's selection of the IRA as the appropriate portability vehicle for non-plan-to-plan transfers of pre-retirement distributions. The IRA is an existing, simple portability vehicle which can be used to accomplish the objectives of pension plan portability and the preservation of retirement plan assets.

B. Liberalization of Rollover Rules

The unrestricted ability to rollover a pre-retirement distribution from a retirement plan to an IRA or another plan is also critical to the portability of retirement

[3] "401(k) Plans, Participation and Deferral Rates by Plan Features and Other Information," Fact Sheet for the Ranking Minori'y Member, Special Committee on Aging, U.S. Senate, GAO/PEMD-88-20FS, April 29, 1988.

[4] A. Crenshaw, "The Case for Automatic Rollovers," *The Washington Post,* May 20, 1990, p. H.15.

[5] U.S. Department of Labor, "Pension Facts," publicly available April 30, 1991 accompanying Martin Speech, *supra,* note 1.

[6] E. Becker, "Retirement Plans That Could Fall Short," *The New York Times,* Sunday, May 27, 1991, p. F11.

plan assets and the preservation of these assets for retirement. Existing rules which restrict the rollover of certain pre-retirement distributions encourage current consumption rather than saving.

Under current law (Code section 402(a)(5)), the rollover of distributions from a qualified plan made on account of the employee's separation from service or another qualifying event is permitted only if such distribution (i) equals at least 50 percent of the balance to the credit of the employee under the plan and (ii) is not part of a series of periodic payments. These rollover restrictions deter retirement saving without serving any valid policy objective.

The Institute supports the provisions in Section 201 of the bill that would eliminate these rollover restrictions and thereby expand the universe of pre-retirement plan distributions which may be rolled over and preserved for retirement. We also recommend that the current law prohibition on the rollover of employee after-tax contributions be eliminated as well. The ability to rollover these additional amounts should further increase the amount available to an employee at retirement.

On behalf of the Investment Company Institute, I would like again to thank the members of this subcommittee for the opportunity to present this testimony.

PREPARED STATEMENT OF ROBERT FOX

Mr. Chairman and members of the Subcommittee on Private Retirement Plans, my name is Robert Fox. I am the Executive Director of The Cultural Institutions Retirement System. The Cultural Institutions Retirement System ("CIRS") is the plan sponsor of a multiemployer 401(k) savings plan, defined benefit pension plan as well as group life insurance plan for over 7,500 active employees from over 350 tax-exempt cultural institutions and day care centers in the New York City area.

I also serve as the Chairman of the National Assembly's Pension Plan Committee and am pleased to be here to testify on The Employee Benefits Simplification and Expansion Act introduced by you on June 25, 1991. Some of the nation's largest charitable organizations join me in supporting your efforts to simplify the rules for plan sponsors to administer retirement plans as well as expand the availability of pension plans. The National Assembly of National Voluntary Health and Social Welfare Organizations represents numerous voluntary human service organizations whose missions focus on Americas most precious resources: its people. The Assembly's member organizations are vital employers in the private sector of the economy who serve our citizens of all ages, colors and backgrounds throughout the 50 states. A complete list of member organizations is attached as Exhibit A.

The Pension Plan Committee was created in 1978 after the establishment of ERISA. The Committee is a voluntary association of the member organizations with retirement programs who meet regularly to exchange ideas, monitor the pension environment and represent the retirement plans for non-profit organizations. We are pleased to be able to share some of our thoughts about the Simplification Bill. We are encouraged by this first step toward simplification and appreciate the leadership role you have taken in this process.

From our perspective as tax-exempt employers, the steps outlined in S.1364 to reduce the costs to plan sponsors of administering retirement plans are sorely needed. Design-based safe harbor requirements for satisfying testing of contributions to 401(k) plans, the determination of annual cost-of-living adjustments based on the quarter ending September 30 as well as the elimination of the half-year age requirements for calculating plan provisions are straight-forward, common sense changes to help plan sponsors administer their various retirement plans. The changes contained in the bill to eliminate complex pension rules will help our organizations in two ways. First, as plan sponsors we can offer our dedicated employees sensible, cost-effective retirement plans without needlessly burdening our administrative staffs. Second, as providers of a vast array of human services, every dollar we can save in mandated administration of pension plans can be translated into a dollar for programs. Every sector of the economy will benefit from the Simplification Bill. But the bottom line for tax-exempt organizations will be more money for programs.

The following will discuss areas of the Simplification Bill that we support and others you may want to consider as enhancements to the policies contained in S.1364:

*Minimum Distribution Rules

We applaud the common sense approach contained in the Bill to correct and modify Section 401(a)(9) of the Internal Revenue Code (the "Code") as amended by The Tax Reform Act of 1986. Those provisions first effective as of April 1, 1990 are very complex and are difficult to explain to plan participants. Plan sponsors have been relying upon their own interpretations of these rules in order to comply with this regulation. Worst of all the Internal Revenue Service (the "IRS") has not issued final regulations.

The human service organizations that make up the National Assembly have many non-highly compensated employees, as that term is defined for purposes of the Code's pension plan discrimination rules. Some of our employees choose to work beyond normal retirement ages. Requiring minimum distributions after age 70 1/2 forces non-highly compensated employees to receive now the pension anticipated to be needed for retirement.

The majority of our members of age 70 1/2 or more were employed by our organizations later in their lives. Many of those members were employed after completing other work careers. For others who come to our organizations after raising families and who have not had a full working career before joining our organization, our pensions represent the only private retirement plan coverage they will ever receive.

Salaries are generally low in these fields. Combine low salaries and short service and it is hard to rationalize the forced payment of accrued pensions from our organizations under the 70 1/2 rules. The minimum distribution rules proposed in the Simplification Bill S.1364 will strenghten the retirement protection our plans were intended to provide.

*Definition of Highly Compensated Employee

The Simplification Bill will provide relief for many non-profit organizations who have been faced with a difficult situation because of the current nondiscrimination requirements of the law. Many National Assembly organizations have branches throughout the United States. Those branches are run by directors who we believe are not "officers" under the Code but may be interperted by the IRS to be officers. In the event an organization has an 'officer', plan sponsors will have to implement costly discrimination testing at multiple locations. The outcome of such testing could result in cutbacks of benefits for the so-called highly-compensated employees.

We believe the Simplification Bill's proposal to exempt non-profit organizations from the one Highly Compensated Employee rule for non-discrimination testing is a valid exception due to the unique employment structure adopted by our members.

*Access to 401(k) Plans

The non-profit community is gratified that the Senate Finance Committee has finally provided for the availability of cash or deferred arrangements under Section 401(k) of the Code.

The fairness and equity arguments that embodied the comprehensive provisions of the Tax Reform Act of 1986 failed to answer the questions raised by members of the tax-exempt community on why 401(k) plans have been limited. 501(c)(3) organizations may offer employees the opportunity to participate in tax deferred annuities under Section 403(b). However other tax-exempt organizations are unable to make either 403(b) or 401(k) savings plans available to their employees. Section 457 arrangements do not provide employees of tax-exempt organizations with the same protections and broad rank and file coverage as plans that meet the standards of qualified 401(k) plans.

The Simplification Bill combined with the support of the Treasury Department will permit all tax-exempt organizations to maintain qualified cash or deferred arrangements, and eliminate the inequities of current law.

*Enhance Portability

The bill should expand the goal of portability by permitting qualified plans to accept transfers or rollovers from other savings and retirement vehicles. The reason is to permit employers both in the for-profit as well as non-profit sectors to attract and retain employees. In the tax-exempt community many employers sponsor tax deferred annuities as the most common form of retirement plan. These type of plans are maintained under Section 403(b) of the

Internal Revenue Code. If a participant in such a plan moves to a job with a for-profit employer who maintains a 401(k) plan, under present law, the new employee can not transfer his 403(b) account into the 401(k) plan. Likewise, if the employee left his previous employer and rolled over that 403(b) distribution into a rollover IRA, he could only roll that money back out into another 403(b) plan.

The Employee Benefits Simplification and Expansion Act of 1991 should rationalize the confusing rules for keeping retirement money separate and distinct. Distributions made from plans under Sections 401, 403 and 457 should be able to be transferred into other savings and retirement plans. This will help portability in the private for-profit, public and tax-exempt sectors of the economy.

Additionally, we support the provisions of S.1364 which would allow a participant or surviving spouse to "roll-over" any portion of a taxable distribution from our plans to an IRA or another qualified plan. In some cases a recipient may receive a distribution which is less than half of his or her interest in a plan. Under current law this requires immediate taxation and encourages immediate consumption. We support every effort on the part of our participants to continue to save for retirement. They should be encouraged to put any and all of their distributions from our plans into other retirement vehicles, and the rules should be simplified so they do just that.

*Transfers of Pre-Retirement Distributions

The Simplification Bill seeks to encourage portability of pre-retirement distributions from qualified plans by transferring distributions over $500.00 to another qualified plan or to an Individual Retirement Account ("IRA").

We endorse the principle of encouraging portability but wonder if the goal will create unforeseen consequences. We do not really know how a plan trustee will designate a transferee plan where the employee does not make a designation or where transfer to the designated plan is not practicable. Could the plan trustee's decision be questioned as being prudent under ERISA's standards for fiduciaries? How would the plan trustee be able to verify that the employee selected a respectable service and investment provider? For these reasons we are concerned that there will be significant adminis-trative problems that will not be offset by a significant increase in retirement savings.

However, if mandated transfers are implemented the Simplification Bill might want to look at the $500.00 threshold. The dollar limit should be raised to $3,500.00 and over in order to make this distribution amount consistent with other required lump sum distributions from qualified plans and simplify the administrative burden on plan sponsors.

*Correct Section 457 Plans

The Employee Benefits Simplification and Expansion Act of 1991 should finally address the long standing argument made by members of the public and tax-exempt sectors that the Tax Reform Act of 1986 which amended Section 457 be once and for all corrected. It is our hope that the bill will clarify that Section 457 will not apply to nonelective deferred compensation.

In 1987 the IRS informed non-profit employers through Notice 87-13 that nonelective retirement pay plans fell under Section 457. This interpretation of the Section 457 rules results in situations where individuals are taxed currently on amounts which they have not yet received, never have had the right to elect to receive, and may not actually receive in the future.

Some tax-exempt organizations offer nonelective deferred compensation plans to recruit employees due to their inability to be able to pay that individual a market rate salary. In lieu of paying that higher salary the organization offers the employee nonelective deferred monies if he or she satisfies certain service requirements before leaving or retiring.

The current Section 457 rules however, require the organization to immediately recognize the total value of the "deferred" compensation as taxable income. The employee is then taxed on that total "deferred" compensation in the current year even though the individual has not satisfied the service requirement. Most important the employee has not even received any of the "deferred" compensation.

The unfairness in the current rule highlighted in the above example deserves consideration. For-profit employers are not held to same standard. We believe employees of tax-exempt and taxable employers should be treated the same in the area of nonqualified, nonelective retirement pay plans. We hope that the Simplification Bill S.1364 can provide for such equity.

I want to thank you for this opportunity to share our thoughts about the Employee Benefits Simplification and Expansion Bill of 1991. The National Assembly Pension Plan Committee is pleased the members of the Senate Finance Committee have proposed this legislation. As representatives of tax-exempt employers we will make ourselves available to your staff to provide additional advice. We hope that you and your colleagues in the House of Representatives will be able to fashion an accord that will produce the best simplification legislation. I am available to answer any questions.

The National Assembly

Exhibit A

American Association of Homes for the Aging
American Camping Association
American Red Cross
Association of Jewish Family and Children's Agencies
Association of Junior League International
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys & Girls Clubs of America
Camp Fire
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Evangelical Lutheran Church in America (Division for Social Ministry Organizations)
4-H, Extension Service
Family Service America
Girl Scouts of the USA
Girls Incorporated
Goodwill Industries of America
Joint Action in Community Service
Junior Achievement, Inc.

National Association of Homes and Services for Children
The National Council on the Aging
The National Crime Prevention Council
National Mental Health Association
National Network of Runaway and Youth Services
The National VOLUNTEER Center
The Salvation Army
Travelers Aid International
United Seamen's Service
United Way of America
Volunteers of America
WAVE, Inc.
Women in Community Service
YMCA of the USA
YWCA of the USA, National Board

Prepared Statement of Senator Charles E. Grassley

Chairman Pryor, I am glad to see you back at work in the Senate and I thank you for calling this hearing on the very important topic of pension law simplification.

Our overall policy goal in this area has to be to help maximize the retirement income of American workers. Anyone who has concentrated on public policies for older Americans, as I have over the years, realizes that the problems that some of them face are often caused by insufficient income. Often this is true even though they worked all of their lives prior to retirement.

Private, employment-based pensions are a very important means of insuring that workers have an adequate level of retirement income.

Unfortunately, we don't seem to be making progress in this area. Private pension coverage, once over fifty percent, has slipped to 46 percent of the work force. According to the Congressional Research Service, there has been almost no growth in the number of participants in defined benefit pension plans since E.R.I.S.A. took effect in 1975. Terminations of defined benefit plans out-numbered new plans by 3 to 1 in 1989.

Providing pension plans for workers is particularly difficult for small employers. According to the Employee Benefit Research Institute, only 18 percent of employers with less than 25 employees have plans, and only 53 percent of employers with 25 to 99 employees have such plans.

It is clear that we have a consensus among interested parties to the effect that one important source of the decline in pension plan growth lies in overly complicated pension law. It also seems clear that this complexity in particular discourages small employers from offering pension plans.

As we will hear today from one of my constituents, Mr. Larry Zimpleman, of the principle financial corporation, most of the small employers with which the principle works simply cannot administer their pension plans without outside expert help, which can be very expensive. This is just unreasonable.

Much of this complexity is caused by rules designed to prevent discrimination in favor of highly compensated employees. As we move ahead on our simplification project, we do need to keep this in mind. I think all of us will agree that tax-favored pension plans should not discriminate against non-highly compensated workers.

In any case, we have moved to the point in this debate at which we have some good legislation to consider and perhaps make even better. I hope that this committee will be able to move this year on this legislation, Mr. Chairman. And if we can't do it this year, it should be one of our highest priorities next year.

Before I finish, I just want to introduce two of our witnesses, both from Iowa, and both very knowledgeable in the pension area.

One I already mentioned—Mr. Larry Zimpleman, second vice president for pension operations at the Principle Financial Corporation. Mr. Zimpleman will be able to tell us about a survey conducted among some of their small business clients on the problem of pension complexity.

The second is Mr. Tom Walker, the president of Associated Benefits Corporation, who is representing the Association of Private Pension and Welfare Plans today on our third panel. Mr. Walker has a lot of experience in the pension field. His firm represents over 200 small agricultural employers with over 8,000 participants in defined benefit and defined contribution plans, and I think this gives him a good perspective on pension simplification.

PREPARED STATEMENT OF KIE D. HALL

INTRODUCTION

Mr. Chairman and members of the Subcommittee, I am Kie Hall, Executive Director of the Arkansas Public Employees Retirement System based in Little Rock, Arkansas. This retirement system has over 48,000 members (37,500 active/10,500 retired) who are school employees and state, county and city employees. The average monthly retirement benefit is $424. These individuals spend an average of 16.5 years working for employers that participate in this multiple employer system.

I am delighted to appear before you today to offer the views of a number of state and local government organizations and public unions concerning the various proposals currently before the Subcommittee to simplify our nation's pension tax laws and facilitate access to retirement benefits.

While there are several items of interest to state and local government plans contained in the legislation that is the subject of today's hearing, perhaps none is as important as the provision contained in S. 1364 that addresses public pension plan compliance with Section 415 of the Internal Revenue Code (IRC). Therefore, before I offer specific comments with regard to the pending legislation, I believe that it would be very worthwhile to briefly review the overall history and purpose of Section 415, and place this within the context of public retirement systems.

History of Section 415

Section 415 of the IRC places both a dollar as well as a percentage-of-pay cap on the amount that an individual can receive annually in the form of an employer-provided pension that has been accumulated in a tax-deferred setting. The dollar limit for 1991 is approximately $108,000 at normal retirement age (62 for public employees), but is actuarially reduced for early retirement. For example, it is about half this amount if retirement occurs at age 50. The percentage-of-pay cap, often referred to as the "100 percent rule," is equal to an individual's average annual compensation based on his/her three highest consecutive years of pay.

Section 415 was adopted as part of the Employee Retirement Income Security Act of 1974 (ERISA) with the goal of limiting the ability to accumulate retirement income on a tax-favored basis. As the Subcommittee may recall, Congress had become concerned that highly-compensated private-sector individuals were building up tax-sheltered and tax-deferred balances in retirement plans that bore no reasonable relationship to retirement needs and were abusive.

As the Ways and Means Committee Report accompanying the landmark 1974 legislation explained:

> "...it is not in the public interest to make the substantial favored tax treatment associated with qualified retirement plans available without any specific limitation as to the size of the contributions or the amount of benefits that can be provided under such plans. The fact that present law does not provide specific limitations has made it possible for extremely large contributions and benefits to be made under qualified plans for some highly paid individuals. While there is, of course, no objection to large retirement benefits in themselves, your committee

believes it is not appropriate to finance extremely large benefits in part at public expense through the use of the special tax treatment."

Effect on State and Local Government Retirement Systems

Thus, Section 415 was aimed at a very specific problem: The use of tax deferrals and deductions by a few highly compensated individuals and their employers in the private sector to finance extremely large retirement benefits. There is no indication in the legislative history of Section 415 that this was an abuse that was also taking place in the public sector - - and for good reason. Consider the following.

o There is little, if any, opportunity in most governmental plans for the relatively few highly compensated public employees to accumulate a benefit wholly disproportionate to their salaries.

Unlike the private sector, where the employer and the highly-compensated employee can sit down and privately negotiate the terms and amount of the employer-provided benefits package, the plans of governmental employers are sponsored and maintained by a State or local government, with all of the constitutional perquisites, regulatory apparatus and voter accountability that this implies.

For example, for virtually all public plans, benefits are prescribed by statute. This means that they must be proposed by elected officials; be subjected to lengthy hearings and other public debate; become the focus of often intense media scrutiny; be passed by majority vote of a legislative body; and be signed into law by an executive officer. The ability of public plans to provide disproportionate benefits is obviously constrained by the political realities inherent in having to pay in part for retirement benefits out of the taxpayer's dollars.

o In a defined benefit plan -- which is the kind of plan used by the vast majority of public employers -- the retirement benefit is based on a formula that is tied in part to salary. It is therefore virtually impossible for a public employee to receive an abusively high employer-provided retirement benefit in relationship to his or her salary.

As this Subcommittee knows, there is simply no comparison between the salaries of even the highest-paid public employees and the CEO's of corporate America. For example, according to a June, 1990 issue of "Industry Week," recent studies have found that in 1989, the average CEO of the nation's 100 largest companies took home $1.4 million in base salary and bonuses alone, while CEO's of mid-sized companies ($200 million to $5 billion in sales) drew down a healthy $900,000 on the average.

Once again, taxpayer accountability imposes a very real cap on State and local government salary and related retirement benefits.

o Private-sector employers receive a significant tax subsidy for the contributions they make to their retirement plans. This tax advantage is a major

> factor in the funding decisions made by a private-sector plan sponsor and has a direct impact on federal revenues.
>
> Indeed, as the Ways and Means Committee report noted in 1974, the 415 limits were adopted "to avoid abuse of the favored tax treatment to finance extremely large pensions."
> On the other hand, governmental employers are not taxpayers, and therefore do not receive a tax deduction for the contributions they make to public plans. Their funding decisions are not motivated by tax considerations, and their funding decisions do not have the same impact on federal revenues as do those of private sector employers.

Therefore, given the fiscal realities and the other political constraints noted previously, there is very little chance that the problems at which Section 415 is targeted did -- or ever can -- arise in the public sector. Nevertheless, State and local governments must comply with Section 415 or face severe penalties. For example, if a pension plan permits even one of its participants to earn a pension that exceeds by any amount, however small, the lower of the two Section 415 limits for that participant, then the Internal Revenue Service (IRS) is authorized to "disqualify" the entire plan.

Disqualification means that the earnings on a pension plan's assets would lose their tax-exempt status. In addition, each plan participant's vested interest in such assets would lose its tax-deferred status, and would have to be taken into the participant's income in one lump sum in the year in which the plan was disqualified.

Simplification: A Section 415 Remedy

Mr. Chairman, the private sector employer can change his or her pension plan's structure without having to go to the trouble of passing a State law or local statute. The private sector employer can even modify the benefits that have been promised employees and retirees. However, we in the public sector are much more constrained in our ability to make such modifications.

Not only do changes in our plan benefit formulas and other design features require a lengthy public process and possible modifications of important State policies, but we are often constrained by our Constitutions or case law from reducing a benefit once it is promised an employee due to prohibitions on impairment of contracts. Approximately 21 states, including Arkansas, and numerous localities have either constitutional or statutory restrictions prohibiting the diminishment of benefits. (See Attachment A.)

Public plan compliance with Section 415's limitations, as it is currently drafted, poses legal and administrative difficulties for state and local governments because of the unique differences between public and private pension plans. State and local government employers, working with public employee unions, have crafted a remedy that upholds the spirit of Section 415 but allows states and localities to meet the benefit promises made to employees.

It is for these reasons that the four-part remedy to our unique problems with Section 415, contained in S. 1364 and its companion in the House, H.R. 2742, is so important and so necessary.

The Four-Part Remedy

Part One. The definition of "compensation" for the purposes of Section 415 testing of public pension plans will be expanded to include employer pension contributions made through the employer pick-up option (414(h)), as well as employee contributions to salary deferral plans such as those offered under Sections 457, 403(b) (tax-sheltered annuities), 401(k), and 125 (flexible spending accounts or cafeteria plans).

These amounts are often included as annual compensation in the public pension plan's computation of an individual's pension benefit, but are required to be excluded when the Section 415 percentage-of-pay limit is determined. The result can often be an average annual compensation amount for testing purposes that is substantially less than the pension plan's average, which in turn produces a benefit that exceeds the 415 limit.

Part Two. Public-sector employees tend to be longer-tenured and lower-paid than their private-sector counterparts. For example, it is not unusual to find public employees with 40 years of service. Because public plan benefit formulas often reward this length of service, the consequence can be a pension benefit that, while not large in absolute dollar terms, can exceed 100 per cent of the individual's high three-year average compensation. This can still occur even if the definition of compensation is changed as proposed in the bills. Therefore, the bills provide that the percentage-of-pay component of the Section 415 limit test will not apply to governmental plans. However, the Section 415 dollar limits will remain.

Part Three. ERISA provides private-sector employers with the ability to maintain "excess-benefit" arrangements, to be used solely for the purpose of providing benefits for certain employees in excess of the limits on contributions and benefits imposed by Section 415 on qualified pension plans. These excess plans are not "qualified," and thus, any amounts placed in them are not treated as deferred; they count as currently taxable income to the employee. Excess plans provide the ability for a private-sector employer to pay a benefit that exceeds the 415 limits without subjecting the private-sector employer's pension plan to disqualification.

Public pension plans have no similar "safety valve" to avoid disqualification. This remedy would therefore extend the same concept to governmental employers while recognizing the unique differences between public and private-sector plans. Specifically, the bills would permit a governmental employer to establish an excess-benefit arrangement. However, its use would be limited solely to providing benefits in excess of the 415 caps for the limited number of employees whose benefits happen to exceed the 415 limits simply by operation of the regular benefit formula of the plan. In effect, the excess-benefit arrangement would serve as an "overflow" device to permit the plan to pay benefits guaranteed under the plan--thereby avoiding the problem of violating state anti-cutback rules--without, in so doing, subjecting the plan to IRS disqualification.

The bills make clear that this excess arrangement is expressly not a new form of salary deferral that a public employee can elect to utilize. While the bills provide that the public pension plan will maintain its tax-exempt status with regard to the investment earnings of any funded excess-benefit arrangement, they also specifically provide that, as with the private-sector employee, such funding will not be deferred, and will therefore have to be taxable on a current basis to those employees who will receive a part of their benefit from an excess plan.

Part Four. Survivor and disability benefit payments can often exceed the Section 415 limits because these payments typically are paid to an employee who is disabled long before normal retirement age, and are therefore subjected to limits that are actuarially reduced from age 62 to the age of the recipient at the time of injury. However, such benefits are usually not paid out of the pension plan in the case of private-sector employers, but are instead more commonly provided through a disability insurance policy. Such disability benefits are therefore not subject to the 415 limits.

In the public sector, however, the tendency is toward self-insurance, with the disability benefit paid out of the pension plan. As such, it is subject to Section 415, even though the actual amount may be far less than that paid out in the private sector. These proposed bills would therefore exempt public pension plan survivor and disability benefits from the Section 415 limits.

Additional Provisions

In a good-faith effort to comply with Section 415 and avoid disqualification, some public plans have elected a grandfathering option provided by a "Special Rule for State and Local Government Plans" contained in Section 415(b)(10). However, the changes contained in these pending bills may be more equitable for both plan sponsors and plan participants than grandfathering. Therefore, those governmental plans that elected to grandfather will be given an opportunity to reconsider and revoke the election if it is more beneficial for them and their participants to do so.

The bills' changes in Section 415 for public pension plans will be prospective, thereby providing a means to avoid disqualification in the future. However, it is possible that some governmental plans may have inadvertently failed to comply with 415 limits in years past. Thus, it would arguably be possible for the IRS to disqualify such a plan even if it were currently in compliance. In the spirit of the grandfather rule previously approved by Congress and providing for a "fresh start," the proposed bills would also provide that governmental plans will be deemed to have been in compliance with 415 for all years prior to enactment.

CLOSING COMMENT

Mr. Chairman and members of the subcommittee, states and localities have made a good faith effort to develop a Section 415 compliance remedy which retains the spirit of the law while permitting public retirement systems to meet the promises made to employees and pensioners. The Committee on Joint Taxation reviewed the proposed four-part remedy in June 1991 and found it to have a "negligible" impact on federal revenues (see Attachment B). These provisions merit passage this year in the Committee's tax simplification package. I am available for questions. Thank you for this opportunity to address the Subcommittee.

Questions concerning this testimony should be directed to Cathie Eitelberg, Director, Government Finance Officers Association's Pension and Benefits Program, 1750 K Street, N.W., Suite 200, Washington, DC 20006, (202)429-2750.

Attachment A

TAX BILLS: SEC. 415 LIMITS ON MAXIMUM RETIREMENT BENEFITS

Twenty-one states presently have state constitutional, statutory or case law that could be interpreted to protect against reduction of benefits under a contract.

Alabama

Arizona

Arkansas

California

Colorado

Delaware

Georgia

Illinois

Kansas

Maine

Massachusetts

Michigan

Minnesota

Missouri

Montana

Nebraska

New York

Pennsylvania

Tennessee

Washington

Wisconsin

Source: City of New York
Washington, D.C. office

July 1986

[illegible]

Attachment B

Congress of the United States
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515-6453
(202) 225-3621

JUN 5 1991

Honorable Robert T. Matsui
U.S. House of Representatives
2419 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Matsui:

This is in response to your request dated March 21, 1991, for a revenue estimate of H.R. 1348, the "Public Pension Equity Restoration Act of 1991." The proposed legislation would modify the application of the limits on contributions and benefits under qualified pension plans with respect to plans maintained by State and local governments.

H.R. 1348 contains four proposals. First, the bill would amend the definition of compensation for the purpose of the limits on contributions and benefits to include contributions made on behalf of an employee pursuant to a salary reduction agreement. Second, the bill would exempt government plans from the 100 percent of compensation limit. Third, the bill would provide that amounts contributed to a qualified government excess benefit arrangement would not be taken into account for purposes of the limits on contributions and benefits and would be treated as contributions to a nonqualified deferred compensation arrangement for tax purposes. Finally, the bill would exempt survivor and disability benefits from the benefits limitation.

The bill would apply to taxable years beginning after the date of enactment. We estimate that the proposal would have a negligible effect on Federal fiscal year budget receipts.

I hope this information is helpful to you. If we can be of further assistance, please let me know.

Sincerely,

Harry L. Gutman

Harry L. Gutman

PREPARED STATEMENT OF REV. PERRY HOPPER

I am addressing you in two capacities; first, as the Assistant to the Executive Director of the Ministers and Missionaries Benefit Board, which provides the American Baptist Churches Retirement Plan under which approximately 12,000 retired and active clergy, lay employees and beneficiaries receive pension coverage, and second, as an assistant pastor of the Canaan Baptist Church in New York, which participates in the Retirement Plan. In my two roles I get to see the problems and uncertainties of the pension laws both from the point of view of a large denomination pension board and as the pastor of a local church that has to comply with them. I appreciate the opportunity to give this statement to you and the subcommittee in support of S. 747. Among the many important provisions of S. 747, I wish to mention two specific problems affecting American Baptist Churches that will be resolved by the bill.

The first of these problems concerns the rules relating to ministers participating in church plans. It is very important to American Baptist Churches that our clergy be able to participate in our denomination's benefit plans not only when they are serving as pastors of local churches but also when they are carrying on their ministries in other capacities. During their careers, many of our clergy will be called to serve in such capacities as chaplains in hospitals, prisons and universities, or on the staffs of drug counseling centers, nursing homes and orphanages, or as teachers of religion in schools and colleges. Most of these institutions will have their own pension plans, and under present law it is extremely difficult for a minister to continue in our denomination's plan while working for such an institution. S. 747 would eliminate this problem by permitting such ministers to be excluded from testing under the other institution's plan, thereby enabling these ministers to continue to participate in our denomination's plans. It can also be extremely difficult under current law for such an institution to permit a minister to participate in the denomination's retirement plan if the institution maintains no other pension plan of its own, and S. 747 would also eliminate that obstacle.

The second problem relates to the "age 70½ rule" of present law. Under that rule, pension payments must begin at age 70½, whether the employee is retired or not. There is already an exception for ministers employed by churches and certain related organizations, but this exception frequently does not extend to clergy who carry on their ministries beyond age 70½ by serving in capacities such as those referred to above. S. 747 would make it possible for church plans to defer the payment of the pensions of such ministers until they retire.

There are a number of other reasons why the enactment of S. 747 is of crucial importance to church pension programs and their participants. These will be explained by my fellow clergy in their testimony and statements. Thank you again for this opportunity to be heard.

PREPARED STATEMENT OF JOHN G. KAPANKE

My name is John G. Kapanke, and I am the president and chief executive officer of the Board of Pensions of the Evangelical Lutheran Church in America. I also serve on the Steering Committee of the Church Alliance.

The Church Alliance is a coalition of the chief executive officers of the pension boards of 30 mainline Protestant and Jewish denominations. The Church Alliance has worked closely with the United States Catholic Conference in formulating S. 747, and the United States Catholic Conference supports its passage.

Appearing with me here today are the following church leaders representing several of the 31 mainline church denominations supporting the passage of S. 747:

> The Reverend Robert John Dodwell, Rector of Saint Anna's Episcopal Church, New Orleans, Louisiana, and Trustee of The Church Pension Fund of The Episcopal Church, New York, New York;
>
> The Reverend Perry Hopper, Assistant to the Executive Director of The Ministers and Missionaries Benefit Board of the American Baptist Churches, and Assistant Pastor of the Canaan Baptist Church of New York, New York; and
>
> Henry O. Shor, C.L.U., member of the Joint Retirement Board of the Rabbinical Assembly of America, the Jewish Theological Seminary and the United Synagogue of America.

We are here to indicate our strong support for passage of S. 747, The Church Retirement Benefits Simplification Act of 1991. Mr. Chairman, we are extremely grateful for your introduction of legislation which was identical to S. 747 in the 101st Congress and for your reintroduction of this legislation in the 102nd Congress. Companion legislation (H.R. 1570) has been introduced in the House by Congressman Robert T. Matsui.

Before I discuss the Church Alliance's views on S. 747, I would also like to commend you, Mr. Chairman, and Senator Bentsen for your introduction of S. 1364, the Employee Benefits Simplification and Expansion Act of 1991. We particularly applaud the provisions in S. 1364 which simplify various retirement plan rules and promote portability of and access to pensions, particularly for small employers. Some of the pension boards represented through the Church Alliance have to serve tens of thousands of these small employers in a truly unique environment. Several of the provisions in S. 1364 are of interest to us.

Like S. 1364, S. 747 is true simplification legislation. It will significantly simplify the rules which apply to church retirement programs and will promote access to pensions on the part of some ministers and lay workers. It will also increase pension portability for ministers serving their denomination outside the pulpit (e.g., a chaplain).

S. 747 is the product of over four years of labor on the part of the Church Alliance and the United States Catholic

Conference. It reflects numerous compromises and modifications required due to the different denominational governmental structures and methods of church pension operations, as well as certain changes suggested by your and Congressman Matsui's staff. Given the labor that has gone into S. 747, the need for simplification and increased access to pensions within the church pension community, and the numerous technical problems which churches encounter daily under present pension laws, we cannot stress enough our hope that S. 747 can be enacted this year.

General Description of S. 747

The primary goals of S. 747 are:

1. To simplify the rules that apply to the two types of church retirement plans (section 401(a) and section 403(b)(9)) and make the rules that apply to church section 401(a) qualified plans consistent with those that apply under current law to church section 403(b)(9) retirement income account programs;

2. To locate the rules that apply to qualified church retirement plans in their own section in the Code so that these rules can be easily identified and not be subject to inadvertent, adverse change;

3. To promote access (and, perhaps more importantly, continued access), to pensions on the part of church ministers and lay workers by simplifying the applicable church retirement plan rules; and

4. To clarify or resolve several other serious technical issues which are of immediate concern to church retirement programs.

Counsel to the Church Alliance have prepared a document which provides a detailed explanation of each of the provisions contained in S. 747. This document is being filed with Finance Committee staff for review and use by the Committee.

A Pension Board Executive's View of S. 747

The Church Alliance was formed in 1975 to address a major problem faced by church pension programs of mainline denominations due to the enactment of the Employee Retirement Income Security Act of 1974. The definition of the term "church plan" used in that Act would have required many church pension boards to segregate the assets of many historic church ministries into separate retirement plans which would be subject to different rules than the plans of other church organizations within their denomination. In 1980, Congress dealt with these problems by clarifying the definition of "church plan." In 1982, in response to an Internal Revenue Service revenue ruling, Congress modified section 403(b) of the Internal Revenue Code to clarify that church pension boards which historically had maintained section 403(b) retirement programs could continue to do so in the future. In 1986, when imposing complex coverage and related rules on section 403(b) annuity programs, Congress provided relief from those rules for churches and certain closely related and heavily subsidized church ministry organizations. Finally, in 1988, faced with the incredible complications provided by the ill-fated section 89 provisions before their repeal, Congress decided that it was appropriate to provide this same type of relief from the complexities of that section.

The history of the Church Alliance has been a series of reactions to legislation that created significant administrative burdens and hurdles for church pension programs. S. 747 represents a different effort on the part of the Church Alliance in that it is an attempt to help shape in advance the rules that apply to church retirement plans.

S. 747 had its origin in a suggestion made by a variety of people, including some Congressional staff, that churches should work with Congress to develop a set of simple, workable rules, located in their own section in the Internal Revenue Code, so that these rules would not be inadvertently changed when Congress is fashioning rules for secular employers.

The cornerstone of S. 747 is based on this concept. Under S. 747, a new Code section would be created to contain the rules that would apply to qualified church plans, and these rules would be made consistent with the rules which apply to section 403(b)(9) retirement income account programs under current law. From a policy perspective, it is difficult to understand why one church should be subject to a different and more complex set of requirements than those imposed on another church. This, however, is the result under current law. The creation of a new Code section for qualified church plans, and the provisions that make the rules contained in this new Code section consistent with those of current law under section 403(b)(9), are the essence of S. 747.

S. 747 also contains a number of provisions which would simplify the administrative compliance burdens churches face under present Internal Revenue laws governing their retirement plans. Of these, I would like to mention one which particularly illustrates the problem churches have in complying with current pension laws. Several provisions in S. 747 would make it clear that ministers who serve their denomination outside the pulpit, in a ministerial capacity, can participate in their denomination's retirement program without adverse impact either to the minister or to the organization employing that minister. Consider a pastor who serves for a period of time as a chaplain at another denomination's hospital. There is a question as to whether this chaplain is entitled to participate in his or her denomination's section 403(b)(9) retirement income account program. This is true because the hospital, and not the denomination, is treated as the chaplain's employer for tax purposes. There also is a question of whether a different contribution rate on behalf of the chaplain could negatively impact the hospital's own retirement plan.[1] S. 747 would address these issues by making it clear that the chaplain can continue to participate in his or her denomination's retirement plan, and that such participation would not negatively affect the retirement plan of his or her employer. This will be of tremendous assistance in promoting pension portability for these ministers, many of whom move from their assigned position every three to five years.

Access to Pensions

One of the primary features of S. 747 is to give section 401(a) qualified church plans the same relief from coverage and other related rules that is available under current law to church section 403(b)(9) retirement income account programs. Some denominations -- particularly those that have qualified church plans -- believe that the result of the enactment of S. 747 will be to enable many small churches and church ministry organizations which have not maintained retirement programs for their ministers and lay workers in the past to do so as a result of relieving the burden of complying with a number of complex, and, in some cases, unworkable rules. For example, several years ago one denomination instituted a section 401(a) qualified church plan. Eventually, this denomination discontinued the plan because it could not be sure

[1] Church-related hospitals and universities would remain subject to coverage and related rules under H.R. 1570.

that volunteer local treasurers were able to follow the complex rules of section 401(a) to make sure that all nonexcludable employees were covered as they became eligible. The creation of new church retirement plans is not the only issue. Of equal -- and perhaps greater -- importance, the relief provided by S. 747 will ensure that many of these church employers will continue their current participation in denominational retirement plans, rather than terminating such participation due to the overwhelming nature of current legal requirements for church plans. Thus, if S. 747 is enacted, the Church Alliance expects that some ministers -- and many lay workers -- who currently do not have pensions will be provided -- or continue to be provided -- with at least some minimum level of pension by the employing church or church ministry organization.

The Unique Characteristics of Churches

Up to this point in my testimony, I have discussed the impetus which brought S. 747 into being and discussed the overall thrust of the bill. I have pointed out why we believe S. 747 qualifies for incorporation in pension simplification and access legislation. I would like to continue my testimony by commenting on the unique characteristics that make churches deserving of the relief provided by S. 747.

The past decisions of Congress to provide special rules and relief for church employee benefit plans from otherwise applicable rules were reflective of the same reasons now being given in support of the similar relief provided by S. 747. These reasons are centered in the inherent differences between churches and secular employers. The most fundamental of these differences are:

1. High Number of Small Employers. Denominations typically consist of many small churches and church ministry organizations having only a handful of employees. In some denominations, there are literally thousands of these small organizations, and they are ill-equipped (both in terms of finances and personnel) to deal with complex rules and associated data gathering requirements.

2. Absence of High Paid Workers. The underlying policy objective of the pension coverage and related rules is principally directed to secular employers, i.e., employers with owners and highly compensated managers that operate their businesses in a manner that enhances the economic benefit available to these two groups. Ministers and lay workers, who make up the majority of church employees, are at best modestly paid, and there are no "owners" in the case of churches. Thus, this underlying policy objective, as a general proposition, does not fit when applied to churches.

3. The Limitations of Church Budgets. Churches rely on voluntary contributions, including tithes and offerings, to pay their expenses, including the compensation of their ministers and lay workers. Unlike secular business entities and government employers, churches cannot pass costs on to customers or meet such costs by raising taxes. A church thus has an arduous task in allocating limited resources between the church's mission and ministries on the one hand, and other priorities (such as ministers' and lay workers' compensation and benefits), on the other.

4. Limitations Created by Church Polity Requirements. Church retirement and welfare benefit programs have

been developed over the years within the confines of the polity, theology and needs of the church denominations served. In many cases, denominational polities and theologies were developed decades ago, before there were any pension laws, and differ greatly among denominations. Moreover, church polities can prevent or not permit ready adherence to the rules and regulations of the Internal Revenue Code which have been developed in the context of secular organizations.

For example, the governing document of one major, mainline denomination requires, as a condition of a minister's call to the congregation, that the minister participate in the denomination-wide retirement and welfare benefit program. The denomination, however, is not a strict hierarchical denomination, and does not have sufficient control over any individual local church or church ministry organization to require participation by 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 of 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 can be easily changed. Both of these factors, however, make it difficult, if not impossible, to comply with the coverage and related requirements imposed by the Code. Other denominations have similar problems in attempting to reconcile the requirements of church polity relationships with the requirements imposed by the Internal Revenue Code.

5. No Tax-Motivated Incentives. Churches are tax-exempt and, unlike secular business organizations, have no need for tax deductions or retirement plans that provide tax-free build-up of retirement income. 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.

6. The Nature of the Churches' Work. In addition to the conduct of worship services, churches and church ministry organizations engage in a wide variety of missions and ministries, including the operation of seminaries, old-age homes, orphanages, mission societies, elementary and secondary rchools, camps, day care centers, hospices, retreat centers and immigration programs. Some of these ministries (e.g., day care programs for the working poor, the provision of hospice beds to AIDS patients, and the provision of food or shelter to the homeless) would in some cases not be carried out but for the work of the church -- work which, as noted, is often carried out under very limited budgets.

7. The Nature of the Church Worker. Due to the modesty of church salaries, many church workers need to receive all of their compensation currently rather than part being paid in the form of deferred retirement benefits. Other church workers serve the church in what could be termed a quasi-volunteer relationship. These employees have chosen their work at least in part out of a sense of mission and service for the church. Some of these employees are retirees receiving pensions or individuals whose spouse may have access to adequate retirement and welfare benefits.

Conclusion

Mr. Chairman, we are grateful for the opportunity to testify today before your Subcommittee concerning S. 747. Members of this Subcommittee and other members of the Finance Committee, particularly you and Senator Bentsen, have been very helpful in the past in making sure that this country's retirement plan laws appropriately address the unique environment in which churches serve. S. 747 is in many respects reflective and a continuation of relief provided by Congress in years past.

S. 747 will save churches and church ministry organizations a considerable amount of time and funds which would otherwise be lost to compliance expenses. Funds which are thus saved can be devoted to carrying out the missions and ministries of the churches, including increasing the amount of retirement benefits which can be paid to our ministers and lay workers.

Although we are not revenue estimators, we believe that S. 747 involves virtually no revenue loss. You and Congressman Matsui have both requested a revenue estimate on this legislation from the Joint Committee on Taxation, and we trust that when this estimate becomes available, it will bear out our conclusion.

In view of the time which has been committed to the development of S. 747, and the immediacy of the problems resolved by this legislation, we cannot stress enough the importance of the passage of S. 747 this year.

Prepared Statement of Meredith Miller

Good morning, Mr. Chairman and members of the Subcommittee. On behalf of the AFL–CIO, I appreciate this opportunity to share with you our views on S. 1364, the Employee Benefits Simplification and Expansion Act of 1991.

We commend the sponsors' leadership on these critical pension issues and for holding this hearing today to focus national attention on these matters. In particular, the AFL–CIO would like to express strong support for the legislation's rollover provisions, the exemption of multiemployer plans from the full-funding limitation and changes contained in the bill for public employee pensions.

We do, however, have concerns that we would like to share with you about the bill. We also would like to comment on certain provisions that may not be contained in S. 1364 but are in other pension simplification bills.

I. The Erosion of Employment-Based Pensions

The various pension simplification and access bills pending before Congress recognize the need to enact measures to end the roll-back of workers' pensions. The erosion of employment-based pensions reflects a larger problem, namely, employers' desires and actions to lessen their long-standing commitment to provide a private sector safety net of benefits for workers and their families.

At present:

- 54% of the full-time private sector has no pension coverage, compared with 14.5% of the workforce lacking coverage for health care insurance;
- Only 28% of retirees currently receive private pensions as a source of retirement income, and the proportion of income represented by pensions has stagnated at 7% since 1976;
- Women's average private pension income has dropped from 73% of men's in 1974 to 53% in 1987;
- The Department of Commerce reports that employer pension contributions have decreased over the last decade, despite a 64% increase in wage and salary payments.

II. Provisions We Support

We strongly support the bill's provisions on rollovers, changes to state and local plans, and the lifting of the full-funding limit for multiemployer plans.

1. Rollovers and Transfers

The liberalization of the rollover provisions and the transfer requirement do much to advance the goal of pension preservation. These are important policy steps toward providing workers with a more portable pension system that better suit today's workforce characteristics and employment trends. We do, however, object to prohibiting after-tax employee contributions to be rolled over, especially if the intent of this proposal is to enhance and ensure pension savings. We also are concerned that these same provisions do not extend to public sector plans except in limited circumstances.

2. Changes to State and Local Government Pensions

We strongly support the bill's provisions which protect public employee plans from potential disqualification by lifting limits on Section 415 pension distributions and by exempting benefits attributed to "qualified excess benefit arrangements" from 415 limits. The unique plan design features and local legislative authority for such plans warrant special consideration for public employees.

State and local government workers also would benefit from the bill's proposal to reinstate public sector workers' entitlement to 401(k) plans. This proposal would afford public workers the same opportunity to save on a pre-tax basis that is currently enjoyed by private sector workers. It also would provide a more secure savings vehicle than public sector 457 plans since 457 contributions are considered to be owned by the employer until distributed to the plan participant. This is not a comforting thought to employees whose state and local governments are buckling under deficit-laden budgets.

3. Multiemployer Exemptions to Full Funding Limitation and the Annual Valuation Requirement

Multiemployer plans provide benefits through pre-negotiated contribution rates that are stipulated for the term of the collective bargaining contract. This funding stream cannot properly cover future benefits when subject to a full-funding limit which fluctuates with interest rates. Attempts by multiemployer plans to stay within the full-funding limits could result in underfunding of the plan benefits, especially when new benefit dollars are needed to meet negotiated increases.

The full-funding limit was intended to thwart the use of the pension fund as a tax shelter for excess company dollars that accrue to the employer in plan terminations. However, by virtue of their funding structure and other legal limitations, multiemployer plans are prohibited from taking reversions upon plan terminations. For these reasons, we are especially pleased with the bill's exemption of multiemployer plans from the full-funding limit. The bill also recognizes that, by lifting the full-funding limit for multiemployer plans, valuations on an annual basis are not necessary.

III. PROVISIONS OF CONCERN

1. Repeal of Income Averaging for Lump-Sum Distributions

All of the simplification and access bills currently being considered by Congress repeal the five-year forward income averaging for lump-sum distributions. The Employee Benefits Simplification Act would retain the transition rule contained in the Tax Reform Act of 1986 for individuals who attained age 50 before January 1, 1986. While we understand that the intent of this provision is to discourage retirement savings from being used for non-retirement purposes, this change may adversely affect future retirees. First, the current financial crises in the banking and insurance industries, including events such as the collapse of the Executive Life Insurance Company, make this an inopportune time to be "forcing" workers and retirees to keep their pension assets in annuities. The PBGC is currently contesting its obligation to insure such annuities. In addition, guaranteed investment contracts (GICs) invested by defined contribution plans are not insured by the PBGC or many state guaranty funds. Tens of thousands of union members have had their retirement security threatened because their pension funds were invested in Executive Life annuities or GICs.

Second, this provision would disrupt the vast number of collectively bargained contracts that have lump-sum payment options for both defined benefit and defined contribution plans. These provisions were not negotiated just for flexibility. Some reflect workers' lack of confidence in the fiscal soundness of employers in declining industries.

2. Modifications to Simplified Employee Pensions (SEP)

We support the bill's efforts to encourage small businesses to offer pension coverage to their employees. Nevertheless, we believe the approach taken to broaden coverage by simplifying SEPs will result in only modest coverage expansion. SEPs, available under current law, are already designed to ease administrative burdens because they are exempt from government reporting and other administrative procedures are streamlined.

However, their lack of popularity has been documented by a recent report of the Bureau of Labor Statistics. By 1990, only one percent of full-time workers in firms with less than 100 employees participated in SEPs. It could be that SEP benefit allocation and coverage rules are the cause for low coverage. Nevertheless, the simplification measures could be counterproductive if they considerably reduce coverage of part-time workers who now enjoy participation under existing rules.

For these reasons, we believe that reduced administrative complexity alone may not provide sufficient incentives for small employers to' offer coverage. Public opinion polls of both employers and employees suggest that health care costs are crowding out other benefit needs and that preferences for new benefit dollars, especially in the small employer market, would be directed towards health benefits regardless of simplification efforts.

3. Modifications to 401(k) Plans

The new design-based safe harbors for 401(k) nondiscrimination testing raises concerns about adequate participation of lower paid employees. Under current rules, plan sponsors must aggressively "market" the 401(k) plan to lower paid workers in order to get sufficient participation (to affect deferral rates) necessary to pass the nondiscrimination tests.

These new proposals, while offering an adequate bottom-loaded employer matching contribution, cannot by themselves substitute for employee education and encouragement. The example often cited as a successful model for private sector plans is the Federal Employees Thrift Plan (FETP), which was exempted under the Tax Reform Act of 1986 from the average deferral percentage ("ADP") test (that reflects the average employee contributions as a percentage of their income) of the Internal

Revenue Code and instead allowed to rely on a $7,000 limit on elective deferrals to cap contributions by highly compensated employees.

The FETP requires an automatic employer contribution of 1 percent of pay regardless of whether employees contribute and matching contributions on up to 5 percent of basic pay. According to a 1989 analysis conducted by the Federal Retirement Thrift Investment Board, despite the automatic employer contribution and the employer matching provision, participation rates significantly varied by income levels with participation of Civil Service employees earning less than $23,000 at 18.3%, compared to a participation rate of 54.2% for those earning greater than $50,000. We urge the sponsors to include more stringent requirements for employers to "market" the 401(k) safe harbors and to conduct pilot studies to determine differences in participation rates of low-paid workers between the current plan and the proposed 401(k) safe harbors.

IV. PROPOSALS WE OPPOSE

1. Modification to Definition of Leased Employees in S. 1364 (and H.R. 2730. H.R. 2641 and H.R. 2742)

To avoid tax liability as well as health and pension responsibilities, many employers are seeking to change the status of traditional permanent employees to either "leased personnel" or they are employing independent contractors. In 1982, Congress developed a rule to assure that "leased employees" would have the same pension benefits provided to other employees of the same employer. The definition of a leased employee was based on a three-part test. A most important part was the "historically performed test," which treated a person as a "leased employee" if the job had been historically performed by a permanent employee.

The new provision provides for a change in this test. It removes the "historically performed test" by substituting a looser "control" test. We believe it will encourage employers to change the status of their present leased employees to independent contractor status. The AFL-CIO is opposed to conversion of leased employees to independent contractor status since the tax and benefit responsibilities fall on the workers and bargaining unit rights may be eliminated.

2. Repeal of Death Benefit Exclusion from Gross Income (in H.R. 2730)

We strongly oppose the proposed elimination of the current $5,000 death benefit exclusion contained in H.R. 2730. We view this cutback as nothing more than a revenue r .ising measure. We find taxing the modest death benefits of bereaved survivors of deceased workers to fund simplification and pension access repugnant.

3. Repeal of the Unrealized Appreciation of Employer Securities Exclusion (in H.R. 2730 and the Administration's POWER Proposal)

The special tax treatment of net unrealized appreciation of employer securities poses serious problems for workers participating in employee stock ownership plans (ESOPs) and other profit-sharing arrangements. This tax exclusion has been on the books for several years and has been an important incentive for workers to invest in company stock which in turn is expected to boost productivity.

Several AFL-CIO affiliated unions have ESOP plans in which workers have significant ownership interests. This provision may have a deleterious effect on workers if they are forced to liquidate part of their portfolio in order to pay for the tax at a time when market conditions are unsound. This also makes the cash-out of employer securities for retirement income less stable and predictable.

4. Repeal of Multiemployer Ten-Year Vesting (in H.R. 2730 and the Administration's POWER Proposal)

We strongly oppose provisions in H.R. 2730 and the Administration's POWER proposal to repeal the ten-year vesting for multiemployer plans. Five-year vesting is designed to allow employees who work for several employers during their careers to vest in their pension benefits. Multiemployer plans already provide such vesting since they are required by law to combine workers' periods of service with different contributing employers for vesting purposes. Many multiemployer plans have already provided five- and seven-year graded vesting. Those that have not have based their decision on the needs of the participants and the plan itself. Some plans sponsors cannot afford to switch to five-year vesting because of either the demographics of their membership, the financial condition of the industry, or the skyrocketing health care costs that are crowding out dollars for other benefits.

V. CONCLUSION

The simplification bills pending before Congress reflect various approaches. Some of the provisions reverse mistaken past policy, while others change pension law to better suit the current demographic and economic climate. Some of the provisions combine simplification with access by trading off tests of coverage and nondiscrimination for safe-harbor plan designs with mandatory employer contributions. There are several reasons why this latter set of provisions are troubling and we urge the sponsors to conduct further study.

First, some of the proposals work at cross-purposes so that administrative ease is achieved at the cost of lower participation. An example includes the new SEP proposals which would drop part-timers from eligibility for SEP benefits. Similarly, the 401(k) safe-harbors may result in lessened participation of lower-income workers because employers would no longer have incentives to "market" the plan.

Second, many of the pension access provisions are based on the assertion that administrative complexity is a barrier to both preservation and expanded coverage. Indeed, administrative complexity is a barrier for pension preservation but not for broader coverage. Costs are the major obstacle for small employers with health care soaking up any new benefit dollars. Therefore, many of the bills' proposals to increase access will result in only modest success.

Finally, the simplification and access proposals sidestep issues of benefit adequacy and security when they rely on deferred contribution plans to expand coverage. Without minimum benefit standards and government guarantees, deferred contribution plans may provide inadequate retirement income when retirees need it most. We also need to identify ways in which we can bolster and preserve the defined benefit plans currently in existence.

Again, the AFL–CIO commends the sponsors' commitment to further the goals of pension preservation and access.

Thank you for this opportunity to comment on S. 1364. We look forward to working with you in the future on these important issues.

PREPARED STATEMENT OF MIKE MOHLER

Good Morning. My name is Mike Mohler, and I am a Lieutenant with the Fairfax County Fire Department as well as a member of the International Association of Fire Fighters. I have been a fire fighter for 15 years. I am here today to ask for this Committee's help in resolving some of the pension-related problems facing state and local government employees, especially for those of us in the fire service. I would like to spend a few minutes this morning explaining these issues from the point of view of a rank-and-file fire fighter. I respectfully request that my written statement, as well as the written statement of the International Association of Fire Fighters, be included in the hearing record.

Like most of my co-workers, I became a fire fighter because it offers me the opportunity to help my community. I wish the Members of this Committee could see the look on the faces of people who are trapped in a burning building when they see a fire fighter has come through the flames to rescue them. While this job has many rewards, the compensation and benefits are not high among them. I do not know a single fire fighter who entered the profession because they thought the pension benefit sounded attractive.

I am therefore at something of a loss to understand why my pension plan could be disqualified by the Internal Revenue Service because our benefits are alleged to be too high. As I understand it, Section 415 of the Internal Revenue Code is the provision designed to ensure that taxpayers are not asked to subsidize huge pensions paid to top corporate executives. Why, then, am I being penalized?

Allow me to offer one simple example of how the Fairfax County Fire Department's pension plan could exceed this Section 415 limitation:

In Fairfax County, the disability retirement benefit for total disability is a modest two-thirds of salary at the time of injury. Yet, if I had become disabled shortly after I was promoted to Lieutenant, my disability benefit could have technically exceeded the Section 415 limitation which caps benefits at 100% of compensation. The reason a 66⅔% disability benefit can exceed a 100% of compensation test is where this gets somewhat confusing. When I was promoted to Lieutenant from a fire fighter, I received a pay raise. I had also been participating in our 457 plan—a deferred compensation plan offered to state and local government workers. In addition, our plan has an employer pickup provision on employee contributions. None of these things makes me at all exceptional.

When the Internal Revenue Service computes the 100% of salary limitation, they do certain things which significantly reduce the amount of allowable benefit. First, they average the three highest consecutive years. In this example, that means they would have counted my Lieutenant's salary as only a small part of the equation. Second, the IRS does not count as salary the money I contribute to my 457 plan and the contributions made on my behalf by the employer, even though that money is counted for computing my retirement benefit. Taken together, these items would reduce the allowable benefit so much that 66⅔% of my actual salary at the time of my disability would be greater than 100% of my compensation as defined by the IRS. That means my disability pension would have placed the entire pension plan in jeopardy and this plan, which covers 1150 fire fighters, could have lost its tax exempt status.

I chose to discuss how the Section 415 limitation is unfairly applied to disability benefits largely because disability retirement is especially important to fire fighters as well as police officers. As the nation's most hazardous profession, fire fighters see more than their share of disability retirements, and sustaining an injury within a year of a promotion is not an uncommon scenario. It must be noted, however, that the disability benefit issue is only one of the ways that a public employee pension can exceed the Section 415 limit and I'm sure others will point those issues out to you.

Finally, I would like to comment on the relationship between individual cases and the pension system as a whole. Under Section 415, if one person receives a benefit in excess of the limitation, the entire pension system could lose its qualified status. In regard to the example I just gave you, that means that just because I was not injured during the year after my promotion, that does not mean the scenario no longer applies to me. If even one fire fighter gets injured shortly after making Lieutenant or Battalion Chief or Chief, I will be affected by it—even if the injury occurs many years from now! As long as I am affected by my pension system—either as a contributor to it or as a recipient from it—disqualification of our pension system will have a direct, adverse affect on me and my family.

Senator Pryor, I understand that your pension simplification legislation would correct this inequity and several others, and would ensure that the Section 415 limitations are applied fairly to public sector workers while not violating the policy it was established to govern. On behalf of all my brother and sister fire fighters, I want express my deep appreciation for your interest in this important issue, and urge you to move as quickly as possible to see that your bill becomes law.

Fire fighters give a lot to America, unfortunately, including their lives, and ask for little in return. All we are asking for right now is fairness—so that the application of this Internal Revenue Code provision be applied fairly to public sector employees so that no pension plan loses its exempt status and that our pensions are not diminished.

Mr. Chairman, I want to thank you for this opportunity to present the concerns of fire fighters before this panel.

Prepared Statement of Senator Bob Packwood

I want to commend the distinguished Chairman of this subcommittee, Senator Pryor, for holding a hearing on this important issue. Senator Pryor has been a leader in the fight to simplify the pension rules, and I am an enthusiastic cosponsor of his pension simplification legislation.

I want to mention two issues to be covered by the hearing today which are of particular importance to me. The first issue relates to the alarmingly low percent of small businesses which offer retirement plans to their employees. Less than 25 percent of the workforce employed by small businesses is covered by a retirement plan. Yet over 80 percent of those employed by large companies are covered by a retirement plan.

This is of particular interest to my home state of Oregon where about 90 percent of the businesses are small ones—having less than 100 employees. The reason most small businesses are reluctant to offer retirement plans is simple. They just are not able to keep up with the complex tax rules governing retirement plans and can't afford to hire someone to do this for them.

As a result, on January 31, 1991, I introduced legislation to create a simplified retirement plan for small businesses—S. 318, the "Private Retirement Incentives Matched by Employers Account', which is known as the PRIME Retirement Account. The Prime Retirement Account combines the best aspects of individual retirement accounts (IRAs) and 401(k) plans, while eliminating the complexity normally associated with employer-sponsored retirement accounts.

I am happy to say that a majority of the Finance Committee are supporters of the PRIME Retirement Account, including the Chairman of the Finance Committee, Senator Bentsen. Small businesses in Oregon are very enthusiastic about the PRIME Retirement Account. I would like to include a few of the many comments I have received into the Record, along with a list of organizations who support my bill.

The second issue I want to discuss is the need to simplify the pension plan distributions rules, specifically the rules permitting lump sum distributions to be rolled over tax-free to IRAS.

The need for simplification really hit home when a constituent told me of the problems he encountered upon receiving his retirement benefits from the Oregon Public Employees retirement System Plan ("PERS"). The gentleman, Mr. Paul Willes, retired from the Oregon Department of Education in 1989. He was entitled to two benefits from the Oregon PERS plan:

a. A lump sum from the part of the plan which resembles a 401(k) plan; and

b. A monthly retirement benefit paid over the retiree's lifetime from the part of the plan resembling a normal defined benefit pension plan.

PERS has been structured this way since 1977. Retirees have been told by State officials and local tax advisors that the "lump sum" amount received from PERS can be rolled over to an IRA tax-free. In 1989, Mr. Willes consulted State officials, a CPA,and the local stock brokerage firm to confirm the tax-free treatment before rolling the lump sum from the PERS plan into an IRA. In November 1990, 17 months after he rolled his lump sum over to his IRA, he was notified that his lump sum did not qualify for tax-free rollover treatment and that he owed $34,000 in back taxes, not including interest and penalties.

Our pension rules are obviously too complicated if the State of Oregon and local tax experts never knew for years that the lump sum payment from the PERS plan didn't qualify for tax-free rollover treatment. If these experts don't understand the pension laws, how are retirees expected to understand the laws.

Senator Pryor's pension simplification bill will simplify the rules for tax-free rollovers so that all distributions from pension plans will qualify for tax-free rollovers. While this proposed change will clarify the tax treatment of any future distributions from the Oregon PERS plan, it does not help retirees like Mr. Willes who received a lump sum distribution in the last few years. I'd like to see this much needed simplification of the tax-free rollover rules apply retroactively to retirees who unknowingly ran afoul of these complicated rules. This will help retirees not only from the Oregon PERS system, but probably many more retirees from public and private employers who right now are unaware, like Mr. Willes was, that they owe thousands in back taxes for a technical error in their lump sum pension distribution.

Mr. Chairman, I would also like to have included as part of the hearing record testimony from a Beaverton, Oregon company, Tektronix, Inc.

Attachments.

OREGONIANS HAVE THIS TO SAY ABOUT THE PRIME PLAN . . .

". . . You have a good idea here. It appears to be simple enough that small businesses will use it. Keep it that way!"

STURDI-BUILT GREENHOUSE
MANUFACTURING, PORTLAND, OREGON.

". . . You are on the right track in trying to fashion an acceptable retirement plan that will work for small businesses such as our's. Much as we would like—and our employees would like—we have not adopted any of the existing plans available because of the complexities and associated costs in the administration of such plans."

HOLIDAY TREE FARMS, CORVALLIS,
OREGON.

". . . As a small business owner, I like the concept outlined in your letter about the PRIME retirement account and encourage you to pursue its enactment."

FLOYD A. BOYD COMPANY, MERILL,
OREGON.

". . . Not only are these investment incentives in the interest of our country's economic development, but they are also important to organizations that wish to attract high caliber employees. More and more employees value the opportunity to save through tax-deferred investments. With the limitations on tax-deferred contributions to individual retirement accounts, the availability of employer-sponsored tax-deferred investment programs is even more important. Thank you for supporting this measure!

PACIFIC COAST ASSOCIATION OF PULP AND
PAPER MANUFACTURERS, PORTLAND,
OREGON.

". . . I got your note today about your retirement plan for small businesses. Sounds like a great idea. We'll take advantage of it probably immediately!"

GUTMANN NURSERIES, CORNELIUS,
OREGON.

". . . I am writing to give you my enthusiastic support for the PRIME legislation. A simple retirement plan which can be easily administered by small companies, but which is an effective vehicle for employees, is long overdue."

LUXTRON CORPORATION, BEAVERTON,
OREGON.

". . . This is a great plan and will help our employees who now do not have retirement plans greatly. We would institute such a benefit if your bill passes. Please keep us informed and keep up the good work."

WILLAMETTE VALLEY VINEYARDS,
TURNER, OREGON.

ORGANIZATIONS SUPPORTING THE PRIME RETIREMENT ACCOUNT

National Federation of Independent Businesses
U.S. Chamber of Commerce
National Small Business United
Small Business Legislative Council
Small Business Council of America
Association of Private Pension and Welfare Plans
U.S. League of Savings and Loans
American Bankers Association
Investment Company Institute (mutual fund association)

PREPARED STATEMENT OF JOSEPH PERKINS

The American Association of Retired Persons is pleased to appear before this committee on the important issue of pension simplification. The Association believes that the current pension system can and should be simplified, but that changes should enhance -- not undermine -- important retirement benefit protections in the law.

BACKGROUND

AARP has long supported improvements in the private pension system in order to make it a more widespread and reliable source of retirement income. While Social Security must continue to supply a floor under retirement income, the private pension system (as well as personal savings, and continued full or part-time employment for some) must supplement Social Security to adequately ensure retirement income security.

The private pension system has made great strides over the years towards meeting the goal of becoming a reliable source of retirement income. Despite these advances, a number of deficiencies remain. Just over one-quarter of individuals currently receive private pension income, and the amounts often tend to be relatively small. In addition, while future pension receipt is expected to rise, only about one-half of all current employees are covered by a private pension plan.

In large part, this pension gap is the result of a lack of pension coverage in the small business sector. Coverage in firms of more than 5000 employees is over 90 percent, while coverage rates at firms with over 100 employees is about 80 percent. A significant drop-off occurs for firms with under 100 employees, where pension coverage is only about 25 percent.

A number of meaningful pension changes during the past decade have significantly improved pension equity and pension adequacy. In particular, shorter vesting, reduced integration of pensions with Social Security, and strengthened coverage and nondiscrimination rules further the fair delivery of pension benefits. However, these changes did not address the pension gap in small business.

Many believe that simplification of the pension laws will go a long way towards encouraging greater pension coverage by small employers. However, simplification should not be the primary goal of the pension system. The pension law should foster plan sponsorship, plan coverage and plan equity. Plan participants, particularly lower-paid employees, should benefit by changes in the pension laws.

The pension system by its nature is complex. Pension plan tax incentives are the single largest tax expenditure, and pension funds represent the largest pool of money in the world. Entrance into this system is voluntary, and a wide variety of plan types are permitted. The flexibility and diversity of plan design, combined with the sheer size of the system, inevitably leads to the need for comprehensive regulation.

Given the difficulty of the task, the Association commends this committee for its attempts to simplify the pension law while balancing the desires of plan sponsors, the needs of plan participants and the principles of tax equity. The Association believes there is enough common ground that efforts toward simplification can be both productive and worthwhile. The Association would oppose, however, those changes that under the cover of "simplicity" undermine fairness and equity in our pension laws.

PENSION ACCESS AND SIMPLIFICATION - ISSUES AND PROPOSALS

A number of pension access and simplification proposals have been put forward this past year, including S. 1364 (Sens. Bentsen-Pryor)/H.R. 2742 (Rep. Cardin), S. 318 (Sen. Packwood), H.R. 2730 (Rep. Rostenkowski), H.R. 2641 (Rep. Chandler), H.R. 1735 (Rep. Kennelly), and the Administration's POWER (Pension Opportunities for Workers Expanded Retirement) proposal. The following are the Association's comments on some of the proposed changes contained in the various proposals.

401(k) PLANS AND SIMPLIFIED EMPLOYEE PENSIONS (SEP'S)

The various proposals seek to expand access to pension plans by increasing the availability of SEP's and by providing safe harbors and simplifying nondiscrimination testing for both SEP's and 401(k) plans. The Association is greatly concerned that some of these proposals over-emphasize simplification to the detriment of pension equity. Simplification should not result in reduced benefit protections for rank and file workers, particularly women and minorities.

The Association believes that 401(k) plan testing is not a significant administrative problem for larger employers. The current tests for allocation of the tax benefit for 401(k) plans are intended to ensure sufficient participation by rank and file employees. These tests, while not ideal, have proved to be both workable and reasonable.

Several safe-harbors have been put forward that would circumvent the nondiscrimination testing requirements. One form of such safe harbors (such as in S. 1364 and S. 318), would eliminate testing if the plan provides for a significant employer matching contribution. While the matching contribution may be generous, it is only applicable _if_ an employee first contributes. Thus _those who do not or cannot save will receive nothing from the employer._ The Association believes this approach to pension simplification is fundamentally flawed, and will inevitably result in a significant percentage of employees, concentrated at the lower wage levels, who will receive no pension benefits. (Currently, it is estimated that about 40 percent of eligible employees do not contribute to a 401(k) plan.)

In addition, since under current law the benefits for higher -paid employees are based on benefits for lower-paid employees, the employer has an incentive to aggressively market a 401(k) plan to rank and file employees. Under the proposed safe harbor, the employer need not have _any_ participation by lower-paid employees to qualify the plan. The offer of a match alone is deemed sufficient to qualify the plan. Indeed, because the employer must match any contribution, the employer actually has a financial incentive to discourage employees from contributing to the plan. This turns the current law incentive on its head. The Association strongly believes that an employer match alone is insufficient to ensure equity in 401(k) plans. Even appropriate notice requirements will offer no help to those who simply do not have sufficient income to save. AARP urges this committee to reject such proposals.

Given the past decade's increasing trend towards employee-contributory plans, the Association believes it is essential that these plans provide meaningful benefits to all eligible employees. The Association believes that if a safe harbor is deemed needed, the proper trade-off for nondiscrimination testing is a required minimum employer contribution for _all_ employees. One such safe harbor, proposed in H.R. 2730, _would_ require a minimum _employer_ contribution of 3 percent of compensation for all employees in order to avoid nondiscrimination testing. The POWER proposal would similarly require a minimum contribution of 2 percent of compensation. The Association believes that an employer contribution of at least 3 percent of compensation (a mere $600 contribution for an individual earning $20,000) should be required in any safe harbor.

While such a simplified safe harbor may be deemed needed in the small employer plan area in order to encourage pension coverage, the Association doubts the need for such a safe harbor in the larger plan area. For larger plans, the current 401(k) rules are not an undue burden. Indeed, even under the current rules, a significant number of employees may not receive any benefits from a plan that is based on an employees own contributions. This lack of pension participation even where coverage exists should also be addressed by this committee. (Indeed, improvements to the current coverage rules, which are overly complex and continue to permit the exclusion of certain employees, should be included in any simplification and access proposal.)

Larger plans do have the desire to have more certainty in determining applicable benefits for the current plan year. Under current rules, such certainty is difficult until the end of the plan year. The Association believes it is appropriate to alleviate this burden by permitting current year contributions to be based on prior year figures. AARP is currently examining such options.

ROLL-OVER AND DISTRIBUTION RULES

Generally acknowledged as an area in need of overhaul, the current roll-over rules are complex for both employers and employees. The various proposals address these rules in much detail. In general, the proposals would significantly liberalize the current roll-over rules, permitting employees (or surviving spouses) to more easily roll over distributions from employer-sponsored plans to other retirement plans or Individual Retirement Accounts (IRA). The Association generally supports the thrust of these changes.

In particular, the Association strongly supports the direct trustee-to-trustee transfer requirement in S. 1364/H.R. 2742. In general, this provision would require a plan, when an employee changes jobs, to transfer amounts above $500 directly to another employer plan or to an IRA.

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 deficiencies with current distribution practices is the encouragement of direct cash-outs to employees, who most often immediately spend money that had been initially set aside for retirement. This is particularly true for lower-income and younger workers, groups who often are least able and most in need of encouragement to save. Increased coverage and shorter vesting of pension benefits will not provide meaningful retirement security if these earned amounts are spent before retirement. The Association believes the transfer requirement will significantly increase the pension amounts that will be saved, and will serve as a necessary incremental step towards greater portability of pension benefits. The minimal administrative overhead of this change pales in comparison to the potential for long-term pension savings that should result.

Some of the proposals also recommend the elimination of current forms of tax treatment for lump sum distributions. In particular, the different proposals would eliminate five-year forward averaging and/or repeal the 10-year forward averaging grandfather rule. While much debate is likely on the need for the various forms of tax treatment, the Association is concerned that any change take into account the needs and expectations of individuals who are at or near retirement.

Public policy should encourage individuals to adequately prepare for retirement and to engage in some form of retirement planning. Congress has recognized such a need in the past. Change in the rules for individuals just as retirement draws near may upset such long-term planning decisions. This is particularly true when it involves the repeal of a current grandfather provision (such as 10-year forward averaging) that Congress has already adopted to deal with just such retirement planning issues. Regardless of the underlying policy decision, individuals have rightly relied upon the law in formulating their retirement plans. Abruptly changing the law will frustrate the reasonable actions and expectations of individuals, and fuel further discontent for our tax system.

One proposal would also eliminate (except for 5% owners) the current requirement for pension distributions at age 70-1/2 (or 70), and permit a delay in distribution until the employee actually retires. In addition, where the employee continues to work, an actuarial adjustment is required in all defined benefit plan benefits. The Association supports this modification, since current law in essence penalizes those who continue to work, and is particularly troublesome for those individuals who continue to work because they cannot afford to retire. Delaying the distribution of retirement benefits until actual retirement will improve the income security intended by the plan when it is needed -- at retirement.

5-YEAR VESTING FOR MULTI-EMPLOYER PLANS

A number of the proposals recommend eliminating the exemption for multi-employer plans from the 5-year vesting rules. The Association supports this change, and believes that members of multi-employer plans should be governed by the same vesting schedule applicable to all other workers. The change in vesting schedules adopted in Tax Reform has proved to be an effective and workable way to improve the earning of pension benefits, and the Association believes there no longer is any reason to deny employees of multi-employer plans the same pension protection applicable to all other private plan employees.

PERMITTED DISPARITY (INTEGRATION)

While a number of simplification initiatives could harm lower-paid employees, there are some simplification changes that would help these workers. Current law pension rules allow for "permitted disparity," or specified amounts by which pension benefits may favor higher-paid employees. These rules merely work to allow a higher degree of discrimination in the delivery of pension benefits than would otherwise be allowed under the general nondiscrimination tests. These new rules replaced the old rules governing a similar practice known as "pension integration with Social Security." The Association believes these rules are overly complex for both employers and employees and should be eliminated.

In addition, and more immediately, a number of changes should be made to limit the effects of this undesirable practice. First, permitted disparity should be prohibited in SEP's. The very complex practice of permitted disparity is directly contrary to the goal of a simplified pension plan for small employers. Given proposals to expand and further simplify SEP's, it is only appropriate that this complex and discriminatory practice be denied to those who would adopt such a retirement vehicle for purposes of simplicity.

Second, the Tax Reform Act, which alleviated many of the past abuses associated with pension integration by adopting the new permitted disparity rules, mistakenly failed to fully put an end to the past practices that Congress found abusive. In particular, the past practice by which an employee could be "integrated out" of an entire pension benefit still continues for current employees for their pre-1989 years. Thus employees well into the next century will find their benefits substantially reduced by a practice that Congress has already determined to be unfair. The Association urges that at the very least the current permitted disparity rules be applied to all working years (including pre-'89 years) for current employees. This will correct a last-minute flaw in the '86 Act that permits past abusive integration practices to continue well into the future.

CONCLUSION

The above statement highlights some of the important issues addressed by the various bills that have thus far been put forward. Pension simplification is an important goal to foster understanding and expansion of the pension system, but it must be accomplished without retreating from the necessary objectives of individual fairness and tax equity. While many current rules are complex, it is often the result of attempts to reconcile the often competing principles of plan flexibility and plan equity.

The Association looks forward to continued work with this committee to develop a simplification package that effectively deals with the unnecessary complexities of our current pension laws without retreating from improved coverage and the equitable delivery of pension benefits.

SUBMITTED BY SENATOR DAVID PRYOR

[JOINT COMMITTEE PRINT]

SIMPLIFICATION OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS (S. 1364, THE EMPLOYEE BENEFITS SIMPLIFICATION AND EXPANSION ACT OF 1991, AND S. 318)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS

OF THE

SENATE COMMITTEE ON FINANCE

ON

SEPTEMBER 27, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Private Retirement Plans of the Senate Committee on Finance has scheduled a public hearing on September 27, 1991, 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. 1364, the Employee Benefits Simplification and Expansion Act of 1991, introduced by Senator Bentsen for Senator Pryor on June 25, 1991, and S. 318, introduced by Senator Packwood and others on January 31, 1991.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the provisions of S. 1364, and a discussion of issues relating to simplification of the Federal income tax rules applicable to tax-qualified retirement plans. Part I of the pamphlet is a summary. This is followed by a description of the present-law Federal tax rules regarding tax-qualified plans (Part II), a description of S. 1364 (Part III), a discussion of pension plan simplification issues (Part IV), and a description of S. 318 (Part V).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Simplification of Present-Law Tax Rules Relating to Qualified Pension Plans (S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, and S. 318)* (JCS-13-90), September 26, 1991.

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. 1364

S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, modifies the present-law rules relating to qualified plans and certain other types of employee benefit plans. In particular, the Act (1) modifies the definition of highly compensated employee; (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) provides an additional safe harbor definition of compensation; (4) modifies the minimum participation rule (sec. 401(a)(26)) and provides that the rule (as modified) applies only to defined benefit pension plans; (5) 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)); (6) modifies the distribution rules relating to pension plans by (a) liberalizing the circumstances in which a distribution may be rolled over tax free, (b) repealing 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) repealing the requirement that distributions to qualified plan participants begin by age 70-1/2 (sec. 401(a)(9)) and generally replacing it with the required beginning date in effect before the Tax Reform Act of 1986; (7) modifies the definition of leased employee; (8) provides that the 150 percent of current liability full funding limit does not apply to multiemployer plans; (9) expands the circumstances under which a group of unrelated employers may establish a voluntary employees' beneficiary association (VEBA); (10) modifies the limits on contributions and benefits (sec. 415) as they apply to go ernmental plans; (11) broadens the availability of simplified employee pensions (SEPs), and provides design-based safe harbor rules for satisfying the special nondiscrimination rules applicable to such plans; (12) permits tax-exempt organizations to establish and maintain qualified cash or deferred arrangements (sec. 401(k)); and (13) 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.

Summary of S. 318

S. 318, the PRIME Retirement Account of 1991, creates a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account. A PRIME account is an individual retirement plan with respect to which employees can make elective pre-tax contributions of up to $3,000 per year, with a 100-percent employer match up to 3 percent of the employee's compensation. No nondiscrimination rules apply to PRIME accounts.

Only employers who normally employ fewer than 100 employees and who do not maintain a qualified plan can establish PRIME accounts for their employees. All employees of the employer who are reasonably expected to work at least 1,000 hours during the year are eligible to participate in the PRIME account. All contributions to an employee's PRIME account are fully vested. Simplified reporting requirements apply.

II. PRESENT-LAW RULES [2]

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.[3]

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 formu'a. 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]

[2] 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.

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

[4] 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 issued final regulations under the general nondiscrimination rules on September 19, 1991.

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) ($8,475 for 1991). 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 requirements 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)).[5] 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-

[5] 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) $108,963 for 1991 (sec. 415(b)).[6] 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

[6] 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 (sec. 415(b)(10)). 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. A plan maintained by an electing employer may not use the special actuarial reduction rules for early retirement benefits generally available to State and local government plans.

This special rule was enacted under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) 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 $90,803 in annual compensation from the employer; (3) received more than $60,535 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 received compensation greater than $54,482. 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)). If, for any year, no officer has compensation in excess of $54,482, then the highest paid officer of the employer for such year is treated as a highly compensated employee.

An employee is not treated as in the top-paid 20 percent, as an officer, or as receiving $90,803 or $60,535 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during the year.

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 $60,535 in annual compensation from the employer as highly compensated employees in lieu of applying the $90,803 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 contributions and benefits (sec. 415).

For purposes of the limits on contributions and benefits 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 issued final regulations on September 19, 1991 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 [7]

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

[7] 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.[8]

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.

[8] 795 F. 2d 1303 (7th Cir. 1986).

III. DESCRIPTION OF S. 1364

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)). Under the bill, as under present law, the dollar limit in effect for 1991 is $60,535.

Under the bill, if no employee is a 5-percent owner or has compensation in excess of $50,000 (indexed), then the highest paid officer 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)), and does not apply with respect to employees of tax-exempt organizations and State and local governments (sec. 457(e)(1)).

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, 1991. An employer may elect not to have the provision apply to years beginning in 1992.

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, 1991.

Definition of compensation

The bill permits an employer to elect to use base pay as a permissible definition of compensation for purposes of all provisions which specifically refer to section 414(s) of the Code. 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 regulations (Treas. reg. sec. 1.414(s)-1(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); bonuses; or reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses deferred compensation, and welfare benefits. It is intended that the resulting definition may not discriminate in favor of highly compensated employees. The election applies for purposes of all applicable provisions and to all employees, and may be revoked only with the consent of the Secretary.

The provision is generally effective for years beginning after December 31, 1991.

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, 1991. 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 401(k). Assume further that the actual deferral percentage ("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, 1991.

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.

This provision is effective with respect to distributions after December 31, 1991.

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 taxpayer 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.

This provision is effective with respect to distributions after December 31, 1991.

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 designed 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)).

These provisions apply to distributions in plan years beginning after December 31, 1992.

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, 1991.

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, 1991.

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, 1991.

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, 1991.

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.

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, 1991.

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, 1991.

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, 1991.

Treatment of certain governmental plans

The bill provides that (1) compensation for purposes of the limitations on benefits and contributions under a qualified plan maintained by a State or local government includes amounts contributed by the employer pursuant to a salary reduction agreement (2) the compensation limitation on benefits under a defined benefit pension plan does not apply to plans maintained by a State or local government, (3) the defined benefit pension plan limits do not apply to certain disability and survivor benefits provided under such plans, and (4) section 457 does not apply to excess benefit plans maintained by a State or local government. Excess plans maintained by a State or local government are subject to the same tax rules applicable to excess plans maintained by private employers (e.g., sec. 83).

The bill also permits government employers to revoke the special TAMRA election under which plans could provide benefits equal to the accrued benefit of participants notwithstanding the otherwise applicable limits on benefits. Plans maintained by employers that revoke the election could then use the special actuarial reduction rules for early retirement benefits generally applicable to governmental plans. To be effective, the revocation must filed with the Secretary of the Treasury by the last day of the third plan year beginning after the date of enactment of the bill. The revocation would apply to all plan years for which the election was in effect, except that the benefit limitations for benefits paid after the date of revocation, but attributable to a preceding taxable year during which such election was in effect, will be determined as if such amount had been received in such preceding taxable year.

The provision generally is effective for taxable years beginning after the date of enactment. However, a qualified plan maintained by a State or local government shall be treated as satisfying the requirements of section 415 for all taxable years before the date of enactment.

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, 1993, 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

In general

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 by-product 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 subsidiaries 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 determine 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).[9] 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-

[9] 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 individual 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. 1364

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 cases 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 employees. 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.

Safe harbor definition of compensation

The bill provides a statutory safe harbor definition of compensation that should be easy for employers to administer. The bill permits the use of base pay, not basic rate of pay, which is already a permissible safe harbor definition of compensation under final Treasury regulations.

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. Final 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 ($8,475 for 1991); 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 ($8,475 for 1991) 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. ($8,474 for 1991). 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 be able to defer enough current 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 cov 'ed 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.

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-bycontributing 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 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.

Salary reduction SEPs

Pension coverage of employees of small employers is significantly lower than that of employees of medium or large employers. A number of factors may contribute to this, including the cost to the employer (both in terms of wage cost and administrative cost of maintaining the plan) as well as the desire of the employees to have pension benefits rather than wages in other forms. The bill attempts to address one factor that may affect an employer's decision to establish a pension plan—administrative burdens—by enabling an employer to establish a salary reduction SEP without testing to ensure that the plan operates in a manner that does not discriminate in favor of highly comensated employees.

Nondiscrimination rules generally are enacted to ensure that the tax benefits for qualified plans benefit an employer's rank and file employees as well as highly compensated employees and to provide broad-based pension coverage. The issues relating to nondiscrimination rules are discussed above under the provision relating to cash or deferred arrangements. The discussion applies equally to the provision that permits salary reduction SEPs for small employers without testing for nondiscrimination.

In addition, even if one concludes that nondiscrimination rules are generally desirable from a policy perspective, some argue that in the case of small employers such rules may be an impedient to establishment of any type of retirement program and that relaxation of such rules is appropriate if doing so will encourage small employers to establish retirement plans.

It is unclear, however, whether elimination of nondiscrimination rules for small employers will actually increase pension coverage of rank and file employees. Such employers may establish SEPs now, and may also establish qualified retirement plans that are relatively easy to administer. Thus, the fact that pension coverage is lower in smaller firms may have little to do with administrative costs associated with nondiscrimination rules. Thus, relaxing those rules may not achieve the desired result.

Some also argue that any increased pension contributions by small employers will be reflected in lower wages (to the extent permitted by minimum wage laws)—which could adversely affect lower-income workers who may desire to have higher current wages. Some also argue that the provision may make hiring minimum wage workers more expensive, so that fewer of such workers will be hired.

Some also argue that it is not fair to provide special rules to small employers only, and that one set of rules ought to apply to all employers. In addition, as a practical matter, it may be difficult to limit special provisions to small employers only. Thus, some argue that exceptions for small employers should be adopted only if it is appropriate from a policy perspective to eliminate nondiscrimination rules for all employers.

Amending the eligibility requirements for SEPs would conform the rules for SEPs more closely to the rules relating to qualified plans and thus may operate to simplify the pension system generally. On the other hand, such rules require employers to keep track of actual hours worked by employees, which may increase the recordkeeping burdens imposed on small employers.

A one-year of service rule permits an employer to require that an employee complete 1,000 hours of service (or work approximately 20 hours per week) in order to qualify for a contribution on the employee's behalf to the employer's pension plan. Long-term, part-time employees would be entitled to a contribution under present law. To the extent that employees of small employers work on a periodic or part-time basis, however, the change to a one-year of service requirement may reduce the number of employees covered by a pension plan.

Treatment of certain governmental plans

Proponents of the provision in the bill modifying the limits on contributions and benefits for governmental plans argue that such plans have special circumstances that warrant exceptions from the general rules. For example, with respect to the exemption from the 100 percent of compensation limitation, they argue that the compensation structure for certain government positions is such that the employees are paid very low current compensation, but are compensated instead with retirement benefits. Also, they argue that in the private sector, disability and similar benefits are often paid outside of a qualified plan, whereas they are paid from qualified plans in the public sector. Further, they argue that private employers are allowed to maintain excess benefit plans (i.e., plans that pay benefits that cannot be paid from a qualified plan because of the limits on contributions and benefits), but public plans cannot maintain excess benefit plans because of the limitations imposed under section 457 (discussed below). Finally, they argue that the scrutiny afforded compensaiton of public employees is sufficient to ensure that excessive benefits are not paid and that no further Federal limitations are necessary.

Opponents of the provision argue tht the provision is merely an exemption from the limits on contributions and benefits, and that the public employees should not be treated more favorably than private sector employees. For example, all low wage employees could benefit from an exemption from the 100 percent of compensation limitation. Similarly, many private employers have pointed out that lower-paid employees are hurt because compensation for purposes of the limits on contributions and benefits does not include salary reduction amounts, such as contributions to a 401(k) plan. Further, they argue that as a matter of public policy, public plans should be subject to the same rules as plans of private employers and that employees in public plans obtain significant Federal tax benefits under qualified 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.

Cash or deferred arrangements for tax-exempt organizations

Under present law, nongovernmental, tax-exempt employers which are not charitable (sec. 501(c)(3)) organizations or public educational institutions (sec. 170(b)(1)(A)(ii)) are prohibited from providing their employees with qualified retirement plans that permit elective contributions. Moreover, rank-and-file employees of such organizations are effectively barred from participating in nonqualified deferred compensation plans because of the ERISA funding rules. By permitting tax-exempt organizations to establish qualified cash or deferred arrangements under section 401(k), the bill eliminates the problem that rank-and-file employees of tax-exempt organizations face in having meaningful elective deferred compensation plans available to them.

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.

V. OTHER PROPOSAL

S. 318 (Senator Packwood and others): The PRIME Retirement Account Act of 1991

Simplified retirement plan

The bill creates a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account.

A PRIME account is an individual retirement plan with respect to which the only contributions allowed are contributions under a qualified salary reduction arrangement. A qualified salary reduction arrangement is a written arrangement of an eligible employer under which an employee can make elective salary reduction contributions to a PRIME account. The amount of such contributions must be expressed as a percentage of the employee's compensation, and are capped at $3,000 per year. The employer is required to match employee contributions to the extent such contributions do not exceed 3 percent of the employee's compensation. No other matching contributions are allowed.

Only employers who normally employ fewer than 100 employees on any day during the year and who do not maintain a qualified plan can establish PRIME accounts for their employees. For this purpose, a qualified plan includes a qualified retirement plan described in section 401(a), a qualified annuity plan (sec. 403(a)), a governmental plan, a tax-sheltered annuity (sec. 403(b)), and a simplified employee pension (sec. 408(k)).

All employees of the employer who are reasonably expected to work at least 1,000 hours during the year are eligible to participate in the PRIME account. All contributions to an employee's PRIME account are fully vested.

No nondiscrimination rules apply to PRIME accounts.

A PRIME account is not an employee benefit plan for purposes of ERISA. A PRIME account is, however, considered a pension plan for purpose of the restrictions on deductible contributions to an individual retirement arrangement (IRA) (sec. 408(g)).

Tax treatment of PRIME accounts

The tax treatment of PRIME accounts generally is the same as that of simplified employee pensions (SEPs). Thus, contributions to an employee's PRIME account are not includible in the employee's gross income (sec. 402(h)). Distributions form a PRIME account generally are taxed under the rules applicable to IRAs (sec. 408(d)). However, distributions from a PRIME account may be rolled over only to another PRIME account.

Early withdrawals from a PRIME account generally are subject to the 10-percent early withdrawal tax applicable to IRAs (sec.

72(t)). However, withdrawals of contributions during the 3-year period beginning on the date the employee first participated in the PRIME account are subject to a 25-percent early withdrawal tax (rather than 10 percent).

Reporting requirements

The trustee of a PRIME account is required each year to prepare, and provide to the employer maintaining the account, a summary description containing basic information about the account. Within 30 days after each calendar quarter, the trustee also is required to furnish, to each individual maintaining a PRIME account a statement with respect to the account balance as of, and the activity during, such calendar quarter. In addition, the trustee is required to file a one-time report with the Secretary of Labor providing information required under regulations issued by the Secretary. A trustee who fails to provide any of such reports or descriptions is subject to a penalty of $100 per day until such failure is corrected.

The employer maintaining a PRIME account must notify each employee of the employee's opportunity to make salary reduction contributions under the account immediately before the employee becomes eligible to make such election. This notice must include a copy of the summary description of the account prepared by the trustee. An employer who fails to provide such notice is subject to a penalty of $100 per day on which such failure continues. The employer also must provide such simplified reports with respect to the account as the Secretary may require by regulations.

No other reports are required.

Effective date

The bill is effective for taxable years beginning after December 31, 1991.

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PREPARED STATEMENT OF MICHAEL O. ROUSH

NFIB is the nation's largest small business advocacy organization, representing more than 500,000 small and independent business owners nationwide. NFIB is a strong supporter of reforming our nation's pension laws because a surprisingly low percentage of small businesses are currently able to afford pension plans for their employees. Our testimony will focus primarily on proposals that have been offered to increase the number of pension plans offered by small business owners.

WHY MORE SMALL BUSINESSES DO NOT OFFER PENSION COVERAGE

According to the *Small Business Employee Benefits* survey taken by the NFIB Foundation in December, 1985, the cost of starting and maintaining a pension plan was the primary reason small employers gave for not having one. Small businesses are rarely profitable enough for the owners to be able to afford the costs of setting up and running a pension plan under current law. Roughly 40% of NFIB members responding to a poll stated they take home less than $30,000 a year. With profits this low, current law offers little incentive to a small employer to start a plan.

Pension plan costs can be broken down into the cost of plan contributions and the cost of administration. Mr. Chairman, your legislation, the Employee Benefits Simplification and Expansion Act, S. 1364, would lower the administrative costs of pension plans by offering small business owners a pension plan without non-discrimination and participation testing. Reducing the administrative burdens of setting up a pension plan will encourage more small business owners to start them.

In addition, keeping administrative requirements simple will encourage small business owners to keep their plans operating. According the 1985 NFIB Foundation study, more than one-third of small businesses which terminated their plans did so because of changing and complex regulations.

S. 1364 requires employers to either match contributions made by their employees or contribute three percent of every employee's pay in order to enjoy the benefits of simpler administrative rules. Although these contributions will increase the cost of starting a plan, they do allow employers to choose between offering their employees an opportunity to have their savings matched or just contribute a set percentage of every employee's income. I would like to point out, however, that less expensive employer contributions have been proposed. Senator Packwood's legislation, S. 318, would require employers to match, dollar for dollar, contributions up to the first three percent of salary and would not require an additional 50% match for the next 3-5% of income. The administration's POWER proposal would require only a two percent contribution to each worker.

NFIB disputes the need to include mandatory employer contributions in a simplified pension plan for small employers. However, if Congress considers employer contributions to be indispensable, then those contributions should be as small as possible. Small business owners purchase pension coverage the same way they purchase any other employee benefit. The lower the cost, the more likely employers will purchase it.

Lack of employee interest is another reason small business owners do not start pension plans. Many young, low-wage workers would prefer to have a higher salary than set aside money for retirement. If a small business owner has $2,000 a year that can be used either to start a pension plan or to increase salaries, invariably the younger, lower-paid employees of that business will prefer higher pay. The Committee should keep in mind, however, that just because workers forego pension coverage at one stage of their careers does not mean that they will retire with no savings. Many employees working for small businesses will move on to better paying jobs and will be afforded the opportunity to participate in a pension plan later in their careers.

WHY SMALL BUSINESSES OFFER PENSIONS

In order to increase the number of small businesses that set up and maintain pension plans, it is important to explore why a small business owner would want to set up one in the first place. Small business owners are motivated by a number of factors when deciding whether or not to start a pension program.

As mentioned above, the primary threshold that must be crossed is whether or not the business can afford the administrative and benefit costs of a plan. If the business can afford the expense of the plan, studies have found that small business owners have a variety of objectives when they start a plan:

(1) to take advantage of the tax benefits pension plans offer.

(2) to provide their employees with an opportunity to save for retirement.

(3) to attract better quality employees.
(4) to reward good employees.
(5) to instill worker loyalty and encourage them to remain with the business.

Obviously, to the extent pension law permits employers to accomplish these objectives, more small employers will offer pensions.

WHAT CAN BE DONE TO INCREASE SMALL BUSINESS PARTICIPATION

The best way to increase the number of Americans saving for retirement is to provide them with a simple way to save. As the number of businesses who offer pension plans increases, so does the opportunity for workers to save.

The Employee Benefits Simplification and Expansion Act of 1991 takes several important steps in the direction of making pension plans more accessible to small business owners. By simplifying pension rules, S. 1364 will make the administration of pensions easier for small employers and, as a result, more employers will be likely to offer plans to their employees.

As mentioned above, cost is the primary factor influencing an employer's decision of whether or not to start a pension plan. S. 1364's requirement that employers either match contributions made by employees or contribute a percentage of every employee's salary creates a barrier for those employers who want to take advantage of the simplified pension rules. If an employer cannot afford to make these payments, he cannot afford this new simplified plan.

The choice of employer contribution offered by S. 1364, however, is preferable to other approaches allowing employers only the option of making across-the-board contributions to all employees. As the Committee is aware, both the Department of Labor and the House Ways and Means Committee have suggested that pension rules be simplified only for small business owners who can afford to contribute two or three percent of their payroll to all of their employees' pension plans.

NFIB suggests that instead of trying to maximize the number of employees within a plan who are saving for their retirement, Congress should focus on trying to maximize the number of plans in which employees have an opportunity to participate. Providing wide-scale opportunity for individuals to save for their own retirement will result in much greater savings than enticing just a few businesses to contribute toward all of their employees' futures.

Since the enactment of ERISA, tens of thousands of small firms have canceled their pension plans. For many reasons NFIB, the Administration, and the Congress agree that this is not in the best interest of working Americans. NFIB believes that the only way to reverse this undesirable trend is to enact legislation making it easy for smaller businesses to set up and fund plans. S. 1364 takes a big step in this direction by addressing the administrative barriers in the current system. We strongly encourage the Committee to steer-clear of pension proposals with high initial price tags. Instead, any proposal should provide employers with a usable alternative for their employees at a cost low enough that smaller businesses will be able to afford it.

OTHER COMMENTS ON PENSION SIMPLIFICATION

NFIB is also concerned about the repeal of five- and ten-year averaging. These changes could leave small business owners who had included the availability of five- and ten-year averaging in their retirement plans out in the cold. This revenue-raising provision penalizes those who have saved over a lifetime and planned on using a lump-sum distribution from their pension to fund their retirement. NFIB is also concerned that some pension proposals use the revenue picked up from the repeal of averaging to pay for an expanded retirement program for state and local government employees. Both the Administration's POWER proposal and Chairman Rostenkowski's proposal include expanded pension benefits for these government employees. State and local employees already have much more comprehensive pension coverage than the employees of NFIB members (pension coverage in the public sector is approximately 90 percent). Pension simplification efforts should focus on expanding pension coverage within the private sector.

NFIB also applauds efforts to simplify the definition of a highly compensated employee. One of the primary contributors to the complexity of pension plans is nondiscrimination testing, and the definition of a highly-compensated employee is a major cause of that complexity. In simplifying the definition of a highly-compensated employee, however, NFIB would recommend that the definition include only those who are truly highly compensated.

The primary problem with the current definition of a highly-compensated employee is that it includes all business owners, regardless of how much they earn. The average NFIB member takes home between thirty and forty thousand dollars a year. These business owners are in no position to abuse the system by socking away tens of thousands of dollars a year in pre-tax income. Pension law should encourage small business owners to start plans. Declaring up front that every small business owner is highly compensated is not a good way to start.

CONCLUSION

To increase pension coverage Congress should focus on making it affordable for all employers to offer his or her employees a pension plan. Three out of every four small businesses do not have pension plans. Until small employers offer pension plans to their employees, most American workers will not be covered. Small employers currently do not offer pension plans to their employees because they cannot afford one. Unless the cost of starting and maintaining a pension plan is lowered, small businesses will not start them.

Congress needs to enact legislation that will provide a workable pension plan; one that will greatly increase the chances that small employers will use the plan, thus enabling them to help their employees provide for their retirement.

Attachment.

STATEMENT OF MARTIN G. IMBACH, INC.

Mr. Chairman, my name is Eamonn McGeady, and I am the president of Martin G. Imbach, Inc., a marine and heavy construction company located in Baltimore. We employ nearly sixty people and have been in business since 1944, when my father incorporated the company. My two brothers and I have run the company since his death in 1968. Our firm is somewhat unusual for a construction company in that we have been able to maintain a cadre of experienced employees, with many of our current ones having been with us for more than twenty years and over half the company having ten or more years' service. We are an open shop company with a benefit package that includes the usual holidays, a vacation plan, various employee assistance arrangements, and a fully paid medical plan that covers our employees and their families. It is from this background that I appear before you today.

You have asked me to address some of the impediments that small businesses face when attempting to establish a pension plan for their employees. I can answer that with one sentence: The three "C's": cost, complexity, compliance.

First, cost. when we explored the possibility of establishing some sort of a pension plan for our company several years ago, the best proposal that we got would have cost us between ten and fourteen thousand dollars a year just for the administrative costs. That did not include any actual contributions to the plan. The consultants who were proposing those plans at that time were up against the then recently passed ERISA amendments, and like the great majority of small and medium businesses, we saw no advantages and a great many disadvantages. The decision was regretfully easy—no pension plan. Although we have not re-examined the possibilities in the last few years, I understand that the costs are still quite high compared to the possible benefits to the employee and the firm.

Next: Complexity. The current IRS and ERISA rules are such that only practicing professionals can hope to keep up with them. A small business person at his or her peril would try to be their own compliance officer, since the penalty for a mistake would be extremely costly.

Finally, compliance. Even some of the professionals disagree as to what constitutes compliance with the current rules. what is a "highly compensated person?" If you have only three stockholders as we do, what can they do, if anything, and not cause the plan to be disallowed by the IRS?

These are just a few of the questions raised in the real world of a small business person's "decision tree." With all of the other daily pressures, it is easy to see that the simplest decision is no decision—and no pension plan.

What then can be done? I sincerely believe that you and your committee are on the right track. If you can produce legislation that removes most, if not all, of the complexity and compliance stumbling blocks, then I believe the third "C"—cost—will take care of itself. I think that a large percentage of my peers would like to offer some sort of a plan to their employees. I know I would. If you can reduce administrative costs and have the plans administered by various financial institutions and have them employee-centered, that is vested and transferable and have them tax favored, I think you will see a rapid increase in the number of employees participating. The benefits I think are obvious—increased savings rates, decreased reliance on future social security payments, increased capital base, better employee relations, etc. All of these and more will more than offset the current tax costs. I urge you to continue your efforts.

Thank you.

NFIB SMALL BUSINESS EMPLOYEE BENEFITS

DECEMBER 1985

RESEARCH & EDUCATION FOUNDATION

PREFACE

This survey of small business employer-provided employee benefits was undertaken by the NFIB Research and Education Foundation as a direct result of Administration and Congressional suggestions to at least review, if not alter, their tax status. Despite some recent research on small business employee benefits, e.g. Chapter 5 in SBA's 1985 The State of Small Business report, it became clear soon after these suggestions were offered that it would be very difficult to make informed judgments on their small business impact with the data available. In particular, questions involving small business owner attitudes and motivations in decisions affecting employee benefits need resolution. It was the process on which data was lacking, not so much the result of the process. The Foundation felt it could obtain information to help explain the process and thereby help assess the probable impact of various legislative suggestions.

While Federal attention was the immediate stimulus for the survey, it was not the only one. States also have an interest in employee benefits. Perhaps the most obvious example is the minimum health insurance requirements whose legality was recently upheld by the United States Supreme Court. But employee benefits is not a new State interest and not one that is likely to recede. Therefore, information on small business employee benefits have on-going value for policy makers in the State capitals.

Finally, there is an entire industry marketing employee benefit products and services to small businesses. The interests of small business owners and their employees dictate that such an industry be competitive. Small business market information can only help this to occur. While it is difficult not to believe that at least the largest industry members possess considerable market data, their proprietary nature limits their availability and therefore their utility. Should the Foundation provide all competitors access to better information it will allow the industry to provide cheaper, better, and more useful products and services to small businesses.

Comments on this report would be gratefully received.

SMALL BUSINESS EMPLOYEE BENEFITS

by

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Executive Summary

* Paid vacations and health insurance were the two most common employee benefits found among the nation's small businesses. They were the only benefits provided by a majority of the small employers surveyed.

* Larger businesses tended to provide more benefits for a greater proportion of full-time employees than did smaller businesses.

* There appeared to be an accepted hierarchy of benefits or a tacit order in which benefits were introduced.

* The median monthly employer cost of voluntary employee benefits, i.e. benefits not provided by legal compulsion, was $1,450 for those providing at least one benefit. Mean or average monthly costs were twice that, pulled upward by a very few firms. The ratio of mean monthly voluntary benefit costs to annual gross receipts was inversely related to firm size. Compulsory employee benefits, i.e. legally required benefits such as FICA and Workers Compensation, cost small business owners about as much as did voluntary benefits.

* The number of small business owners providing employee health insurance has been rising. Sixty-five (65) percent offered

health insurance coverage for at least some full-time employees, an increase of eight percentage points from a similar survey conducted in 1978. Most responsible for the increase were financial service, professional service, retail, and smaller firms.

* Well over 80% of health insurance plans offered in small firms carried an option for dependent coverage. However, few part-time employees were provided any health benefits.

* The mean monthly health insurance premium paid by small employers was over $1,766, more than double the monthly premiums paid in 1978. A majority of small employers absorbed 100% of the premium with the smallest employers most frequently paying the full cost.

* Small business owners purchased private health insurance from a great variety of carriers. Self-insurance (4%) and HMO's (3%) remained an oddity.

* While the firm was the group sponsor more often than not, trade/business associations have been increasingly assuming that role. Apparently, the trend to greater association sponsorship is tied directly to increasing employee health coverage in small firms.

* Nearly 2/3's of small business owners with health insurance reported they were generally satisfied with the health care plan offered their employees. That represented a 17 percentage point drop from 1978 and can be directly related to insurance costs.

* Small business owners and/or a designated employee spent comparatively little time searching for health insurance alternatives, health care cost control options, etc. Outside advisors, particularly insurance agents, often substituted for owner/employee search.

* Employee health insurance was not provided by about one-third small employers. No single reason dominated their decisions. The most frequently cited reasons were: generally covered under a spouse or parent policy (secondary wage earners), premiums too high, employee turn-over too great, firm insufficiently profitable, and can't qualify for group policy.

* No dramatic increase in the quantity of employee health coverage should be expected in the near future. The composition of the labor force and differences in small business profitability will limit growth in the proportion of small business owners instituting employee health insurance

plans. However, coverage will continue to rise as the increase in health care costs decline, labor markets accept it as a condition of employment, and associations make it increasingly accessible for the smallest.

* Few small businesses provided employee retirement plans. Of those made available, the defined contribution type appeared most popular. But in a recurrent theme, substantial percentages of small business owner respondents were not familiar with the terminology or specifics of the plan for which they were paying.

* Outside advisors often influenced plan selection. Contribution flexibility, tax advantages, and ease and cost of start-up were major considerations in plan choice.

* The small business owner or a designated employee served as the plan administrator in a plurality of instances. Bank trust departments were the second most frequent source of plan administration.

* The most common reason for instituting a retirement plan was the need to keep valued employees, followed by the general feeling that employees needed a plan.

* Sixty-five (65) percent of business owner respondents expressed general satisfaction with their employee retirement plan. Those with defined contribution plans were most frequently satisfied. Yet, at one time or another, one in ten has either cancelled or withdrawn from a plan.

* Constant change in governmental rules and regulations was far and away considered to be the most important problem in maintaining an employee pension plan.

* The most frequently cited reason for not providing a retirement plan was affordability. However, 1/3 did not respond, probably indicating important alternatives were not provided the respondent.

* Accountants were most often the single most important source of information on retirement planning for small business owners. Insurance agents and financial consultants followed in frequency.

RETIREMENT PLANS

One in four (26%) small businesses provided some type of employee retirement plan. In 70% of those instances (18% of the total population), all full-time employees were included in the benefit; in 30% of those instances, just some full-time employees were eligible.

The most common type of retirement plan was the defined contribution plan (Table 24). Thirty-nine (39) percent reported using that kind, although a disproportionate number of no answers (30%) almost certainly should have fallen in the class. The defined benefit type of plan was possessed by 27%; the multiemployer type was characteristic of just 5%. Since multiemployer plans are closely related to union contracts and previous work indicates less than 5% of small businesses have any union employees, it is likely few if any non-respondents would need to be apportioned to that variety of retirement plan.

The most common form of defined contribution plan was profit sharing (Table 24). Profit sharing was reported by just over half of those identifying the type of defined contribution plan they possess. The money purchase variety was used by about half the number that used profit sharing. Simplified Employee Plans (SEP) and 401(k) plans were virtually the only others identified. Respondents were also presented the Thrift, Keogh, and ESOP options, but so few identified one of those plans as theirs that such plans are henceforth clumped under the heading "Other."

Table 24

TYPE OF SMALL BUSINESS PROVIDED EMPLOYEE RETIREMENT PLAN BY PERCENT OF FULL-TIME EMPLOYEES COVERED IN EACH FIRM (in percent)

	PERCENT OF FULL-TIME EMPLOYEES COVERED IN EACH FIRM				
TYPE OF PLAN	1-39%	40-60%	61-99%	100%	Total
Multi-Employer	8	14	4	3	5%
Defined Benefit	14	32	19	31	27%
Defined Contribution	24	23	43	41	39%
Profit Sharing	14	32	32	39	35%
Money Purchase	14	18	19	16	16%
401(k)	3	5	4	7	6%
SEP	11	9	6	5	6%
Thrift	3	5	*	1	1%
Keogh	5	*	*	4	1%
ESOP	*	*	2	1	2%
Other/No Answer	50	31	37	27	29%
Subtotal	100%	100%	100%	100%	100%
No Answer	54	32	35	25	30%
Total	100%	100%	100%	100%	100%
Number of Respondents	37	22	54	263	376

*Less than 0.5%

Many small business owners providing some type of employee retirement plan were either unfamiliar with the terminology employed in the questionnaire or have delegated responsibility for such activity to the extent that familiarity with the terminology appears unnecessary. Thirty (30) percent of those with a plan could not or would not identify it by basic type. Curiously, respondents from firms employing 50 or more people were less likely to know their plans by name than were those from smaller firms, indicating greater delegation or reliance on advisors.

While a profit sharing plan is normally considered to be a type of defined contribution plan, small business owner respondents do not necessarily consider it as such. In fact, there were almost as many who marked profit sharing as marked defined contribution. The implication is that profit sharing is often an additional benefit not specifically considered to be a retirement benefit.

Conditions

Where retirement plans were offered, they normally were offered to all full-time employees. But in those cases where coverage was not complete, there appeared no discernable trend between those covering just salaried workers and those covering just hourly employees (Table 25). Typically, an employee became eligible to participate in the plan after one year of service. Sixteen (16) percent had a shorter service requirement; 21% had one that was longer. Technically, a service requirement of more than one year is not legal under ERISA. However, most responses of that nature fell under non-covered informal profit-sharing arrangements. There probably was also some confusion with vesting.

The vesting period, i.e. the period of service prior to eligibility for benefits, was surprisingly brief. Only 31% (42% of those answering the question) possessed a vesting period of more than five years. Twelve (12) percent had none, indicating both direct payments to employee savings plans, e.g., IRA's, and perhaps some confusion with service requirements. If nothing else, this distribution of responses indicates the polarized forms small business employee retirement plans take. On the one side, there are highly formal plans of the type that any professional pension manager would recognize and feel comfortable handling. On the other, there are very informal plans which may not be a plan at all under any professionally accepted definition, but which serves the same purpose.

Responses of small business owners having defined benefit and defined contribution plans were similar in two of the three participation requirements outlined above. Both had similar employee type and employee service restrictions. The "odd men out" were those with multiemployer plans. Multiemployer plans were much more likely to affect only one class of employee, but had generally lesser servicé requirements. When it came to the vesting period, however, responses of those with defined benefit and multiemployer plans appeared similar. Those with defined contribution plans exhibited substantially greater variance. The reason for the difference is the greater formality or rigidity of the two former plan types and the greater informality or flexibility of the latter.

Table 25

SELECTED PARTICIPATION FACTORS IN SMALL BUSINESS PROVIDED EMPLOYEE RETIREMENT PLANS BY TYPE OF RETIREMENT PLAN

	TYPE OF PLAN				
PARTICIPATION FACTORS	Multi-Employer	Defined Benefit	Defined Contribution	No Answer	Total
Employee Type					
All Full-Time	42	78	86	47	70%
Salaried Only	6	5	3	3	4%
Hourly Only	35	3	1	1	3%
No Answer	18	15	9	50	23%
Total	100%	100%	100%	100%	100%
Employee Service					
No Requirement	18	54	8	5	6%
Less Than 1 Year	24	8	11	3	8%
1 Year	37	48	49	38	45%
2 Years	*	4	7	4	5%
3 Years or More	*	15	16	12	14%
No Answer	18	19	8	47	24%
Total	100%	100%	100%	100%	100%
Vesting Period					
No Requirement	6	8	17	10	12%
1-2 Years	12	11	5	6	7%
3-5 Years	24	24	26	14	22%
6-10 Years	29	35	37	18	30%
No Answer	29	22	16	52	29%
Total	100%	100%	100%	100%	100%
Owner Participation					
Yes	41	83	86	49	72%
No	59	11	9	8	11%
No Answer	*	7	5	43	17%
Total	100%	100%	100%	100%	100%
Number of Resp.	17	103	145	111	376

One measure of a plan's value is whether the owner participates. If the owner participates, he presumably has no better alternative and the plan is the best available under the circumstances. Seventy (70) percent of owners with an employee retirement plan participated in their employee plan. Eliminate multiemployer plans because the individual small business owner has no practical influence over its content, and the figure rises somewhat. While the very largest and the very smallest were somewhat less likely to experience owner participation, there was little differentiation by firm size.

Plan Choice

The selection of a small business employee retirement plan is heavily influenced by advisors (Table 26). While there are usually multiple reasons for plan selection, the recommendation by an advisor influenced the small business owner decision at least half the time. Those with a defined benefit plan were most likely to cite recommendations from an advisor as their reason for choice, one indication of the more complex nature of defined benefit plans.

A second tier of reasons in frequency of note followed advisor recommendations. Contribution flexibility was cited by 34% overall, but by 44% of those choosing a defined contribution plan. Twenty-nine (29) percent indicated tax advantages were a reason. The third and last reason in the cluster was that plan costs could be anticipated (25%). Again, this response was much more characteristic of those with defined contribution plans.

Further down the list in frequency of mention was most generous employee benefits, lowest administrative cost, most generous owner benefits, and ease and cost of start-up. While noted less frequently than several others, they were important reasons for many small business owners. In fact, the notable part about the distribution of reasons for plan choice was its dispersal. Eight different reasons were cited by more than 15% of respondents having a plan; only one -- a reason inherently having nothing to do with the plan, i.e. recommended by an advisor -- reached higher than 35%. There was usually just one reason cited for selection of a multiemployer plan -- negotiated with a union.

Plan Administration

In a plurality of instances (39%), the small business owner or a designated employee managed the retirement plan on behalf of the beneficiaries (Table 27). Among larger employers the percentage declined somewhat despite the presumably greater internal capacity to absorb those responsibilities. Bank trust departments appeared to substitute. Over all size classes, bank trust departments proved the single most frequent source of retirement plan administration outside the firm (17%).

Investment brokers were named by 12%; they were disproportionately managers of smaller plans. Consultants followed at 11%, and 21% either engaged yet another source or did not respond. Not surprisingly, consultants were most often employed when the plan was of the defined benefit variety. Those with defined contribution plans were somewhat more likely to have used either an investment broker or a bank trust department. Multiemployer plans provided a different pattern in administration. Most used either bank trust departments or some "Other" vehicle.

Satisfaction and Problems

Sixty-five (65) percent of small employers expressed general satisfaction with the employee retirement plan they now have (Table 28). Despite complaints over administrative costs and regulatory changes, it appeared that virtually none intended to drop his plan in the foreseeable future. The caveat to the latter observation was the intent of the comparatively large 21% who failed to respond.

Greatest satisfaction was expressed with the defined contribution type plan (85%). Given that affordability and contribution flexibility were major factors in plan selection, it was not surprising that the plan type offering these advantages received the highest approval. A substantial majority (69%) also expressed satisfaction with their defined benefit plan. But differing from those providing defined contribution plans, a large contingent of those offering defined benefit plans, though not satisfied, couldn't afford a better one (17%). Least satisfacton was found with the multiemployer type and while probably an accurate reflection of the actual situation, the small sample size (n=17) allowed no conclusions.

While there were no mutinous rumblings similar to those which resulted in cancellation of many retirement plans during the mid-1970's, small business owners reported problems with their retirement plans. The most prevalent of these problems was constant governmental changes in the rules and regulations affecting their offerings (Table 29). Nearly two of five (37%) cited the problem as their most important in plan maintenance. Moreover, nearly half who were generally satisfied with their plans pointed to problems created by frequency of regulatory changes.

Regulatory changes generally inflate administrative costs. The two most frequently mentioned problems--regulatory change and administrative costs (15%)--are therefore, related and accounted for 52% of total responses. Other problems, such as "top heavy" restrictions and restrictions on fund usage, were noted considerably less often. The concern over multiemployer withdrawal liability, so strongly expressed by many with multiemployer plans, was not evident in the totals. Just a small percentage have multiemployer plans, although most of those reported their withdrawal liability as problem number one.

Table 26

SMALL BUSINESS OWNER REASONS FOR RETIREMENT PLAN CHOICE BY TYPE OF RETIREMENT PLAN
(in percent)

	TYPE OF PLAN				
REASON FOR PLAN CHOICE	Multi-Employer	Defined Benefit	Defined Contribution	No Answer	Total*
Recommended by Advisor	*	60	52	46	50%
Negotiated with Union	63	3	4	3	6%
Ease and Cost of Start-Up	*	10	19	21	16%
Can Anticipate Costs	5	20	32	22	25%
Most Generous Owner Benefits	5	23	17	7	16%
Tax Advantages	11	27	35	24	29%
Contribution Flexibility	5	21	44	36	34%
Lowest Administrative Cost	4	10	21	16	16%
Most Generous Employee Benefits	16	19	21	9	17%
Chosen Before Present Owner	5	7	3	2	4%
Other	5	3	1	1	2%
Total@	114%	203%	249%	187%	215%
Number of Respondents	17	103	145	111	376

* less than 0.5%
@ respondents could mark more than one answer

Reasons for Instituting a Plan

The most important reasons for instituting employee retirement plans focused on employees themselves (Table 30). Twenty-nine (29) percent cited the need to keep valued employees as their principal motivation. The owners feared competitive pressures created by other employers and instituted a plan to help retain employees. The reason noted with second greatest frequency was that employees needed a plan (24%). A variant of this theme probably is that it was the right thing to do. Together, these employee-directed reasons accounted for 53% of responses, or more than 60% of those providing an answer.

Table 27

SMALL BUSINESS EMPLOYEE RETIREMENT PLAN MANAGER
BY SMALL BUSINESS ANNUAL GROSS RECEIPTS
(in percent)

	ANNUAL GROSS RECEIPTS ($000's)					
RETIREMENT PLAN MANAGER	Under 500	500-1,499	1,500-4,999	5,000 or More	No Answer	Total
You or Someone in Your Business	39	44	41	29	33	39%
Consultant	8	13	11	12	7	11%
Investment Broker	19	10	12	9	13	12%
Bank Trust Department	14	15	14	24	27	17%
Other	4	5	9	9	13	7%
No Answer	16	13	13	16	7	14%
Total	100%	100%	10u%	100%	100%	100%
Number of Respondents	74	104	108	75	15	376

Table 28

SMALL BUSINESS OWNER SATISFACTION WITH EMPLOYEE
RETIREMENT PLAN BY TYPE OF RETIREMENT PLAN
(in percent)

	TYPE OF PLAN				
SATISFACTION	Multi-Employer	Defined Benefit	Defined Contribution	No Answer	Total
Generally Satisfied	53	69	85	51	65%
Not Satisfied, Can't Afford Better	2	17	3	4	6%
Not Satisfied, Soon Will Have Better	*	6	3	4	4%
Soon Will Reduce Coverage	*	2	*	*	1%
Soon Will Drop Coverage	*	1	1	2	1%
Subject to Union Agreement	35	1	3	2	2%
No Answer	2	5	6	38	21%
Total	100%	100%	100%	100%	100%
Number of Respondents	17	103	145	111	376

* less than 0.5%

Table 29

MOST IMPORTANT SMALL BUSINESS PROBLEM IN MAINTAINING CURRENT EMPLOYEE RETIREMENT PLAN BY SMALL BUSINESS OWNER SATISFACTION WITH CURRENT EMPLOYEE RETIREMENT PLAN
(in percent)

	SATISFACTION WITH RETIREMENT PLAN			
PROBLEM	Generally Satisfied	Other Views	No Answer	Total
Administrative Costs	19	22	3	15%
Multi-Employer Withdrawal Liability	2	9	*	2%
Constant Government Changes	51	37	4	37%
Restrictions on Fund Use	2	4	3	2%
Top Heavy Restrictions	9	9	*	7%
Other	7	15	*	6%
No Answer	11	19	91	32%
Total	100%	100%	100%	100%
Number of Respondents	245	54	77	376

*Less than 0.5%

Direct personal motives were also often behind institution of a plan, but much less often than employee centered motives. Tax advantages and best way for the owners to establish a personal plan each attracted an 11% response. Outside influences, such as labor bargaining and procuring a business with an established plan, accounted for another 10%. The remainder (13%) offered no reason.

The median number of years these retirement plans have been in existence is about nine. Reviewing the distribution of years in existence on Table 31, it appears clear the relative number of plans is about holding its own over time. There is neither any great rush to institute them nor a trend to eliminate them. However, there do appear to be some changes over time in the reasons for instituting a plan. For example, the need to keep valued employees was cited more frequently by those with newer plans, probably indicating increased labor market pressures. Union negotiated was inversely related to plan age, illustrating the comparatively early union entry into retirement plans. The impact of incentives created by tax advantages presents no real pattern of responses.

Opting Out of Plans

One in ten (10%) respondents reported that they had either cancelled or withdrawn from an employee retirement plan (Table 32). The most frequent reason cited for leaving a retirement plan was changing and complex regulations. Thirty-five (35) percent of those having dropped a plan offered that explanation. Another 8% cited increased administrative costs. These two government-caused reasons accounted for 43% of all small business owners who either have dropped or cancelled a retirement plan (and are still in business).

A second group of almost identical size (42%) offered market-related reasons for their actions. A majority in that group (25% of the total) pointed to lower sales or profitability. Changes in the labor force accounted for another 17%.

Of those small business owners cancelling or withdrawing from a plan, about two of five (39%) now provide a different plan. Firms fitting these conditions tended to fall in the mid-size range of small businesses (Table 33). Unfortunately, there were only 54 cases (N=54). This number is insufficient to cross-tabulate against reasons for dropping and reasons for instituting a retirement plan. However, the subject offers an intriguing possibility for additional inquiry.

Table 30

MOST IMPORTANT SMALL BUSINESS OWNER REASON FOR INSTITUTING EMPLOYEE RETIREMENT PLAN BY ANNUAL GROSS RECEIPTS OF SMALL BUSINESSES (in percent)

	ANNUAL GROSS RECEIPTS ($000's)					
MOST IMPORTANT REASON FOR INSTITUTING PLAN	Under 500	500- 1,499	1,500- 2,999	3,000 Or More	No Answer	Total
Needed to Keep Valued Employees	18	31	33	33	27	29%
Employees Needed a Plan	15	24	32	23	47	24%
Union Negotiated	8	3	3	8	7	6%
Tax Advantages	19	9	14	7	13	11%
Chosen Before Present Owner	3	2	6	6	*	4%
Best Way for Owners to Establish Personal Plan	19	14	5	9	*	11%
Other/No Answer	19	13	8	15	*	14%
Total	100%	100%	100%	100%	100%	100%
Number of Respondents	74	104	16	117	15	376

* less than 0.5%

Table 31

MOST IMPORTANT SMALL BUSINESS OWNER REASON FOR INSTITUTING EMPLOYEE RETIREMENT PLAN BY YEARS PLAN IN EXISTENCE (in percent)

MOST IMPORTANT REASON FOR INSTITUTING PLAN	YEARS PLAN IN EXISTENCE						
	Less than 2	3-5	6-10	11-15	16 and Over	No Answer	Total
Needed to Keep Valued Employees	28	39	35	34	23	16	29%
Employees Needed a Plan	34	27	15	25	36	17	24%
Union Negotiated	3	4	3	4	21	5	6%
Tax Advantages	22	13	12	18	6	3	11%
Chosen Before Present Owner	3	1	6	7	8	*	4%
Best Way for Owners to Establish Personal Plan	3	14	23	10	8	4	11%
Other/No Answer	6	1	7	2	*	*	14%
Total	100%	100%	100%	100%	100%	100%	100%
Number of Respondents	32	77	69	68	53	77	376

Table 32

PERCENT OF SMALL BUSINESS OWNERS HAVING CANCELLED OR WITHDRAWN FROM RETIREMENT PLAN AND OWNER REASON FOR ACTION

ACTION TAKEN	CANCELLED OR WITHDRAWN FROM PLAN	REASON FOR ACTION
Yes	10	
Change in Workforce		17
Lower Sales or Profitability		25
Reduction in Owner Benefits		2
Increased Administrative Costs		8
Changing and Complex Regulations		35
Other		12
Subtotal		100%
No	83	
No Answer	7	
TOTAL	100%	

Table 33

PERCENT OF SMALL BUSINESS OWNERS WHO HAVE CANCELLED
OR WITHDRAWN FROM AN EMPLOYEE RETIREMENT PLAN
BUT WHO CURRENTLY HAVE ONE BY FIRM SIZE

	FIRM SIZE (FULL-TIME EMPLOYEES)							
CANCELLED OR WITHDRAWN FROM PLAN	1-4	5-9	10-19	20-49	50-99	100+	No Answer	Total
Yes	4	10	20	23	18	11	23	14%
No	91	81	78	73	80	85	62	81%
No Answer	5	10	3	5	2	4	15	5%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Number of Resp.	76	73	81	62	44	27	13	376

Non-Provision

A healthy majority of small businesses (74%) offer their employees no retirement plan. The most frequently cited reason (39%) for this situation was "Can't Afford One" (Table 34). This result was to be expected given a similar experience with the more popular health insurance benefit. But no other response even reached the double digit level. Start-up problems tallied 9%, followed by an employee preference for direct compensation (6%). The remainder of the provided responses drew even less mention. Administrative costs amounted to an asterisk, probably indicating that many are unfamiliar with problems occurring once a plan has been established.

A whopping 33% failed to answer the question. Unfortunately, there is no obvious reason why that action was taken by so many. Perhaps there were more important reasons, e.g., not commonly given in businesses like mine, which were not presented to respondents. Perhaps the positioning of the question on the page caused respondents to miss it. One could even speculate that an employee retirement benefit is not considered normal or usual (which is accurate in smaller firms), therefore no conscious reason is available for its non-provision. But there is no way of knowing which, if any, of these possibilities is accurate.

A variety of incentives or causes to provide an employee retirement plan were considered important by small firms. However, with the exception of "Business Becomes More Profitable" which was cited by 38%, no single reason was cited by as many as one in four (Table 34). A corollary to the business becoming more profitable rationale, and the second most frequently cited reason, was "Tax Advantages Increased" (20%). For a tax advantage to be useful, however, there must be something to tax. As a result, direct provision of tax code incentives to create or expand retirement plans will be useful to some, i.e. those responding to tax advantages increased, but will leave many unaffected, i.e. those responding to business becomes more profitable. The dilemma created by the differential tax situations of varying businesses is certainly not unknown, but remains no less difficult. This is particularly true when so many with plans (those who have already acted) attributed their behavior to tax advantages (see Reasons for Instituting a Plan and Table 31).

Twelve (12) percent asserted a cause to provide a retirement plan would be the ability to reinvest plan assets into the business. Suggestions have been made to relax rules disallowing such treatment of capital. But it appears inconsistent that over twice as many reported investment ability a cause to establish a retirement plan as (Table 29)

Table 34

SMALL BUSINESS OWNER REASONS EMPLOYEE RETIREMENT PLAN NOT PROVIDED ALL FULL-TIME EMPLOYEES BY FIRM SIZE
(in percent)

	FIRM SIZE (FULL-TIME EMPLOYEES)							
REASON NOT PROVIDED	1-4	5-9	10-19	20-49	50-99	100+	No Answer	Total
Can't Afford One	50	37	29	33	22	18	28	39%
Start-Up Costs, Red Tape, Etc.	8	9	13	15	7	*	3	9%
Employees Prefer Compensation	6	6	8	4	11	6	5	6%
Too Much Employee Turnover	5	3	6	1	4	*	2	4%
Administrative Costs	*	*	1	*	*	6	*	*
Capital Needed to Reinvest in the Business	5	5	7	3	7	6	5	5%
Changing and Complex Regulations	*	1	2	3	*	6	*	1%
Insufficient Owner Benefits	3	6	3	4	*	*	2	3%
No Answer	23	33	31	37	48	59	54	33%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Number of Resp.	484	252	150	100	27	17	146	1176

* less than 0.5%

reported the lack of reinvestment ability a cause for not instituting a plan in the first place (Table 35).

Nine (9) percent, or 8% of the total population, indicated they would not provide such an employee benefit under almost any circumstance. That represents four times the number responding in a similar manner to the provision of employee health insurance.

Information Sources

Accountants were most frequently cited by small business owners as the single most important source of information on pensions, options available for retirement income, etc. (Table 36). Twenty-six (26) percent named accountants, with insurance agents (18%) and financial planners (11%) following. Trade associations, magazines/publications, business consultants, bankers, and lawyers were infrequently mentioned as the most important source of information on retirement financial planning. Twenty-two (22) percent did not respond. However, examination of Table 35 shows that non-response was, located by several orders of magnitude, disproportionately among those who had no retirement plan. This distribution implies that many small business owners don't have a most important source simply because they don't pay much attention to the matter. This is not an isolated phenomenon. A disproportionately large group not providing health insurance also failed to identify a most important information source for health-related matters (see Table 26).

Those small business owners not providing an employee retirement plan were as likely to cite accountants and insurance agents as their most important source of information as were those providing plans. Virtually all other potential sources of information were noted with much greater frequency by the latter group. This differential was particularly notable among financial planners and business consultants.

Those with retirement plans covering all full-time employees were much less likely to cite accountants than were those who had just a portion. The reverse was true of financial planners. Arguably, the larger the retirement plan (in terms of coverage), the greater the shift to more specialized sources of information.

Concluding Observations

Employer provided employee retirement programs are not common in small businesses. Formal plans appear even less common. But the precise extent of benefit provision is difficult to determine. The principal interpretational problem comes with profit-sharing benefits. Survey responses indicated that profit sharing doesn't fit any prearranged benefit classification scheme very well. Many small business owners considered it a "free-standing" benefit which may or may not eventually become an employer provided retirement program. Evidence supporting this

Table 35

CAUSES FOR SMALL BUSINESS OWNERS TO PROVIDE EMPLOYEE RETIREMENT PLAN BY FIRM SIZE (in percent)

	FIRM SIZE (FULL-TIME EMPLOYEES)							
CAUSE TO PROVIDE	1-4	5-9	10-19	20-49	50-99	100+	No Answer	Total@
Business Becomes More Profitable	45	40	34	37	15	12	24	38%
Comparative Costs, Options Clearer	11	13	13	14	7	*	3	10%
Employees Asked for One	11	10	13	9	15	*	3	10%
Administrative Costs Could Be Cut	8	8	13	8	*	*	2	2%
Tax Advantages Increased	24	22	21	23	15	6	5	20%
Good Employees More Difficult to Attract	8	7	4	6	7	*	1	6%
Plan Assets Could Be Reinvested in the Business	12	12	16	14	7	6	7	12%
Wouldn't Provide Under Almost Any Condition	9	9	9	7	7	12	11	9%
Total @	128%	121%	123%	118%	73%	36%	56%	109%
Number of Resp.	484	252	150	100	27	17	146	1176

* less than 0.5%
@ respondents could mark more than one answer

observation lies in the relatively large number of respondents checking profit sharing while also indicating they either did not have a retirement plan or the plan was other than a defined contribution plan.

Employee retirement benefits are provided in a minority of small businesses. Given the hierarchy of benefit introduction noted earlier, retirement benefits among the nation's small businesses will probably increase incrementally over time. But there appears to be means to accelerate or retard the speed of change. The experience of the mid-70's with its policy emphasis on rigidity and uniformity was an example of how to retard it. Flexibility and uniqueness, both in terms of regulatory policy and marketing as continually underscored in this survey, are the means to accelerate it. While provision of retirement benefits is not the only important possible effect of the trade-off between the two regulatory poles, it is one that should never be forgotten.

Table 36

MOST IMPORTANT SOURCE OF EMPLOYEE RETIREMENT PLAN INFORMATION FOR SMALL BUSINESS OWNERS BY PERCENT OF FULL-TIME EMPLOYEES IN EACH FIRM

MOST IMPORTANT INFORMATION SOURCE	PERCENT OF FULL-TIME EMPLOYEES COVERED IN EACH FIRM					
	None+	1-39%	40-60%	61-99%	100%	Total
Accountant	26	30	32	30	21	26%
Insurance Agent	18	22	18	13	17	18%
Trade Association	6	8	18	13	10	8%
Financial Planner	7	19	18	19	24	11%
Magazines/Publications	7	5	*	4	4	6%
Business Consultant	2	5	*	9	7	4%
Lawyer	1	3	9	4	4	2%
Banker	2	3	5	*	4	2%
Other	1	3	*	4	2	2%
No Answer	29	3	*	6	6	22%
Total	100%	100%	100%	100%	100%	100%
Number of Resp.	1063	37	22	54	263	1439

+ includes non-respondents
* less than 0.5%

SURVEY SAMPLE

The preceding report was based on data gathered from a mail survey of small business owners conducted in September, 1985. The survey sample was randomly drawn from the membership file of the National Federation of Independent Business (NFIB). All regular members in the file were eligible for selection, the exception being a comparatively small percentage who had no full-time employees. Thus, the resulting sample consisted entirely of small employers. Each of the 7,750 small business owners in the sample received a questionnaire (a copy provided in Questionnaire, p. 46) and a follow-up two weeks later. There were 1,439 usable responses for a 19% response rate, 11 percentage points less than NFIB normally experiences in such surveys.

There is little a priori reason to fear a sample bias. Dunkelberg and Scott have demonstrated that the NFIB membership file reasonably reflects the universe as the universe can best be estimated.*/ Moreover, the sample was not contaminated by association activities involving extensive sale or promotion of employee benefit packages. And while response rates of 30%, let alone 19%, never can provide a survey analyst comfort, previous experience in comparing NFIB-collected responses to equivalent data collected by other organizations shows remarkable consistency, particularly within size class. The differences that do exist usually involve "levels" for the entire population resulting from the somewhat larger businesses within the NFIB file.

Tables A and B provide comparisons of the estimated universe, the survey sample, and the survey respondents. (The estimated universe measures were drawn from the Small Business Administration's (SBA) Small Business Data Base as published in the annual The State of Small Business Report.) Note on Table A that the industry-by-industry differences in these data sets are minimal. Survey respondents are somewhat overrepresented among manufacturers and underrepresented among services. In the other major industries, however, differences usually involve only a percentage point or two.

When employee size is substituted for industry in the three set comparison (Table B), the result is not as satisfactory. The profile of survey respondents and the survey sample are virtually identical, with the exception of 1-4 employee class size and "no answer." Distributing the no answers proportionally among all size classes creates a survey respondent profile still somewhat underrepresented in the 1-4 employee class and a percentage point or two overrepresented in the others. That distribution in and of itself should be sufficient to cover all concerns over the response rate. However, the responses of "no answers" and the

*/William C. Dunkelberg and Jonathan A. Scott, Report on the Representativeness of the National Federation of Independent Business Sample of Small Firms in the United States, Small Business Administration, 1984.

responses of other size classes to other comparable questions produce an uncommon similarity between the "no answers" and the 1-4 employee size class. Given that similarity and previous experience which indicates the smallest are most likely not to respond to size questions, responses proportionally allocating "no answers" probably do not assign enough to the smallest size class. As a result, the profile of survey respondents and the survey sample is probably even better than the considerable similarity previously shown.

Table A

COMPARISON OF ESTIMATED UNIVERSE, SURVEY SAMPLE, AND SURVEY RESPONSES BY INDUSTRY (in percent)

INDUSTRY	ESTIMATED UNIVERSE	SURVEY SAMPLE	SURVEY RESPONDENTS
Construction	14	11	12
Manufacturing (includes Mining)	9	13	13
Transportation	4	3	4
Wholesale	10	7	10
Retail	29	27	27
Agriculture	4	5	5
Financial Services	8	7	9
Services	24	24	19
No Answer	--	2	1
Total	100%	100%	100%

While the estimated universe inflates the 1-4 employee size class a percentage point or two by inclusion of some non-employers, there remains a difference between the estimated universe and the sample. Sample small business owners (as well as respondents) have somewhat larger businesses on balance. The estimated universe contains approximately 10 percentage points more firms in the 1-4 employee size class than did the sample on the response. Those 10 percentage points were distributed over other size classes. Thus, population "levels" are unduly influenced, though not greatly, by owners of firms larger than 1-4 employees.

Table B

COMPARISON OF ESTIMATED UNIVERSE, SURVEY SAMPLE, AND SURVEY RESPONSES BY EMPLOYEE SIZE (in percent)

EMPLOYEE SIZE	ESTIMATED UNIVERSE	SURVEY SAMPLE	SURVEY RESPONDENTS
1-4	57	48	37
5-9	21	21	21
10-19	11	15	15
20-49	7	11	10
50-99	2	3	4
100 or more	2	2	3
No answer	--	1	11
Total	100%	100%	100%

NFIB EMPLOYEE BENEFITS SURVEY

(Please mark appropriate answers or fill in the blanks)

1. What is the legal form of your business?
[1] Proprietorship [2] Partnership [3] Corporation [4] Sub-chapter S Corp. 1

2. Please classify your **major** business activity, using one of the categories of examples below. (If more than one applies, mark the one which contributes the most toward your gross sales or total revenues.)
[1] Construction (general contractor, painting, carpentry, plumbing, heating, electrical, highway, etc.)
[2] Manufacturing and mining (including dairy processor, printer, publisher, etc.)
[3] Transportation, travel agency, communication, public utilities (truckers, movers, broadcasters, etc.)
[4] Wholesale (including grain elevator, livestock dealer, distributor of equipment, manufacturer's rep., etc.)
[5] Retail (including service station, restaurant, bar, radio and TV store, drug store, florist, apparel, etc.) 2
[6] Agriculture, veterinarian, forestry, landscaping, fisheries, etc.
[7] Financial, insurance, real estate, bank, savings & loan, etc.
[8] Beauty salon, barber shop, garage, motel, hotel, repair service, bookkeeping service, photographer, funeral director, rental agency, credit bureau, laundry, etc.
[9] Physician, dentist, attorney, engineer, architect, accountant, skilled nursing care facility, etc.
[10] Other (please describe) ______________________________

3. During the last calendar or fiscal year, what were your **gross sales** or receipts?
[1] Under $100,000 [4] $500,000-799,999 [7] $3,000,000-4,999,999
[2] $100,000-199,999 [5] $800,000-1,499,999 [8] $5,000,000-9,999,999 3
[3] $200,000-499,999 [6] $1,500,000-2,999,999 [9] $10,000,000 or more

4. How many people do you employ, **not including the owner(s)**? (A part-time employee is generally thought of as working less than 35 hours per week.)

a) Full-time (Total) ____________ 4-6
Teenagers ____________ 7-8
65-69 years old ____________ 9-10
70 years old or more ____________ 11-12
b) Part-time (Total) ____________ 13-15
Teenagers ____________ 16-17
65-69 years old ____________ 18-19
70 years old or more ____________ 20-21

5. What type of fringe benefits do you provide full-time employees who have been on the job past any probationary period you have? (Mark appropriate answers)

		1	2	3	4	5	
		Not	Provided	Provided	Provided	Provided	
		Provided	Some	About Half	Most	All	
		Employees	Employees	Employees	Employees	Employees	
	Benefit	(0%)	(1-39%)	(40-60%)	(61-99%)	(100%)	
a)	Health Insurance	______	______	______	______	______	22
b)	Dental Insurance	______	______	______	______	______	23
c)	Retirement Plan (including a Profit Sharing or Capital Accumulation Plan)	______	______	______	______	______	24
d)	Paid Vacations	______	______	______	______	______	25
e)	Paid Sick Leave	______	______	______	______	______	26
f)	Long-Term Disability Insurance (not Workers Comp)	______	______	______	______	______	27
g)	Life Insurance	______	______	______	______	______	28
h)	Education Assistance	______	______	______	______	______	29
i)	Employee Discounts	______	______	______	______	______	30
j)	Employee(s) set own working hours (flex time)	______	______	______	______	______	31
k)	Paid Lunch Break	______	______	______	______	______	32
l)	Dependent Care	______	______	______	______	______	33
m)	Legal Assistance	______	______	______	______	______	34
n)	Other (specify):	______	______	______	______	______	35

6. Please estimate your firm's average monthly payroll. (Do **not** include voluntary fringe benefit costs, FICA, FUTA, etc.)

$____________________ per month 36-39

7. Please estimate your firm's average monthly contribution for all **voluntary** fringe benefits. (Do **not** include FICA, FUTA, Workers Comp, etc.)

$____________________ per month 40-43

8. Please estimate your firm's average monthly contribution for **compulsory** fringe benefits, e.g. FICA, FUTA, Workers Comp. (Do **not** include employee withholdings.)

$____________________ per month 44-47

HEALTH INSURANCE

9. In the past twelve (12) months, how many hours have you and/or an employee(s) on your behalf spent investigating health insurance options, controlling health care costs, etc.?
   (1) Less than 1 hour
   (2) 1-4 hours
   (3) 5-8 hours
   (4) 9-16 hours
   (5) 17 24 hours
   (6) 25-40 hours
   (7) 41-80 hours
   (8) 81 hours or more 48

10 What is your **most important** source of information on health insurance, control of health care costs, health insurance benefits, etc. (Check **one** only)
   (1) Local insurance agent
   (2) Insurance broker
   (3) Tr ide, business, professional association
   (4) Health care providers, e.g., doctors, nurses, etc.
   (5) Magazines, publications, etc.
   (6) Business consultant
   (7) Other (specify): ______ 49

11 Does your State require any minimum health insurance coverages, e g. any policy must include alcohol or drug rehabilitation coverage, outpatient mental health?
   (1) Yes (2) No (3) Don't know 50

   11a. If "yes", how has your firm responded to "minimum coverage" requirements (Mark **one** only)
   (1) No change, already had "minimum coverage"
   (2) Expanded coverage to achieve "minimum coverage"
   (3) Shifted coverage; increased in some areas, reduced in others
   (4) Dropped all coverage 51
   (5) No employee health insurance, so doesn't affect me
   (6) Not yet applicable; Don't know

If you provide employee health insurance for **all** full-time employees, please move to question #13. If not, please continue.

12. If your firm **does not** provide health insurance for **all** full-time employees, why doesn't it? (Check **all** that apply)
   (1) Premiums too high 52
   (2) Employee turn-over too great 53
   (3) Employees generally covered under a spouse or parent's policy 54
   (4) Never thought about it 55
   (5) Administrative expenses too high 56
   (6) Employees prefer compensation in cash/Lack of employee interest 57
   (7) Firm insufficiently profitable 58
   (8) Can't qualify for a group policy 59
   (9) Other (specify): ______ 60

   12a. If you can't qualify for a group policy, why not?
   (1) Not enough employees
   (2) My type of business normally can't get coverage
   (3) Never really explained to me
   (4) Other (specify): 61

   12b What would cause you to purchase group health insurance for your full-time employees? (Mark **all** that apply)
   (1) If we could qualify as a group 62
   (2) If the business became more profitable 63
   (3) If insurance rates were lower 64
   (4) If minimum coverage requirements were dropped 65
   (5) If insurance rates and coverages were more stable 66
   (6) If the business got bigger 67
   (7) If it became more difficult to find good employees 68
   (8) If employees asked for it 69
   (9) Would not provide under almost any circumstance 70
   (10) Other (specify): ______ 71

If you don't provide employee health insurance, please go to question #19. If you have employee health insurance, please continue. If more than one plan, please refer to the plan covering **most** employees.

13. If health insurance coverage is available to **at least some** of your full-time employees, what basic coverage do you have?
   (1) Hospitalization/surgical only
   (2) Major medical only
   (3) Hospitalization/surgical and major medical
   (4) Don't know 72

   13a. Approximately what portion of the group health insurance premium do your **employees** pay? (Do not include administrative costs)
   (1) None
   (2) 1-24%
   (3) 25-49%
   (4) 50-74%
   (5) 75-99%
   (6) 100%
   (7) Don't know 73

   13b. Do your full-time employees have the option of covering a spouse and/or dependents under your firm's group health insurance plan?
   (1) Yes (2) No 74

13c. If your firm provides group health insurance for some, but not all, of your full-time employees (past some probationary period, if applicable), what is the basis for providing coverage? (Mark all that apply)

(1) Years on the job 75
(2) A certain wage or salary level 76
(3) Age 77
(4) Level of responsibility (e.g., only supervisors, foremen, etc.) 78
(5) Other (specify): ____________ 79

13d. Do your part-time employees generally have the same type of health insurance coverage as your full-time employees?

(1) Have no part-time employees
(2) No, no health coverage for part-time employees
(3) No, some health coverage, but less than for full-time employees 80
(4) Yes, generally the same as for full-time employees

14 Over the past three years, how has your employee health insurance coverage changed? (Mark appropriate places)

□ Not in business three years ago
□ No health insurance three years ago 81

	Coverage	Health Insurance Changes			
a)	Percent of Employees	1. No Change	2. Greater	3. Smaller	82
b)	Benefits	1. No Change	2. Increased	3. Decreased	83
c)	Premium Cost (your cost)	1 No Change	2. Increased	3. Decreased	84
d.	Premium Cost (employee's cost)	1. No Change	2. Increased	3. Decreased	85
e)	Deductibles	1. No Change	2. Higher	3. Lower	86
f)	Co-Insurance Requirements	1. No Change	2. Increased	3. Decreased	87

15. Are you satisfied with the health insurance plan now made available to your employees?

(1) Generally satisfied
(2) Not satisfied, but can't afford a better plan
(3) No, but will have better plan in the near future
(4) Will reduce coverage in near future
(5) Will drop coverage in near future
(6) Subject to union agreement 88

15a. Who put together your group health insurance plan?

(1) Firm qualifies as a group
(2) Business, trade, or professional association
(3) Self-insured
(4) Other (specify): ____________ 89

15b. Who is the actual carrier of your group health insurance?

(1) HMO
(2) Self-insured
(3) Blue Cross/Blue Shield
(4) Other private carrier (specify): ____________ 90

16. How many employees (full- and part-time) are covered by your health insurance program?

____________ employees 91 93

17. What is your firm's total monthly health insurance premium for this plan?

$ ____________ per month 94 97

18. What is your firm's share of the average monthly premium for **individual** employee coverage?

(1) $0-9
(2) $10-24
(3) $25-49
(4) $50-74
(5) $75-99
(6) $100-124
(7) $125-149
(8) $150 or more 98

18a. What is your firm's share of the average monthly premium for an employee with **family** or **dependent** coverage?

(1) $0-24
(2) $25-49
(3) $50-74
(4) $75-99
(5) $100-124
(6) $125-174
(7) $175-224
(8) $225 or more 99

RETIREMENT PLANS

If your firm has a retirement plan, please move to question #20. If not, please continue.

19. If your firm does **not** provide a retirement, pension or capital accumulation plan for at least **some** full-time employees, why doesn't it? (Mark **one** answer only)

(1) Can't afford one/not sufficiently profitable
(2) Too much cost, red tape, and hassle to start one
(3) Employees prefer benefits in cash/No employee interest
(4) Too much employee turn-over
(5) Administrative costs to keep one are prohibitive
(6) Takes capital needed to reinvest in the business 100
(7) Changing and complex regulations
(8) Insufficient benefits to owner(s)

19a. What might cause you to provide a pension plan for at least some of your employees? (Check all that apply)

(1) If the business became more profitable 101
(2) If the comparative costs, options, etc. were more clear 102
(3) If employees asked for one 103
(4) If plan administrative expenses could be cut 104
(5) If tax advantages were increased 105
(6) If good employees became more difficult to attract 106
(7) If plan assets could be reinvested in the business 107
(8) Wouldn't provide under almost any condition 108
(9) Other (specify): ____________

20 Have you ever provided a pension plan **and** either cancelled it or withdrawn from it?
[1] Yes [2] No 109

20a. If "yes", what was the most important reason? (Mark **one** only)
[1] Change in the workforce
[2] Lower sales or profitability
[3] Reduction in owner benefits
[4] Increased administration costs
[5] Constantly changing and complex regulations and paperwork 110
[6] Other (specify): ______

21. What is your **most important** source of information on pensions, options available for retirement income, financial planning, etc.? (Mark **one** answer only)
[1] Accountant
[2] Insurance agent
[3] Trade, business, professional association
[4] Financial planner/investment advisory firm
[5] Magazines, publications, etc.
[6] Business Consultant
[7] Lawyer
[8] Banker 1
[9] Other (specify): ______

If your firm has **no** retirement plan, you are finished. Thank you very much. If your firm has a plan, please continue. If your firm has **more** than one plan, please answer the following referring to the plan covering the most employees.

22. If your firm has a pension plan for at least some full-time employees, which basic type is it?
[1] Defined benefit plan (the employee benefit is specified)
[2] Multi-employer plan, e.g. most union plans 2
[3] Defined contribution plan (the employer contribution is specified)

22a. If it is a **defined contribution** plan, which **best** describes the plan? (Mark **one** only)
[1] Profit sharing plan
[2] Money purchase plan (fixed contributions regardless of profitability)
[3] 401(k) plan — employees have choice of cash or tax deferred compensation
[4] SEP (simplified employee pension plans) — contributions to an employee's IRA 3
[5] Thrift plan — employer contribution dependent on employee contribution
[6] Keogh plan
[7] Employee Stock Ownership Plan (ESOP)
[8] Other (specify): ______

23. Why did you choose the type of retirement plan you did? (Mark **all** that apply)
[1] Recommended by advisor as most appropriate for my business 4
[2] Negotiated with a union 5
[3] Ease and cost of start-up 6
[4] Can anticipate (plan) costs 7
[5] Provides most generous benefits to owners 8
[6] Tax advantages 9
[7] Flexibility of contributions 10
[8] Lowest administrative expense 11
[9] Provides most generous benefits to employees 12
[10] Chosen before I got here or had any "say" 13
[11] Other (specify): ______ 14

24. Why did you institute a pension plan in the first place? (Mark **one** only)
[1] Needed to keep valued employees
[2] Employees needed retirement plans
[3] Union negotiated
[4] Tax advantages
[5] Done before I got here or had any "say"
[6] Best way for owners to establish personal plan 15
[7] Other (specify): ______

25. What are the basic qualifications for participating in your pension plan? (Mark the **best** answer for each qualification)

a)	Employee Type	[1] All full-time	[2] Salaried only	[3] Hourly only		16
b)	Employee Service	[1] No requirement [5] 3 years or more	[2] Less than 1 year	[3] 1 year	[4] 2 years	17
c)	Vesting Period	[1] No requirement	[2] 1-2 years	[3] 3-5 years	[4] 6-10 years	18

26. Is the owner(s) included in this plan?
[1] Yes [2] No 19

27. How many years has the plan been in existence?
______ years 20 21

28. Who manages your retirement plan?
[1] You or someone in the business
[2] Consultant
[3] Investment broker
[4] Bank trust department
[5] Other (specify): ______ 22

28a. Please estimate the administrative expenses incurred over the last 12 months to maintain (or start or modify if applicable) your retirement plan.

23 26

29. How much did you contribute to the funding last year?

8 ____________ 27 30

30 How many employees are... participating in the plan? ____________ 31 33
fully vested in the plan? ____________ 34 36
partially vested in the plan? ____________ 37 39

31. Are you satisfied with the retirement program now made available to your employees? (Mark the one best answer.)
[1] Generally satisfied
[2] Not satisfied, but can't afford a better plan
[3] No, but will have a better plan in the near future
[4] Will reduce benefits in the near future
[5] Will soon terminate plan 40
[6] Subject to union agreement

32. What is your single most important problem in maintaining your current retirement plan (Mark one only)
[1] Administrativ: costs (paperwork, accounting, legal fees)
[2] Multi-employer withdrawal liability
[3] Constant government changes requiring plan amendments 41
[4] Restriction on use of pension funds
[5] Top-heavy restrictions on small business owners
[6] Other (specify): ____

THANK YOU

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□ Check here if you would like a free copy of the results 42

Responses of Michael O. Roush to Questions Submitted by Senator Grassley

Question No. 1. I would appreciate your assessment of how important simplification will be on pension plan formation by small employers. Are we going to see a very big effect, a modest effect, or what exactly?

Answer. The impact pension simplification will have on small business participation in pension plans will depend primarily on how Congress approaches pension simplification. If the goal of Congress is to allow small business owners to start and maintain pension plans at a minimal cost, small business pension participation is likely to increase dramatically. If Congress focuses on ensuring that every employee of the small business is provided with retirement savings paid for by the employer, then the increase in small business pension participation will be minimal.

Question No. 2. Is the NFIB concerned about the apparent move by employers away from defined benefit arrangements to more of an employee-paid approach. Some have suggested this is an aging trend. Do you agree, and can you offer an explanation for this?

Answer. A large number of employers have moved away from defined benefit plans to defined contribution plans because Congress has made it cost prohibitive to have a defined benefit plan. NFIB is not so concerned about the movement from defined benefit plans to defined contribution plans as we are about the large number of small businesses which have no plan at all.

Question No. 3. Do you think simplification will result in an increase in defined benefit plans specifically? I ask because it is argued by some that the decline in defined benefit plans has sources other than pension law complexity. I refer, for example, to the argument that labor force mobility, stock market gains, and tax law changes might all have encouraged formation of more defined contribution plans than defined benefit plans.

Answer. Small employers with defined benefit plans are changing to defined contribution plans because defined contribution plans are simpler and less expensive to set up and maintain. To the extent that pension simplification makes it easier for small employers to establish a defined benefit plan, it will result in increasing the number of defined benefit plans that are offered. NFIB's primary concern, however, is not whether employees are able to participate in a defined benefit or defined contribution plan, but whether or not they will have the opportunity to participate in anything at all.

Question No. 4. 401(k) and (m) average deferral and average contribution tests were changed as part of the tax reform act of 1986 to limit potential abuse by highly compensated employees, and also to limit revenue loss.

What assurances do we have that if these tests were dropped, this wouldn't lead to abuse in favor of highly paid employees, and in turn, cost the government revenue?

Answer. Any action that Congress takes to increase the number of people using a pension plan to save for their retirement will cost the federal government revenue.

Senator Bentsen'S IRA bill is expected to be very expensive because it will be very successful.

Dropping the nondiscrimination tests could lead to increased abuse. However, the amount of abuse that can take place is very limited. Non-discrimination tests have two effects: (1) they limit the ability of highly compensated employees to save for their own retirement while denying benefits for non-highly compensated employees, and (2) they dramatically increase the cost of pension plans. Under current law, we have very effective, very expensive non-discrimination rules. As a result, a large number of smaller businesses have no pension plans at all. In an attempt to be fair, these nondiscrimination rules have effectively denied pension coverage to millions of small business employees.

Question No. 5. Some people think that requiring employers to decide where the mandatory roll-over would go is excessive, both because of the administrative burden it creates, and because it would raise questions of fiduciary liability.

It is also argued that the mandatory roll-over just generates fees for IRA providers given that the employee can still get the money from the IRA to which it has been transferred.

Can you comment?

Answer. Keeping the employer's involvement in the plan minimal will maximize the number of small business owners willing to start a plan.

Question No. 6. I have received complaints that the form 5500 is more complicated and costly to complete than is really necessary. I told that much of the information required is of little use to either participants or the government.

Would you agree with that?

Answer. Yes. The Form 5500 is one of the things pension simplification is trying to steer away from for the reasons you note.

Question No. 7. Do you think we should try to get this form simplified as part of our pension simplification project?

Answer. NFIB'S focus in the pension simplification debate has been on those small businesses without plans. Current pension simplification proposals that have been introduced would not require small employers to complete a Form 5500. However, NFIB encourages the exploration of any and all ways to simplify pension law.

Prepared Statement of Henry O. Shor

I am a member and past-chairman of the Joint Retirement Board of the United Synagogue of America, and I also serve on the national board of the United Synagogue of America. In the past, I served as the president of my local synagogue, and I am a life member of its board. I serve, and served, in the above capacities as a volunteer.

I am in the insurance business, and I consequently am familiar with the rules and regulations governing pension plans. My profession, and my involvement with church retirement plan issues, both at the national level and the level of my local synagogue, give me what I think is a somewhat unique understanding of the problems churches and synagogues face in complying with those rules.

Our synagogues support S. 747 wholeheartedly. S. 747 for the first time would collect in two separate places in the Internal Revenue Code those rules relating to qualified church plans and retirement income accounts. If in the future Congress enacts legislation of general applicability1 it will not by accident impinge on church plans.

It is also of great interest to us that S. 747 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 the necessary expertise.

S. 747 recognizes a very important fact—most of the rules in the Code have been drafted with the secular employer in mind and do not work very well, if at all, in the case of the unique features of churches. We will do everything we can to help carry through S. 747 to enactment in 1991.

Prepared Statement of Paul Smith

Good morning, Mr. Chairman. I am Paul Smith, Treasurer of the National Association of Life Underwriters, a member of the Association for Advanced Life Underwriting, and president of a firm specializing in the design, implementation and administration of pension and employee benefit plans. On behalf of the almost 140,000 career life underwriters represented by NALU, and the 1,500 members of AALU, let me thank you and compliment you for your efforts to simplify the law in this area. We also thank you for this opportunity to comment on your pending legislation.

NALU is a federation of over 1,000 state and local life underwriter associations who represent almost 140,000 full time life and health insurance salespeople all over the country. We have over 1,200 local association members in Arkansas. AALU is a conference of NALU. AALU's membership is comprised of 1,500 men and women who specialize in advanced life underwriting practices, including pension and employee benefits plan design.

Mr. Chairman, NALU and AALU support the simplification effort generally, and the Pryor/Bentsen bill specifically. We believe it is an important first step toward simplification of an area of law that has grown increasingly complex over the last decade. We offer detailed comments on the beneficial impact that the specific provisions of your bill, and the other pending simplification efforts, will have on this area of the law in a statement prepared by AALU and joined by NALU. That statement emphasizes our support for S. 1364, and most especially for its provision of design-based safe harbor discrimination tests that would allow 401(k) and SEP plans to escape the burden of annual testing for discrimination. The statement also outlines the benefits that will accrue to pension plan participants, sponsors and the government as a result of proposed changes in distribution, funding, rollover and administrative rules in the pension law. Our statement also suggests further changes that, when the time is right to consider them, would improve the ability of employers to offer their workers retirement protection at a reasonable cost to the Federal Government. How, though, we would like to use our time here to emphasize the need for simplification, and to highlight the particular benefit of and need for the design-based discrimination rule options provided in your legislation.

Employer-sponsored pensions and other employee benefit plans are important to both the long and short term financial security of literally millions of Americans. They represent a significant investment by corporate America and, due to the tax expenditure attributable to pension laws, by the Federal Government. Yet, the result of the past years' revenue and fairness driven changes to pension and employee benefits law has been tortuous complexity. Such is the current complication of the law that many employers, and especially small employers, are now considering whether to terminate their plans altogether, or to replace those plans that are best for their workers with others that are less complicated, and therefore more affordable.

This is an unfortunate result, especially in light of the fact that it was apparently unintended. The law's complexity grew in part due to very real revenue needs over the past 10 years. It also resulted from very real concerns in both the government and the private sector that pension and employee benefits tax expenditures provide *fair* benefits to all workers, whether high-paid or rank-and-file, whether employed by large or small businesses. Thus, the current law rules that attempt to maximize coverage while minimizing revenue impact are in fact a nightmare of hundreds of interrelated provisions that boggle the minds of even many experts in the pension area. And, of course, they are an especially acute problem for smaller businesses.

Life underwriters are grateful for the comprehensive review of the tax side of pension and employee benefits law that you began last year. We believe that stepping back to look at how the various pieces of the law work when taken together is necessary to avoid the potential of employers choosing to forego establishment or maintenance of their pension plans because of their complexity and cost. This simplification effort should also reduce the law's complexity to a manageable level that will encourage more and more employers to provide for the long-range financial welfare of their employees.

We understand that rationalizing and simplifying even just the tax side of employee benefits and tax law is a task that must be accomplished in an incremental manner. Competing policy interests as well as revenue considerations demand a step-by-step approach. Thus, while in our written statement we do offer suggestions for additional change, our support for the effort before us for consideration today is untempered by the fact that more can and should be done sometime in the future.

Mr. Chairman, among the most important provisions in your legislation are the changes to discrimination rules that would provide safe harbor discrimination tests for 401(k) and simplified employee pension plans. These optional safe harbors would allow these plans to meet nondiscrimination requirements with a plan design that is generous to rank-and-file employees but that does not require annual comparative testing of actual dollar amount contributions among employees. This ability to meet nondiscrimination obligations is particularly helpful and important to smaller businesses, who sometimes decline to implement a 401(k) plan solely because of the unaffordability of the annual testing requirement.

Current law discrimination tests require annual mathematical computation of ratios of contribution levels among highly-compensated employees and non highly-compensated employees. These tests are complicated and therefore expensive, and they must be performed each year. They are designed to assure that highly compensated employees do not disproportionately benefit (as compared to rank-and-file workers) from the 401(k) plan. Proponents of the tests argue that part of the assurance comes from the incentive effect on HCEs to promote participation in the plan by NHCEs because HCE contribution levels are directly tied to NHCE participation levels.

In our experience, the incentive effect of 401(k) plans is largely due to the employer contribution, whether in the form of a matching contribution or in the form of a direct contribution with a match available. As a result, the administrative expense of annual calculations under current law average deferral percentage and/or actual contributions percentage tests overly credits the benefits of communication in those plans that already have strong incentives for employee contributions, such as substantial matching contributions, and undervalues the administrative waste from having to perform these tests in plans that have strong incentives.

The safe harbors allow an employer to calculate the cost of a 401(k) or SEP plan with reasonable precision, incur the cost of the plan's implementation, and not have to worry about the potential for failure of discimination rule requirements due to employment factors that are essentially not within the employer's control at the start of the plan year.

Also worthy of note is the potential for greater benefits for rank-and-file employees as a by-product of these safe harbor options. Many of the employers with whom we work would much prefer to provide the richer benefit required by these safe harbor plan designs than to spend the significant administrative money required to conduct annual ADP/ACP tests. This is especially true for somewhat larger employers who already have established 401(k) plans.

Many of these businesses are spending substantial amounts to comply with the annual testing requirements. Their benefit contribution levels are generally below those required by the safe harbors, but the combination of contributions and administrative costs are not far from the cost of the safe harbor plan design. These businesses would certainly opt to spend the money on more benefits for their employees if the safe harbor options were available to them.

In addition, we work with a significant number of employers who would choose to implement a 401(k) plan for their employees even if the cost of benefit contributions under the safe harbor provisions exceeded their current contribution plus administration cost level. Many such employers are now in "striking distance" of the safe harbor contribution level cost. For them, the certainty that they could design a plan to be nondiscriminatory, even at a somewhat higher cost than their current cost, would be sufficient motivation to shift to the safe harbor plan design. This would result in greater benefits for the plans' participants. Of course, this furthers our mutual goal of increased pension protection for more people.

Thus, the safe harbor provisions not only make 401(k) plans more attractive to more employers, they also will produce a more generous benefit for rank-and-file workers of employers who already have these plans in place.

In conclusion, Mr. Chairman, NALU and AALU strongly support your bill, and especially its safe harbor provisions. Thank you for this opportunity to comment.

Attachment.

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
Washington, DC, October 15, 1991.

MS. JEANNE M. ROBY,
Committee on Finance
205 Dirksen Senate Office Building
Washington, DC.

Dear Jeanne: During the pension simplification hearing on September 27 MALO's and AALU's witness, Paul Smith, told Senator Pryor that the plans administered by his company would show an approximate 70% participation rate under current law, and that he would expect that participation rate to go up to near 90% under the proposed safe harbor option in S. 1364. He offered to analyze the small employer plans administered by his company to reinforce his point.

Enclosed is that analysis. The underlying data are from 153 401(k) plans, one of which is at a company with 122 employees, and one of which is a company with only 2 workers. The other 151 fall into a range of numbers, from fewer than 10 to nearly 100 employees. The plans were analyzed based on the total number of plans (and eligible participants in the plans), on plans segregated by whether they include an employer matching contribution, and on plans segregated by whether they don't include an employer match.

We hope you find this information useful. If you have questions, please don't hesitate to contact me.

Cordially,

DANEA M. KEHOE, *Associate General Counsel.*

Enclosure.

TOTAL 401(k) PLANS ANALYZED: 153, AVERAGE NUMBER OF EMPLOYEES/PLAN: 31 (range: 2 to 122)

		Percent
All Plans:		
Total number of employees eligible to participate:	4,780	
Total number of employees actually participating:	3,323	
Participation rate:		69 5
Total number of NHCEs eligible to participate:	4,049	
Total number of NHCEs actually participating:	2,824	
Participation rate:		69 7
Plans Without Match (40):		
Total number of employees eligible to participate:	1,289	
Total number of employees actually participating:	787	
Participation rate:		61 0
Total number of NHCEs eligible to participate:	1,094	
Total number of NHCEs actually participating:	635	
Participation rate:		58 0
Plans With Match (113):		
Total number of employees eligible to participate:	3,491	
Total number of employees actually participating:	2,536	
Participation rate:		72 6
Total number of NHCEs eligible to participate:	2,955	
Total number of NHCEs actually participating:	2,189	
Participation rate:		74 0

PREPARED STATEMENT OF ROBERT S. STONE

Good morning, Chairman Pryor and members of the Subcommittee. I am Robert S. Stone. I am appearing on behalf of The ERISA Industry Committee, also known as "ERIC."

We very much appreciate the efforts by you and other sponsors of pension simplification bills to make it easier and more cost-effective for an employer to provide oenefits for its employees and to make it easier for employees to understand what their benefits are.

In commenting on these bills, ERIC hopes to help disentangle employee benefits law. We believe that the law should not be a barrier to employers who want to sponsor retirement plans or to employees who want to participate in them. Rather the law should facilitate sponsorship and encourage participation. We also believe that disentanglement should proceed carefully, precisely, and avoid the temptation to raise revenue by ratcheting down benefit or funding levels.

S. 1364, along with H.R.2730 and H.R.2641, address the need to revise the leased employee rules. We appreciate this recognition of a position ERIC has been taking for several sessions. Of the proposals, we favor the leased employee provision in S .1364 because it prevents abuse, meets common industry practice, and provides a needed retroactive effective date.

We also support provisions that:

- eliminate the requirement that distributions begin before an employee retires,
- simplify the definition of highly compensated employees,
- provide more timely notice of cost-of-living adjustments, and
- allow coordination of normal retirement age with the social security retirement age.

These provisions are in line with the simplification guidelines we proposed to the Subcommittee last year and that are summarized in our written testimony.

However, there are provisions in the various pension simplification bills that will substantially obstruct employees' plans for retirement.

For example, the bills would repeal, either in full or in part, long standing provisions of current law that apply when an employee receives his or her benefits in a single lump-sum distribution.

Many employees were induced to participate in retirement plans because of these provisions and many others, particularly those whose retirement is imminent, have based their retirement plans on them. This proposed repeal is the type of change that has dramatically shaken employee confidence in the pension system—with the employer often taking the blame. Consequently, employer interest in providing retirement coverage will diminish.

S. 1364 would eliminate five-year averaging and also would extend the 15% excise tax to retirees who receive lump-sum and other distributions that exceed $150,000. The Administration and Ways and Means proposals would eliminate net unrealized appreciation provisions in the tax code that have applied to distributions of employer stock since the early 1950s and the ten-year averaging and capital gains grandfather provisions that were included in the 1986 Tax Reform Act.

Employees rely on the tax law when they make their retirement plans. If these provisions are enacted, many lower-income retirees will pay higher taxes on their distributions even if they roll the distributions into IRAS. In addition, problems with the existing rollover rules often have stemmed from the 60-day limit on rollovers, which the bills would not repeal. If the proposed changes are enacted, many retirees will not act quickly enough and will find their retirement savings decimated by marginal tax rates as high as 46%. It would not be at all unusual, for example, for a lower or middle-income employee to receive total distributions in the year of retirement well in excess of $150,000, and therefore subject to the proposed 15% excise tax in S. 1364. They may have planned for the use of those funds, after full income tax will have been paid, in reliance on existing tax law—only to find the federal government biting even more deeply into a lifetime plan.

Similarly, repeal of the net unrealized appreciation provision will shock and upset the many thousands of employees who, in reliance on the existing tax rules, have invested in employer stock over many years and expected the fully taxable dividend flow to be part of their retirement income. Those people may now have to sell a substantial part of their stock in order to pay an unexpected tax.

To employees, the elimination of the lump-sum distribution and employer stock rules will look like a "bait and switch."

While we would like to see expansion of access to plans and liberalization of rollover rules, we believe the withdrawal of important incentives on which employees have relied will nullify the positive effect of such proposals by further reducing employer and employee confidence in the pension system.

We are also concerned that the proposed effective dates for most of the provisions in all of the bills are far too early. Constant change is costly for major employers and prohibitive for medium and small employers. The costs and complications are multiplied when time for compliance is too short. Constant and rapid change upsets employees, who want their retirement security programs to be safe, stable, and understandable.

We are committed to legislation that will facilitate and simplify plan administration. We cannot, however, support legislation that will cut back on employees' retirement options, impede their retirement planning, or erode their confidence that they can rely on the plans they made. As a result, we cannot support the bills in their present form.

We believe it is possible to fashion legislation that will disentangle plan administration without disrupting established systems and employee expectations and that will make progress without raising revenue concerns for the Committee or the Congress. We have made specific suggestions in our written statement and earlier testimony.

We appreciate the attention you have given to this issue and will be pleased to continue working with you. Thank you.

PREPARED STATEMENT OF THOMAS C. WALKER

Mr. Chairman and members of the Subcommittee, my name is Thomas Walker. I am President and CEO of Associated Benefits Corporation which represents over 200 small agricultural employers with over 8,000 participants in both defined benefit and defined contribution plans. I appear today on behalf of the Association of Private Pension and Welfare Plans (APPWP). 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 the country's pension system and we are delighted to be here to testify on the important topic of pension simplification.

The APPWP commends Chairman Pryor, Chairman Bentsen and the cosponsors of the "Employee Benefits Simplification and Expansion Act," S.1364, for identifying the current complexity of the pension system as a problem that must be addressed.

THE NEED FOR PENSION SIMPLIFICATION

The urgent need for pension simplification could not be clearer. In Fiscal Year 1989, according to Internal Revenue Service data, the number of terminations of defined benefit pension plans rose by 37 percent. In FY 1990, there were more than seven times as many such plan terminations as new plans established. This continued a trend which we in the benefits community unfortunately have come to expect. Perhaps even more troubling, is that in FY 1990, for the first time, there was also net negative growth of defined contribution plans (e.g. 401(k) and similar type plans). (See Appendix A). These statistics do not bode well for the future retirement income security of Americans.

In response to the growing complexity of the pension system, the APPWP in 1989 issued a report entitled "Gridlock: Pension Law in Crisis and the Road to Simplification." Rather than merely criticize the complexities of the pension system, "Gridlock" offered 29 specific recommendations for making the system simpler.

Our report was followed this year by a list of 10 additional suggestions for corrections to numerous problem areas regarding pension nondiscrimination rules (IRC Sect. 401(a)(4)) and separate lines of business rules (IRC 414(r)). We are pleased that a number of the APPWP's additional list of suggestions have been incorporated into the various proposals, particularly Rep. Rod Chandler's bill, H.R.2641. We would like to submit for the hearing record a copy of our publication, "Gridlock Revisited"' which explains these additional items as well as some of the highlights from our original 29 recommendations.

Fundamentally, pension complexity is not just about responding to troubling statistics and rationalizing the maze of new Internal Revenue Code provisions. It is about real problems faced by real companies that want to more readily provide meaningful retirement income security to their workers. The APPWP has heard from its employer members about the need for pension simplification, and so has the Congress. Appendix B of this testimony includes a sample of letters from just a few of the APPWP employer members who have written to Congress in recent weeks, expressing support for simplification, generally, and for specific APPWP recommendations.

THE PENSION SIMPLIFICATION LEGISLATIVE PROCESS

Before I turn my attention to the specifics of the legislative proposals pending before Congress, allow me to make a few general remarks about the process by which these measures will be considered. Obviously, if pension simplification is to be enacted at all, it will likely be part of a broader tax measure. That process is always fraught with difficulties for the employee benefits system. Proposals advanced in the name of simplification or equity have brought us some of the worst pension policy results and complexity over the past decade.

It is critical, therefore, that the Congress, and especially the House Ways and Means and Senate Finance committees, not lose sight of the ultimate goal of this effort. It is to make the pension system easier to administer.

In developing its own legislative recommendations over the past two years, the APPWP was governed by two overriding principles. First, simplification must not break any new ground in terms of pension policy. Rather, current policy must be made to work better. Second, recognizing the fiscal realities within which the Congress operates, any recommendation that costs revenue must be financed.

SETTING PRIORITIES FOR PENSION SIMPLIFICATION

Solutions to significant pension complexity problems identified by the APPWP in our "Gridlock" report were included in Senator Pryor's 1990 bill and again in this year's bill. We applaud you for including these recommendations and are pleased to have worked with you last year in the development of the bill. However with the passage of a year, much has changed... for the worst.

In May 1990, the Internal Revenue Service published proposed rules implementing IRC 401(a)(4) and other provisions related to nondiscrimination standards for retirement plans These proposed rules were very problematic. In some respects they went far beyond the scope of what Congress envisioned in the Tax Reform Act of 1986.

In addition there were a number of problems that could not be fixed through regulation. Thus, the APPWP proposed earlier this year that the pension simplification effort include several corrections to the nondiscrimination rules.

*These items included problems related to: 1) mandatory disaggregation, 2) normal retirement age, 3) "worst case" test for accruals, 4) Social Security supplements, 5) interest rate for contributory defined benefit plans, 6) employee transfers, 7) grandfather rule for integrated plans, and 8) rate of pay.

Solutions to each of these problems are included in Rep. Rod Chandler's bill, H.R.2641.

In testimony before the House of Representatives Ways & Means Committee on July 25, 1991, the Treasury Department asked that Congress not legislate on most of the IRC 401(a)(4) issues listed above. Treasury indicated that many of the problems might be dealt with in final regulations, and Congress, therefore, should wait.

Mr. Chairman, the final regulations were issued last week. They comprise 609 double-spaced pages. In only a few modest ways do they address a few of the specific problem areas identified several months ago by the APPWP as requiring simplificaiton. Congress has waited for relief and so have pension plan sponors. The time is now to fix these remaining problem areas because the final IRC 401(a)(4) rules go into effect in three months. These items are a priority for simplification. In addition, other areas particularly requiring simplification, most of which are already addressed in S.1364, include:

*401(k) Plan Nondiscrimination Rules

*Leased Employee Rules

*Separate Lines of Business Rules

*Definition of "Highly Compensated Employee"

*Required Beginning Date of Distributions Rules

*Minimum Participation Rules

401(k) Nondiscrimination Testing

The APPWP commends inclusion in S.1364 of provisions that would extend relief from the very complex ADP and ACP nondiscrimination tests governing 401(k) plans. 401(k) plans are among the most popular retirement savings vehicles in a nation sorely in need of greater savings. Regrettably, the current nondiscrimination tests are not only unduly complex, but they unfairly have an adverse impact on middle-income earners who are at the lower end of the so-called highly compensated group. This is because the rules require employees who contribute the highest percentage of their compensation to first reduce their contributions.

For example, a highly paid executive earning $200,000 who contributes $7000 to the 401(k) plan is contributing 3.5% of compensation. That same $7000 amount contributed by a middle manager earning $60,000 represents a contribution of 11.66% of compensation. Under the 401(k) rules, it is the $60,000 earner who must curtail his contributions in order for the plan to comply with nondiscrimination standards.

S.1364 would establish safe harbors for 401(k) plans which would obviate the need for separate plan testing. The theory behind safe harbors is the idea that anyone should be able to easily determine whether or not a plan discriminates by looking at the design of the plan itself. As long as an employer is willing to make a generous enough contribution on behalf of its employees, the employer should be relieved of having to administer very complex and costly testing procedures. If the employer is not willing to commit that level of contributions, then the current, tough nondiscrimination rules would apply.

This approach is philosophically consistent with what you, Senator Pryor sought to do in 1989 in order to reform the complex Section 89 nondiscrimination rules for health and welfare plans. You crafted a design-based rule which, by its very terms, identified what was considered to be a nondiscriminatory plan.

A recent Wyatt Company survey suggests that greater participation of workers in 401(k) plans is not a function of nondiscrimination rules, as some contend. Rather, it is related to the employer matching contributions which encourage participation. Thus, the APPWP believes that 401(k) sponsors should be relieved of cumbersome testing provided they make a generous contribution on behalf of their employees who choose to participate in the plan. S.1364 provides for just such an approach by means of optional 401(k) plan safe harbors.

Of course even with safe harbors, some employers will still choose to apply the nondiscrimination rules, and all three bills recognize that the rules must be simplified.

Under present law, or for purposes of 401(k) testing, a plan must use data on current year contributions by non-highly compensated employees throughout the year. This makes the application of the nondiscrimination rules much more complex than necessary.

To rectify this problem Rep. Rostenkoski's pension simplification bill, H.R.2730, and Rep. Chandler's bill, H.R.2641, permit an employer to use the data regarding contributions by nonhighly compensated employees from the previous plan year in calculating the allowable contribution in the "current" year for each highly compensated employee. The ability to use prior year data is indeed a welcome simplification. It helps avoid the need to track contributions throughout the year or to worry about returning excess contributions. We applaud this change.

One problem with the way this correction is currently drafted, in Rep. Rostenkowski's bill however, is that it eliminates the ability to "average" the contributions of the group of highly compensated employees. Thus, once again, it will be the workers at the lower range of the highly compensated group -- rather than the most highly paid workers -- who will find their 401(k) contributions limited because these middle income employees are deferring a greater percentage of their compensation.

One way to avoid this problem, would be to allow the use of prior year data, as the Rostenkowski bill does, but retain the ability of a plan to average the contributions of the highly compensated group, even if this meant some tracking of contributions of those workers. This averaging approach is consistent with the way the provision is drafted in both S.1364 and H.R.2641.

Aside from the problem, under present law, of not being able to use prior year data, one of the greatest complexities for 401(k) plans concerns the current correction mechanism for plans that must return

The specific nondiscrimination rule problem areas were explained fully in our "Gridlock Revisited" publication and were the eight items briefly enumerated above in the section entitled "Setting Priorities for Pension Simplification." Time does not permit a complete explanation of all of these problems and a recommended simplification. A brief description of two of the problems, mandatory disaggregation and the uniform retirement age issue, appear below. They illustrate how nettlesome these problems can be and the ease with which they can be remedied without undermining the policy of nondiscrimination. We direct the Committee's attention and favorable consideration to the provisions of Title III of H.R.2641 which addresses each of the other above-referenced items.

Mandatory Disaggregation of Union and Non-Union Employees

Under current law, a portion of a plan that benefits collectively bargained workers and a portion that benefits non-collectively bargained workers must be treated as separate plans (e.g. disaggregated) for purposes of coverage and nondiscrimination rules. This often causes the plans to fail these tests -- despite the fact that the workers may be receiving the identical benefits.

Countless large employers who provide rank and file workers with the same generous benefits offered to other workers, unnecessarily fail the tests despite any evidence that this result serves any tax or pension policy purpose. It certainly does not serve the interests of employees or retirees (neither union or non-union) who, as a result of this artificial disaggregation, may end up being offered less generous benefits in a separate plan. This problem must be fixed by allowing an employer to combine the two groups of participants in a plan for purposes of coverage and nondiscrimination testing. This is a simplification which should enjoy the support of labor and management alike.

Uniform Retirement Age

A number of sponsors of defined benefit plans changed the normal retirement age under their plans to an employee's Social Security retirement age (SSRA) so as to conform to the changes in the SSRA made by Congress for Social Security benefit purposes. For Social Security purposes, the commencement date for receiving Social Security retirement benefits was pushed back to an age between 65 and 67, depending on an employee's birth date, to reflect the longer life expectancies of younger workers. For similar reasons, other plan sponsors amended their plans to determine benefits such as early retirement benefits with reference to an employee's SSRA.

The proposed IRC section 401(a)(4) regulations provide that to qualify for a safe harbor a defined benefit plan's benefit formula must use a "uniform age" and that all subsidized early retirement benefits must be available to employees on similar terms. It is the Treasury Department's position that an employee's SSRA is not a uniform age and that early retirement benefits based on an employee's SSRA are not provided on similar terms; thus, plans that use SSRA's to determine normal or early retirement benefits cannot fit within a safe harbor.

An employer should be able to treat employees' SSRA's as a uniform age or to determine early retirement benefits so as to qualify for use of the defined benefit plan safe harbor. First, SSRA's are not discriminatory. Using SSRA's helps employers only in offsetting the increase in retirement benefits that naturally occurs for younger employees on account of their increasing life expectancies. Second, encouraging use of SSRA's is good public policy. It would help employers to encourage younger employees to work for more years before retiring. This responds to a projected critical need for experienced workers in the future. Finally, allowing use of SSRA's to qualify for the safe harbor would greatly simplify the demonstration of nondiscrimination by a number of major plans.

For all these reasons, the law should be amended to make the SSRA the maximum permissible normal retirement age (rather than age 65) and allow it to be used in testing discrimination and determining vesting under the plan, and for various other plan purposes.

excess contributions to highly compensated employees. We are pleased that S.1364 changes this anomalous rule.

As described above, current law penalizes the lowest paid of the so-called highly compensated group by deeming excess contributions to be attributable first to those contributing the highest percentage of compensation. S.1364, would change the rule to require the return of excess contributions first to those with the greatest dollar contributions, and thereby the highest income earners, rather than the middle earners, 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."

The APPWP "Gridlock" report called for simplification of the leased employee rules and we commend you for including provisions that replace the "historically performed" test with a test that determines whether the individual is performing services under the control of the recipient.

Special Nondiscrimination Rule Problem Areas

As described earlier, the final IRC 401(a)(4) nondiscrimination rules are unnecessarily complex. They are a product of what is referred to in "Gridlock" as "evil plan myopia": the regulators' tendency to formulate general rules aimed at those few plan sponsors with abusive intent, failing to consider their effect on the vast majority of non-abusing sponsors. Because of this, only a small number of very basic plans will be able to meet the allowable safe harbors provided in the proposed IRS rules. Thus, most plans must resort to the "general" test set forth in the regulations.

Under the general test, a plan satisfies IRC 401(a)(4) only if no single highly compensated employee has an accrual rate greater than that of any nonhighly compensated employee. In order to satisfy this test, or avoid it, the regulations permit plans to be restructured into component parts, each of which may then be tested separately, provided each component separately satisfies the minimum coverage rules set forth in regulations under IRC 410(b). Restructuring will be the last refuge for many plans attempting to demonstrate that they satisfy the general test.

Not only are the restructuring rules (and the data collection for the general test in the absence of restructuring) inordinately complex, but such a worst case test was not mandated by the changes of Tax Reform Act of 1986 nor is it supported by any published position of the IRS issued prior to TRA '86. The fact that one highly paid employee can cause a plan to be disqualified, cannot be supported under the statute or legislative history of TRA '86.

A better approach that retains nondiscrimination testing, but in a much simpler manner, would replace the worst case test with an "averaging" test under which the average accruals for nonhighly paid workers would have to equal or exceed average accruals for highly paid workers. Such a rule would greatly simplify testing because the artificiality of restructuring would be unnecessary. It would permit the continuation of most large plans that have been deemed nondiscriminatory for years, without requiring enormous effort and expense annually to prove what they have known all along -- that they do not discriminate. A correction, as described above, is contained in Section 317 of Rep. Chandler's bill, H.R.2641.

There are numerous other specific problem areas that can readily be corrected without in any fashion undermining the policy underlying the nondiscrimination standards. Many of these changes require a legislative fix, because the Internal Revenue Service and Treasury Department simply do not have the statutory authority to make the required changes. In other instances, regulations could have solved the problem but did not do so.

Separate Lines of Business Rules

The Tax Reform Act of 1986 provides that employers who have *bona fide* separate lines of business may elect to satisfy the coverage and nondiscrimination rules separately with respect to their separate lines.

A number of APPWP members sponsor different pension programs for different businesses for sound business reasons. It was the expectation of these companies that the separate lines of business rules would allow them to do so without qualification problems. The IRS proposed regulations earlier this year defining separate lines of business. Under this proposal, employers who operate a centralized headquarters, where staff functions (e.g. legal, accounting, payroll) for all of their other lines of business are performed, will be unable to qualify for separate lines of business treatment. The complete unworkability of these rules is evidenced by the preamble to the proposed regulations which acknowledges that fewer than 700 companies in the entire country will be able to avail themselves of these rules. That clearly thwarts Congress' intent in passing this statute in 1986.

The proposed regulations for separate lines of business, like the nondiscrimination rules discussed earlier, exemplify the "evil plan myopia" discussed earlier. In general, the proposed IRS regulation requires that each separate line have a workforce and management structure, 90 percent of which performs services exclusively to that line of business, but considers any employee who provides more than negligible services to the other lines of business as an employee of each of the lines he serves. This, in effect, makes it impossible for a business with centralized functions to satisfy the IRS proposed regulations.

In addition, the proposed regulations require that each plan of the separate lines satisfy the new proposed nondiscriminatory classification tests on an *employer-wide basis*, and that if the employer wishes to test one plan on a separate line of business basis, it must allocate all employees to qualified separate lines of business. These rules would make the statutory provision virtually meaningless, as only a very few employers will be able to satisfy them.

The APPWP proposes a threefold change to simplify these rules. First, the requirement that plans be tested on an employer-wide basis should be eliminated. Thus, each plan of a separate line would be tested for coverage based only on employees of the separate line. Second, in allocating employees for purposes of the separate employee workforce and separate management tests, each employee should be allocated to only one line of business. Third, a special rule for headquarters employees should be provided, under which an employer may treat its headquarters as a separate line of business and allocate all headquarters employees to that line. These corrections are included in H.R.2641.

The APPWP believes that this approach goes a long way toward making the separate lines of business standards more workable and thereby fulfills Congress' intent in passing this provision in 1986.

Redefinition of Highly Compensated Employee

The complex definition of who is a highly compensated employee is another area identified in the APPWP's "Gridlock" report as ripe for correction. S.1364 and the bills introduced in the House of Representatives all wisely simplify this definition. We commend the sponsors for making this important simplification.

Required Beginning Date of Distributions

We applaud the fact that S.1364 includes revisions to the IRC Sect. 401(a)(9) required beginning date rules. The overinclusiveness of the rule is evident from its application to one particular APPWP member, Southwestern Bell Corporation. This company has devoted a significant amount of time, energy and money to understand and implement these rules. Yet, out of a workforce of more than 66,000 employees, only eight workers were effected by the rules for 1990.

Moreover, only one of the eight workers was even a highly compensated employee. None of the eight were 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 Sect. 401(a)(26) minimum participation rules was aimed at the elimination of individual defined benefit plans which only covered a small segment of highly compensated employees. They have outlived their usefulness. 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 proposed IRS regulations. S.1364 appropriately goes further by statutorily restricting the application of the minimum participation rules to defined benefit plans and by reducing the minimum number of people who must be covered to qualify under IRC Sect. 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.

TAX AND PENSION POLICY CONSIDERATIONS

As noted earlier the APPWP is concerned that pension or tax policy not encroach into the simplification debate. Regrettably, the provisions of S.1364 to eliminate five year income averaging and the so-called "Five times rule" and to implement a mandatory transfer of certain plan distributions have that effect. Those proposals are not simplifications at all. Rather, they change the tax liabilities of retirees.

In the Tax Reform Act of 1986, an individual's ability to income average a distribution over ten years was repealed (except for certain individuals) and replaced with five year averaging.

In addition, TRA '86 imposed a 15 percent excise tax on distribution in excess of $150,000 and also enacted a "five times rule" whereby the $150,000 level is multiplied by five for lump sum distributions. Inexplicably both five year income averaging and the "five times rule" -- both enacted only five years ago -- would be repealed by S.1364. These are precisely the kind of sudden changes that foster complexity and a lack of faith in the pension system by employers, workers and retirees alike.

Finally, the provision of S.1364 to require the mandatory transfer of certain distributions to other qualified plans or IRAs is ill-advised. Such a requirement is a serious penison policy change which will lead to more, not less, administrative complexity for retirement plans. It has no place in a simplification bill.

CONCLUSION

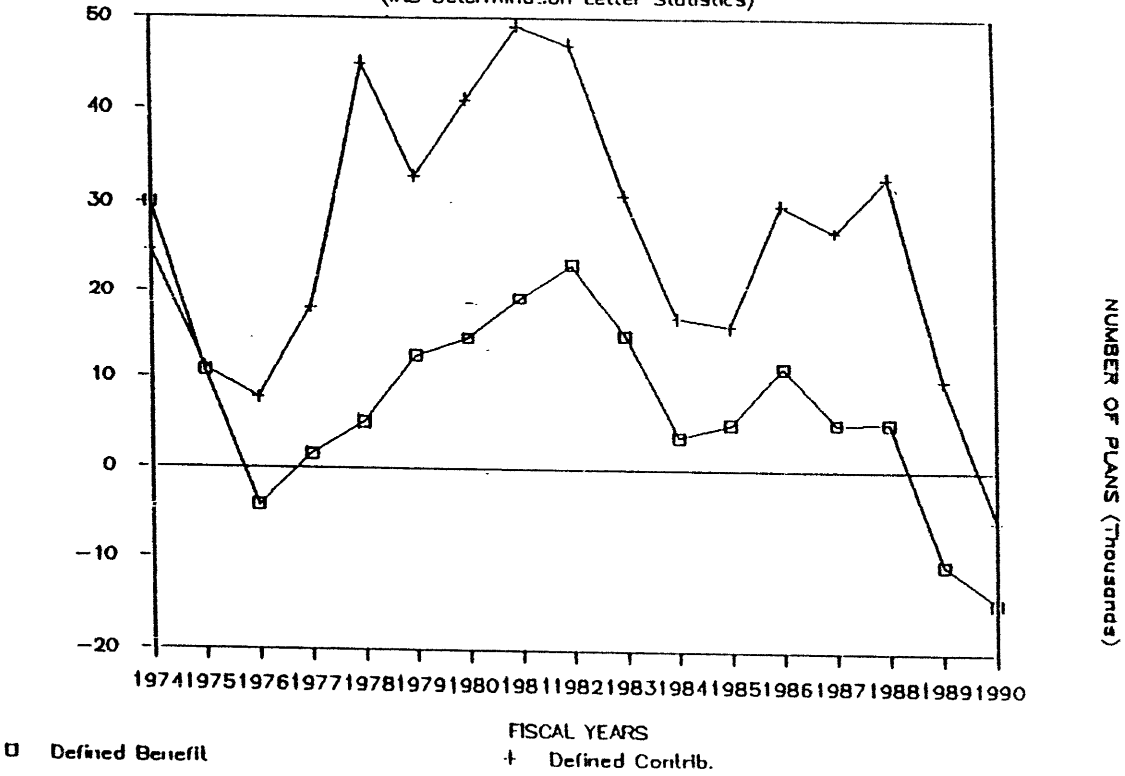
In summary, we commend the members of the Senate Finance Committee who have sponsored S.1364. This is a recognition that the pension system faces "gridlock" and must be simplified. Some of the provisions under consideration include significant tax or pension policy changes and we caution against eliminating sound pension benefits.We look forward to working with the members and staff of the Committee to refine proposals that will improve the pension system.

(APPENDIX A)

APPPWP
Association of Private Pension and Welfare Plans

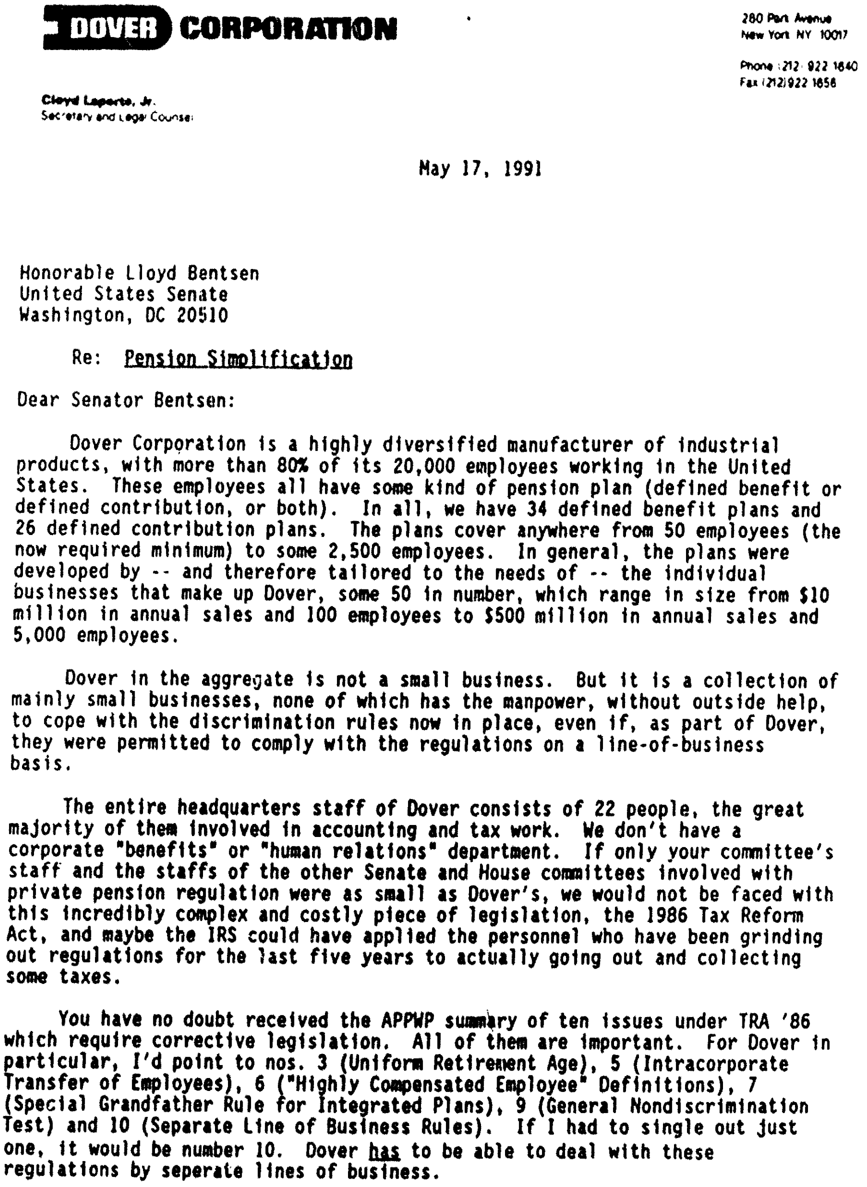
NET NEW PENSION PLANS

(IRS Determina.:on Letter* Statistics)



APPENDIX B

SAMPLE LETTERS FROM APPWP MEMBER COMPANIES CALLING FOR PENSION SIMPLIFICATION



DOVER CORPORATION

280 Park Avenue
New York NY 10017

Phone (212) 922 1640
Fax (212) 922 1656

Cloyd Laporte, Jr.
Secretary and Legal Counsel

May 17, 1991

Honorable Lloyd Bentsen
United States Senate
Washington, DC 20510

Re: Pension Simplification

Dear Senator Bentsen:

Dover Corporation is a highly diversified manufacturer of industrial products, with more than 80% of its 20,000 employees working in the United States. These employees all have some kind of pension plan (defined benefit or defined contribution, or both). In all, we have 34 defined benefit plans and 26 defined contribution plans. The plans cover anywhere from 50 employees (the now required minimum) to some 2,500 employees. In general, the plans were developed by -- and therefore tailored to the needs of -- the individual businesses that make up Dover, some 50 in number, which range in size from $10 million in annual sales and 100 employees to $500 million in annual sales and 5,000 employees.

Dover in the aggregate is not a small business. But it is a collection of mainly small businesses, none of which has the manpower, without outside help, to cope with the discrimination rules now in place, even if, as part of Dover, they were permitted to comply with the regulations on a line-of-business basis.

The entire headquarters staff of Dover consists of 22 people, the great majority of them involved in accounting and tax work. We don't have a corporate "benefits" or "human relations" department. If only your committee's staff and the staffs of the other Senate and House committees involved with private pension regulation were as small as Dover's, we would not be faced with this incredibly complex and costly piece of legislation, the 1986 Tax Reform Act, and maybe the IRS could have applied the personnel who have been grinding out regulations for the last five years to actually going out and collecting some taxes.

You have no doubt received the APPWP summary of ten issues under TRA '86 which require corrective legislation. All of them are important. For Dover in particular, I'd point to nos. 3 (Uniform Retirement Age), 5 (Intracorporate Transfer of Employees), 6 ("Highly Compensated Employee" Definitions), 7 (Special Grandfather Rule for Integrated Plans), 9 (General Nondiscrimination Test) and 10 (Separate Line of Business Rules). If I had to single out just one, it would be number 10. Dover has to be able to deal with these regulations by seperate lines of business.

I believe TRA '86 had two purposes in the pension area:

(1) to make it harder for companies to get tax deductions for making contributions to defined benefit plans;

(2) to prevent small employers from sheltering their income in retirement plans without including their employees on a fair basis.

If this is a fair summary of what you were after, then the simplification proposals leave the first objective intact. I believe there was already enough in place to achieve the second objective with proper IRS enforcement, just as you eventually decided in the case of section 89. But if we cannot get total repeal, it would be a great help to enact the corrective legislation.

Let's try to get back to spending money on benefits instead of on benefits consultants!

Sincerely,

Cloyd Laporte Jr.

COOPER

June 10, 1991

The Honorable Michael A. Andrews
United States Senate
Washington, D.C. 20510

Re: Pension Plan Simplification

Dear Representative Andrews:

I am writing to you as an individual and as an Employee Benefits professional to express my concern about how enormously complex our pension laws and rules have become. I urge you to actively support the Pension Plan Simplification legislation which is being drafted.

I am the Director, Employee Benefits for Cooper Industries, Inc., a diversified manufacturing company with 42,000 employees in the United States including 4,109 in Texas. Cooper Industries maintains about 150 pension plans to provide retirement income for substantially all of these employees.

I am also a member of the Board of Directors of the Association of Private Pension and Welfare Plans (APPWP), an organization that is also very concerned about Pension Plan Simplification. In particular, I call your attention to a 1990 APPWP report entitled: "Gridlock: Pension Law in Crisis and the Road to Simplification." This report outlines the reasons for the current pension law complexities and offers twenty-nine specific recommendations for change. In addition to these twenty-nine suggested changes, the attachment to this letter lists additional areas where corrective legislation could simplify pension administration without adversely impacting the key components of our pension regulatory structure.

I am writing to you about pension plan simplification not because I am seeking to make my life easier, but because I sincerely believe that the current web of complex rules is strangling the private pension system. Five years ago, I felt quite comfortable telling my management that our pension plans were in compliance with the law. Today, due to the explosion of law and regulations in the past five years, I cannot make that type of statement.

I think that it is instructive that the Pension Section of the New York State Bar has publicly called for a simplification of our pension laws and regulations. When you consider that these individuals actually benefit from the law being complex, you can deduce hat we have a real problem.

Also, in the past 2-1/2 years, the IRS has issued over 500 pages of regulations related to pension plan non-discrimination. While we all agree that our tax favored pension plan should be non-discriminatory, I question the need for over 500 pages of complex regulations to achieve this goal.

Over the past five or ten years, we have been told that much of this regulation is necessary to prevent discrimination and other abuses and that the principal offenders were "small" employer plans. As a result of this regulation, small employers are either not adopting or are abandoning pension plans because the rules for them are so complex. In response to this, the Secretary of Labor and others are proposing simplified pension plans for small employers which don't have to comply with all of these rules. I submit that a better approach is to rethink our pension policy and simplify the rules for all plans.

Sincerely,

Stephen V. O'Neill
Director, Employee Benefits

Burlington Industries, Inc.

Donna Lee McGee
Director
Government Relations

1001 Connecticut Avenue, NW
Suite 701
Washington, D.C. 20036

202/223-3167

May 30, 1991

Mr. Steve Glaze
Legislative Assistant
Office of Sen. David Pryor
U.S. Senate
Washington, DC 20510

Dear Mr. Glaze:

Your work in helping to develop pension simplification legislation has recently come to my attention. We at Burlington Industries, Inc. are very pleased to hear that some important pension revisions are being considered. One issue in particular is of serious concern to us, that is why I am writing to you.

It concerns -

Defined Benefit Plans with Employee Contributions.

The changes we strongly endorse for inclusion in the legislation are:

- that under the rules governing contributory plans, the rate of interest to be credited to employee contributions not be mandated at 120% of the federal mid-term rate - currently 10.23% for this plan - but be changed to the PBGC rate, and,

- that the benefit from employee contributions accumulated with interest at this rate may not exceed the employee's accrued benefit under the plan without regard to the assumed interest on employee contributions.

Attached FYI is a copy of correspondence sent to Senator Pryor in 1989 on a similar effort to change these costly and burdensome requirements.

If you would like additional information or would like to speak to someone at Burlington who is particularly knowledgable in the pension area, please do call me and I will immediately handle your request.

Thank you very much for your consideration.

Sincerely yours,

Donna Lee McGee

June 19, 1991

Mr. Randolph H. Hardock
Tax Counsel
Senate Finance Committee
205 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Pension Simplification

Dear Mr. Hardock:

I am writing to suggest that Senator Bentsen support the reintroduction of a Pension Simplification Bill during this Congressional session and would urge that any such bill address the following issues.

Specifically, Kodak hopes that a Pension Simplification Bill will sanction the broadening of Internal Revenue Code section 414(s) to include the use of an employee's rate of pay as an acceptable definition of compensation. An employee's rate of pay is used to ensure a minimum level of compensation in the Kodak Retirement Income Plan. In addition, we hope that any Bill will include the ability to use a Social Security supplement to meet the general discrimination testing requirements of section 401(a) (4) and in determining whether integrated benefits commence before the Social Security retirement age in section 401(l).

Additionally, with continuing IRS delays in issuing the final regulations around these issues, we would urge that the Pension Simplification Bill include a provision that the effective date of the nondiscrimination regulations be no earlier than six months after the issuance of the final regulations rather than the current January 1, 1992 effective date. As you are well aware, these regulations are quite complex, and we at Kodak will need this time to complete our analysis and implement any required changes to a plan as complicated as the Kodak Retirement Income Plan.

On another pension topic, we would urge that any Pension Simplification Bill repeal the 401(k) Average Deferral Percentage (ADP) test or, as alternatives, either retain the ability to restructure a plan into component plans or disregard those non-highly compensated employees (NHCE) necessary to pass the 70 percent ratio test under section 410(b) before testing.

Again, we appreciate your efforts in these matters and would be glad to help in any way possible.

Sincerely,

COLGATE-PALMOLIVE COMPANY

300 Park Avenue
New York, NY 10022-7499

June 4, 1991

The Honorable David H. Pryor
United States Senate
267 Senate Russell Office Building
Washington, DC 20510-0402

Re: Pension Simplification Bill

Dear Senator Pryor:

It is our understanding that a pension simplification bill similar to that contained in last year's S 2901/HR 5362 will soon be introduced in Congress. We are generally supportive of such simplification measures.

As Congress reviews pension simplification issues, we request that you give consideration to the proposed regulations promulgated under section 401(a)(4) of the Internal Revenue Code (the "Code"), which provide a general nondiscrimination test for plans that fail to satisfy one of the safe harbor tests. This general test requires that no single highly compensated employee have an accrual rate that is greater than that of any non highly compensated employee. Given general business practices of large corporations such as ours, we feel that such a requirement is unduly restrictive, particularly given the consequence of failing the test--namely plan disqualification. We suggest that this test be replaced with a statutory averaging test under which plans would satisfy the nondiscrimination requirements if the average accruals for the non highly compensated employees equal or exceed the average accruals for the highly compensated employees. Such a test would still meet the Congressional desire to prohibit discrimination against low-paid workers, and also would help assure that a plan will not fail to qualify in the event that one or a few highly compensated employees would cause the plan to fail the general test that is currently in place.

Although we feel most strongly about making the general nondiscrimination test of section 401(a)(4) of the Code better reflect the actualities of large corporations, we ask that you give consideration to the following issues with regard to pension simplification as well:

- o We propose that the separate lines of business rules be amended as follows:
    - o Delete the precondition that the nondiscriminatory classification test of Code section 410(b)(5)(B) be satisfied.
    - o In allocating employees for the separate employee workforce and separate management tests, each employee should be allocated in accordance with special rules to only one line of business.
    - o A special rule for headquarters employees under which an employer may treat its headquarters as a separate line of business and allocate all headquarters employees be non-highly compensated employees. Furthermore, the 80% requirement would be lowered if the concentration of highly compensated employees of the employer in its headquarters is less than 95% of the employer's highly compensated employees.
- o The proposed regulations under Code section 414(s)--defining compensation--require the use of actual pay rather than a rate of pay. Because using a rate of pay is easier administratively, and has been permitted traditionally, we propose that using a rate of pay be permitted in testing for discrimination.
- o Defined benefit plans that provide for employee contributions are required to credit such contributions with interest at 120% of the federal mid-term rate. This rate of interest continues to accrue even after the individual is not longer employed. The amount accumulated at this rate will be treated as a minimum benefit which must be paid to the participant even if such a minimum benefit will exceed the amount promised under the plan to the participant. Plans should not be required to guarantee a rate to the employees that is higher than the rate the plan can achieve over the long term, or higher even than the rate the PBGC will guarantee. We therefore propose that the rate of interest to be credited to employee contributions should be the PBGC rate, and the benefit from employee contributions accumulated at this rate may not exceed the employee's accrued benefit under the plan without regard to the assumed interest on employee contributions.

Exhibit A

34 Current value of plan assets and liabilities at the beginning and end of the plan year. Combine the value of plan assets held in more than one trust. Allocate the value of the plan's interest in a commingled trust containing the assets of more than one plan on a line-by-line basis unless the trust meets one of the specific exceptions described in the instructions. Do not enter the value of that portion of an insurance contract which guarantees, during this plan year, to pay a specific dollar benefit at a future date. Round off amounts to the nearest dollar. Plans with no assets at the beginning and the end of the plan year, enter zero on line 34f.

Assets		(a) Beginning of year	(b) End of Year
a Total noninterest-bearing cash	a		
b Receivables (net):			
(i) Employer contributions	b(i)		
(ii) Participant contributions	(ii)		
(iii) Income	(iii)		
(iv) Other	(iv)		
(v) Total	(v)		
c General investments:			
(i) Interest-bearing cash (including money market funds)	c(i)		
(ii) Certificates of deposit	(ii)		
(iii) U S. Government securities	(iii)		
(iv) Corporate debt instruments	(iv)		
(v) Corporate stocks:			
(A) Preferred	(v)(A)		
(B) Common	(B)		
(vi) Partnership/joint venture interests	(vi)		
(vii) Real estate			
(A) Income-producing	(vii)(A)		
(B) Nonincome-producing	(B)		
(viii) Loans (other than to participants) secured by mortgages:			
(A) Residential	(viii)(A)		
(B) Commercial	(B)		
(ix) Loans to participants:			
(A) Mortgages	(ix)(A)		
(B) Other	(B)		
(x) Other loans	(x)		
(xi) Value of interest in certain investment arrangements (see instructions)	(xi)		
(xii) Value of funds held in insurance company general account (unallocated contracts)	(xii)		
(xiii) Other	(xiii)		
(xiv) Total	(xiv)		
d Employer-related investments:			
(i) Employer securities	d(i)		
(ii) Employer real property	(ii)		
e Buildings and other property used in plan operation	e		
f Total assets	f		
Liabilities			
g Benefit claims payable	g		
h Operating payables	h		
i Acquisition indebtedness	i		
j Other liabilities	j		
k Total liabilities	k		
Net Assets			
l Line f minus line k	l		

Exhibit B

Form 5500 (1989) Page 5

			Yes	No
32 During the plan year:				
a (i) Was this plan covered by a fidelity bond?		32a		
(ii) If (i) is "Yes," enter amount of bond ▶				
b (i) Was there any loss to the plan, whether or not reimbursed, caused by fraud or dishonesty?		b		
(ii) If (i) is "Yes," enter amount of loss ▶				

33a Is the plan covered under the Pension Benefit Guaranty Corporation termination insurance program?

□ Yes □ No □ Not determined

b If a is "Yes" or "Not determined," enter the employer identification number and the plan number used to identify it.

Employer identification number ▶ Plan number ▶

34 Current value of plan assets and liabilities at the beginning and end of the plan year. Combine the value of plan assets held in more than one trust. Allocate the value of the plan's interest in a commingled trust containing the assets of more than one plan on a line-by-line basis unless the trust meets one of the specific exceptions described in the instructions. Do not enter the value of that portion of an insurance contract which guarantees, during this plan year, to pay a specific dollar benefit at a future date. Round off amounts to the nearest dollar. Plans with no assets at the beginning and the end of the plan year, enter zero on line 34f.

		(a) Beginning of year	(b) End of Year
Assets			
a Total noninterest-bearing cash	a		
b Receivables. (i) Employer contributions	b(i)		
(ii) Participant contributions	(ii)		
(iii) Income	(iii)		
(iv) Other	(iv)		
[redacted]	(v)		
(vi) Total (add (i) through (iv) less (v))	(vi)		
c General Investments: (i) Interest-bearing cash (including money market funds) .	c(i)		
(ii) Certificates of deposit	(ii)		
(iii) U.S. Government securities	(iii)		
[redacted]	(iv)(A)		
[redacted]	(iv)(B)		
(v) Corporate Stocks: (A) Preferred	(v)(A)		
(B) Common	(v)(B)		
(vi) Partnership/joint venture interests	(vi)		
(vii) Real estate: (A) Income-producing	(vii)(A)		
(B) Nonincome-producing	(vii)(B)		
(viii) Loans (other than to participants) secured by mortgages: (A) Residential .	(viii)(A)		
(B) Commercial	(viii)(B)		
(ix) Loans to participants: (A) Mortgages	(ix)(A)		
(B) Other	(ix)(B)		
(x) Other loans	(x)		
[redacted]	(xi)		
[redacted]	(xii)		
[redacted]	(xiii)		
[redacted]	(xiv)		
[redacted]	(xv)		
[redacted]	(xvi)		
(xvii) Value of funds held in insurance company general account (unallocated contracts)	(xvii)		
(xviii) Other	(xviii)		
(xix) Total (add (i) through (x) and (xvi) through (xviii))	(xix)		
d Employer-related investments: (i) Employer securities	d(i)		
(ii) Employer real property	(ii)		
e Buildings and other property used in plan operation	e		
f Total assets	f		
Liabilities			
g Benefit claims payable	g		
h Operating payables	h		
i Acquisition indebtedness	i		
j Other liabilities	j		
k Total liabilities	k		
Net Assets			
l Line f minus line k	l		

BEST AVAILABLE COPY

Exhibit C

		Yes	No
32 During the plan year:			
a (1) Was this plan covered by a fidelity bond? If "Yes," complete a(2) and a(3)	32a(1)		
(2) Enter amount of bond ▶			
(3) Enter the name of the surety company ▶			
b (1) Was there any loss to the plan, whether or not reimbursed, caused by fraud or dishonesty?	b(1)		
(2) If (1) is "Yes," enter amount of loss ▶			

33a Is the plan covered under the Pension Benefit Guaranty Corporation termination insurance program?

□ Yes □ No □ Not determined

b If a is "Yes" or "Not determined," enter the employer identification number and the plan number used to identify it.

Employer identification number ▶ Plan number ▶

34 Current value of plan assets and liabilities at the beginning and end of the plan year. Combine the value of plan assets held in more than one trust. Allocate the value of the plan's interest in a commingled trust containing the assets of more than one plan on a line-by-line basis unless the trust meets one of the specific exceptions described in the instructions. Do not enter the value of that portion of an insurance contract which guarantees, during this plan year, to pay a specific dollar benefit at a future date. **Round off amounts to the nearest dollar; any other amounts are subject to rejection.** Plans with no assets at the beginning and the end of the plan year, enter zero on line f.

Assets		(a) Beginning of year	(b) End of Year
a Total noninterest-bearing cash	a		
b Receivables: (1) Employer contributions	b(1)		
(2) Participant contributions	(2)		
(3) Income	(3)		
(4) Other	(4)		
(5) Less allowance for doubtful accounts	(5)		
(6) Total (add (1) through (4) less (5))	(6)		
c General Investments: (1) Interest-bearing cash (including money market funds). .	c(1)		
(2) Certificates of deposit	(2)		
(3) U.S. Government securities	(3)		
(4) Corporate debt instruments: (A) Preferred	(4)(A)		
(B) All other	(4)(B)		
(5) Corporate stocks: (A) Preferred	(5)(A)		
(B) Common	(5)(B)		
(6) Partnership/joint venture interests	(6)		
(7) Real estate: (A) Income-producing	(7)(A)		
(B) Nonincome-producing	(7)(B)		
(8) Loans (other than to participants) secured by mortgages: (A) Residential.	(8)(A)		
(B) Commercial	(8)(B)		
(9) Loans to participants: (A) Mortgages	(9)(A)		
(B) Other	(9)(B)		
(10) Other loans	(10)		
(11) Value of interest in common/collective trusts	(11)		
(12) Value of interest in pooled separate accounts	(12)		
(13) Value of interest in master trusts	(13)		
(14) Value of interest in 103-12 investment entities	(14)		
(15) Value of interest in registered investment companies	(15)		
[redacted] . .	(16)		
[redacted]	(17)		
[redacted] (17)).	(18)		
d Employer-related investments: (1) Employer securities	d(1)		
(2) Employer real property	(2)		
e Buildings and other property used in plan operation	e		
f Total assets (add a, b(6), c(18), d(1), d(2), and e) . . . . ▶	f		
Liabilities			
g Benefit claims payable	g		
h Operating payables.	h		
i Acquisition indebtedness	i		
j Other liabilities	j		
k Total liabilities . . . . ▶	k		
Net Assets			
l Line f minus line k . . . . ▶	l		

Exhibit D

Welfare Plans Do Not Complete Items 15 Through 27. Go To Item 28. Fringe Benefit Plans Complete 22h and 22m. Yes | No

15a If this is a defined benefit plan, subject to the minimum funding standards for this plan year, is Schedule B (Form 5500) required to be attached? 15a

b If this is a defined contribution plan, i.e., money purchase or target benefit, is it subject to the minimum funding standards? (If a waiver was granted, see instructions.). . . . . b

If "Yes," complete *(1)*, *(2)*, and *(3)* below:

(1) Amount of employer contribution required for the plan year under Code section 412 b(1) $

(2) Amount of contribution paid by the employer for the plan year . . . . . . b(2) $

Enter date of last payment by employer ▶ Month .... Day........ Year.....

(3) If *(1)* is greater than *(2)*, subtract *(2)* from *(1)* and enter the funding deficiency here; otherwise, enter zero. (If you have a funding deficiency, file Form 5330.) b(3) $

16 Has the plan been top-heavy at any time beginning with the 1984 plan year? 16

17 Has the annual compensation of each participant taken into account under the plan been limited to $200,000 (adjusted for cost of living)? 17

18a If the plan distributed any annuity contracts this year, did these contracts contain a requirement that the spouse consent before any distributions under the contract are made in a form other than a qualified joint and survivor annuity? 18a

b Did the plan make distributions to participants or spouses in a form other than a qualified joint and survivor annuity (a life annuity if a single person) or qualified preretirement survivor annuity (exclude deferred annuity contracts)? . . . . b

c Did the plan make distributions or loans to married participants and beneficiaries without the required consent of the participant's spouse? c

d Upon plan amendment or termination, do the accrued benefits of every participant include the subsidized benefits that the participant may become entitled to receive subsequent to the plan amendment or termination? d

[redacted] 19 20 21 22a c d e

IF YOU ANSWERED a, c, d, or e "YES", DO NOT COMPLETE THE REST OF QUESTION 22 AND SEE INSTRUCTIONS FOR INFORMATION TO BE FURNISHED.

f If you meet either of the following exceptions, check the applicable box to tell us which exception you meet and do NOT complete the rest of question 22:

(1) □ No highly compensated employee benefited under the plan at any time during the plan year;

(2) □ This is a collectively bargained plan that benefits only employees covered under a collective bargaining agreement, and no more than 2 percent of the employees who are covered under the collectively bargained agreement are professional employees.

g Did any leased employee perform services for the employer at any time during the plan year? . . . . . . g

Number

h Total number of employees of the employer. Employer includes entities aggregated with the employer under Code sections 414(b), (c), or (m). The number of employees includes leased employees and self-employed individuals. h

i What is the total number of employees excludable because of: *(1)* failure to meet requirements for minimum age and years of service; *(2)* coverage under a collective bargaining agreement; *(3)* nonresident aliens who receive no earned income from U. S. sources; and *(4)* the 500 hours of service/last day rule?. i

j Enter the number of nonexcludable employees (subtract line i from line h) . . . . j

k Do 100 percent of the nonexcludable employees entered on line j benefit under the plan? . . □ Yes □ No

If line k is "Yes," do NOT complete lines 22l through 22o.

l What is the number of nonexcludable employees (line j) who are highly compensated employees? l

m What is the number of nonexcludable employees who benefit under the plan? . . . . m

n What is the number of employees entered on line m who are highly compensated employees?. . . . . . n

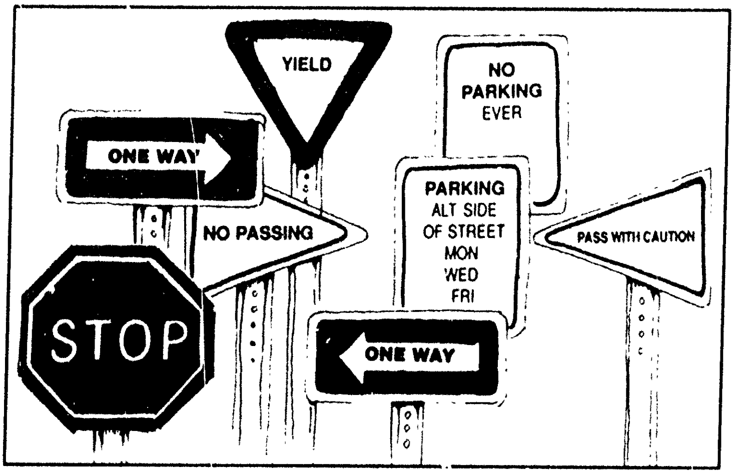
o This plan satisfies the coverage requirements on the basis of (check one):

(1) □ The average benefits test

(2) □ The ratio percentage test—Enter value ▶

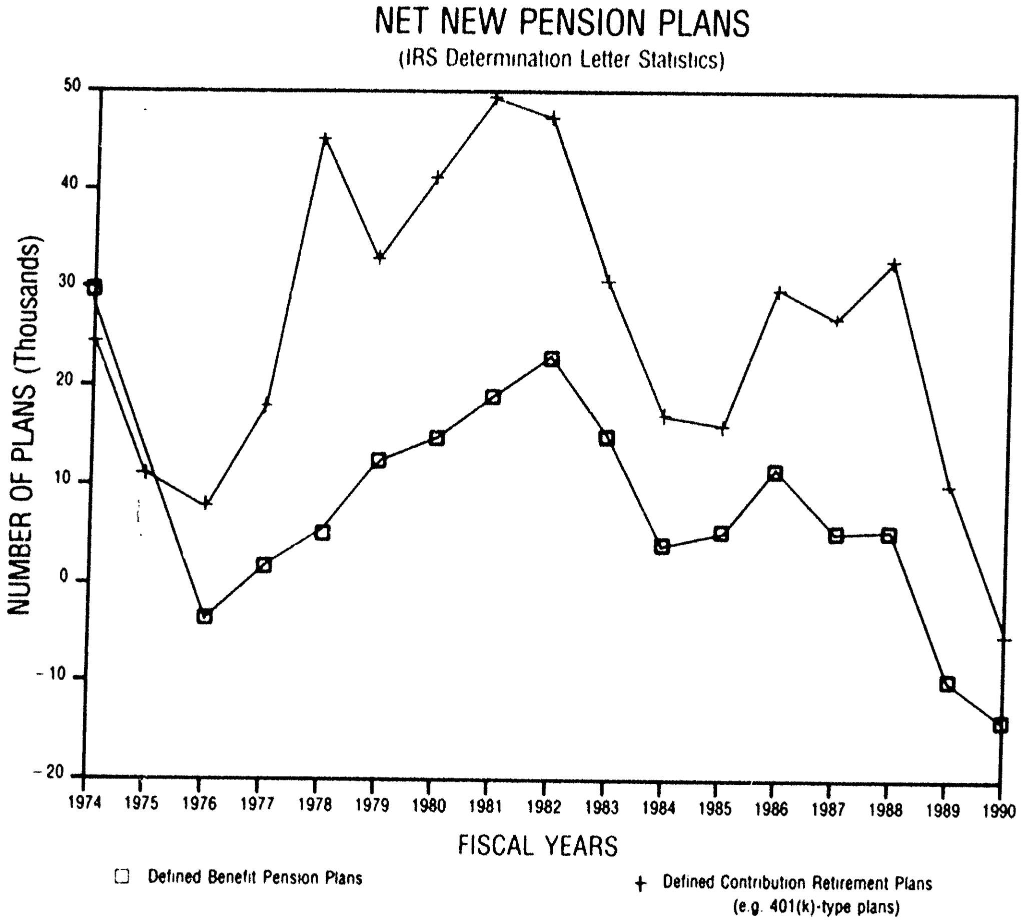
GRIDLOCK REVISITED

ON THE ROAD TOWARD PENSION SIMPLIFICATION


YIELD
NO PARKING EVER
ONE WAY
PARKING ALT SIDE OF STREET MON WED FRI
NO PASSING
PASS WITH CAUTION
STOP
ONE WAY

Association of Private Pension & Welfare Plans

September 1991


NET NEW PENSION PLANS
(IRS Determination Letter Statistics)
NUMBER OF PLANS (Thousands)
50
40
30
20
10
0
-10
-20
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
FISCAL YEARS
□ Defined Benefit Pension Plans
+ Defined Contribution Retirement Plans
(e.g. 401(k)-type plans)

Gridlock Revisited: On The Road Toward Pension Simplification

The gridlock snarling the nation's retirement system continues! The laws and regulations that govern the system are complex, cumbersome and costly. While most of the rules are well-intentioned, the cumulative effect of nearly two decades of legislation is that, rather than encouraging the establishment of new plans to provide for retirement income security for America's retirees, new plan formation has come to a virtual standstill . . . indeed a decline.

The facts speak for themselves. In Fiscal Year 1989, according to the Internal Revenue Service (IRS), terminations of existing defined benefit pension plans rose by 37 percent and new plan creations dropped by 67 percent. In the following year more plans were terminated with an average size of over 100 participants. Equally alarming, in Fiscal Year 1990, for the first time there was net negative growth of defined contribution plans (plans like profit-sharing plans and 401(k) retirement savings plans). Terminations of these plans rose by 29 percent, while the number of new defined contribution plans fell by 50 percent.

Rather than merely complain about the challenges confronting the retirement system, the APPWP decided to provide lawmakers with meaningful and doable proposals that would make the system not simple . . . but certainly simpler. The outcome of this process was the 1989 APPWP publication, *Gridlock: Pension Law in Crisis and the Road to Simplification*, which contained 29 specific recommendations to simplify or remove some of the most complex, duplicative or no longer needed provisions of the Internal Revenue Code and ERISA.

Throughout the development of *Gridlock*, the APPWP was guided by two principals. First, the recommendations should not pursue new retirement policy or tax policy, but rather make current policy operate more smoothly. Second, recognizing the realities of the federal budget deficit, the proposals should not be inordinately costly. And because we have set these principals for ourselves in championing the cause of simplification, the APPWP will apply these same criteria to others' legislative proposals.

Simplification is Succeeding

The APPWP is delighted that such a vast and diverse constituency for pension simplification has emerged. In 1990 several organized labor, state and local employer and business groups joined the coalition in favor of the "Employee Benefit Simplification Act" sponsored by Senator David Pryor (D-AR) and a majority of the Senate Finance Committee and by Rep. Rod Chandler (R-WA) and a bi-partisan group of the House Ways & Means Committee. Some of the APPWP's recommendations and the proposals in the Pryor/Chandler legislation of last year have already borne fruit: the regulations defining the term "compensation" and the revised proposal concerning the minimum participation rules are examples

This year a number of simplification initiatives have been introduced. A third of the U.S. Senate has joined Senator David Pryor and Senator Lloyd Bentsen (D-TX) in a reintroduction of last year's Pryor bill. Rep. Benjamin Cardin (D-MD), a member of the Ways & Means Committee, has introduced the companion bill in the House of Representatives. These measures, S. 1364 and H.R. 2742 are entitled the "Employee Benefits Simplification and Expansion Act."

House Ways and Means Chairman Dan Rostenkowski (D-IL) has introduced a bill, H.R. 2730, the "Pension Access and Simplification Act" patterned largely after the Bush Administration Pension Opportunity for Workers' Expanded Retirement (POWER) proposal. The Rostenkowski bill contains a few simplification concepts proposed by the APPWP, but it also seeks to expand pension coverage for small firms by means of a modified Simplified Employer Pension (SEP) plan. Many small business groups for whom the SEP is intended have indicated that the SEP proposed in H.R. 2730 would be too costly for them to use.

By far the most comprehensive simplification measure introduced to date, is H.R. 2641 the "Employee Benefits Simplification Act" introduced by Rep. Rod Chandler (R-WA) and a bi-partisan group of members of the Ways & Means Committee: Reps. Anthony (D-AR), Archer (R-TX), Guarini (D-NJ), Johnson (R-CN) and Matsui (D-CA). The APPWP appreciates that the Chandler bill incorporates numerous APPWP proposals.

The various bills under consideration are far from perfect. All three would repeal 5 year averaging of lump sum distributions. The Rostenkowski measure also repeals 10 year averaging and the deferral of tax on net unrealized appreciation on employer stock. The Pryor/Bentsen & Cardin bills contain a provision *requiring* the transfer of most pre-retirement distributions to an IRA or another qualified plan. The APPWP will continue to vigorously oppose proposals that do not simplify the pension system but, rather, raise revenue or further certain policy goals.

The APPWP reiterates its support for the proposals contained in *Gridlock*. What follows is a hignlight of some of the most critical proposals from *Gridlock* that demand action this year. At the same time, the APPWP earlier this year identified *additional* problem areas that must be corrected concerning proposed nondiscrimination rules and proposed separate lines of business rules. These proposed regulations either fall far short of what is needed to make plans workable or do not implement Congressional intent. Each problem either requires a legislative correction or is unlikely to be fixed in final regulations, so legislation is appropriate. We applaud Rep. Chandler and the co-sponsors of his bill for addressing many of these serious problems as part of their bill.

Simplification of the retirement system is not an academic exercise. The future retirement income security of millions of American workers depends upon unsnarling the current pension system's gridlock. The APPWP applauds the bi-partisan leaders who have committed themselves to that goal.

* * * *

Reader's Note: What follows is a description of some of the major pension law complexities identified by the APPWP either in its 1989 "Gridlock" report or its 1991 Supplemental List of Simplifications. Following each description of the problem is the APPWP's recommended solution and the relevant section number of each bill (e.g. Chandler, Rostenkowski, Pryor/Bentsen & Cardin) which addresses all or a portion of the problem.

401(k) Plans: Average Deferral Percentage Tests

The Problem:

The average deferral percentage ("ADP") tests of Code Section 401(k) and the average contribution percentage ("ACP") tests of Code Section 401(m) are too complex, are unnecessary and are unfair to those at the low end of the so-called highly-compensated employee group. The rules for calculating the limits and correcting any excess contributions are extremely complicated, particularly when both the ADP and ACP tests are required and when contributions may be treated as deferrals or vice versa.

The ADP test, which limits elective pre-tax deferrals, is unnecessary because the $7,000 (indexed) limitation on these contributions effectively prohibits discriminatic.n in favor of the highly compensated, as long as the opportunity to make elective deferrals is g.enerally available (as is the case for 403(b) annuiti.s and Simplified Employee Pensions, SEPs.) The un.airness of the ADP test is its disproportionate impact on middle income employees. For example, suppose a $60,000 per year middle manager and a $300,000 per year top executive both defer the statutory maximum contribution ($8475 in 1991) to a 401(k) plan. Under current law, the employee with the highest *percentage* of deferral must first reduce his contributions if the ADP tests are not met. Thus, the ADP tests force the middle manager to take back much of his contribution and go through the headache of filing amended returns, etc., while the top-paid executive suffers no ill effect.

The ACP test of Code Section 401(m), which limits employer matching contributions and employee after-tax contributions, is hard to understand because it tests two disparate types of contributions together, and it involves the same complexity as the ADP tests, with the added factor of contributions of one sort being recharacterized or otherwise treated as contributions of another sort under very difficult technical rules. The "multiple use test," which permits use of the more liberal disparity amounts for either the ADP or the ACP test, but not for both, is unnecessarily complex.

The Solution:

Gridlock originally proposed the elimination of the ADP tests. We continue to support this proposal to simplify the law. The ADP tests should be eliminated and the cash-or-deferred arrangements of an employer should be deemed to be nondiscriminatory if all non-excludible employees of the employer are eligible to make elective deferrals under a cash-or-deferred arrangement. While this proposal was met with enthusiasm by many, it also generated some negative reaction from those who felt that nondiscrimination rules were important in addition to dollar limitations. Consequently, the bills proposed in 1990 by Sen. Pryor and Rep.

Chandler, and the various measures introduced in 1991, did not eliminate the ADP tests altogether, but established a safe harbor alternative. Under the safe harbor in the Pryor/Bentsen & Cardin bill, the ADP tests would not have to be run if the plan provided fully-vested contributions on behalf of each non-highly compensated employee which matched dollar-for-dollar the employees' contribution up to the first 3% of compensation, and provided a 50% match for employees' contributions between 3% and 5% of compensation.

While the APPWP generally supports the idea of a safe harbor if the repeal of the tests is not feasible, the safe harbor should be large enough for more than just a small boat! The matching contribution envisioned in this bill exceeds the levels currently offered in most plans, and we do not believe the trade-off of the ADP tests for a more expensive 100% match requirement would be viewed as positive by many plan sponsors. A safe harbor which required a fully-vested 50% match of elective deferrals up to 5% of compensation would be more realistic.

The Chandler bill of 1991 comes much closer to the APPWP recommendation. The safe harbors would allow a 100% match on the first 3% of compensation, or a 50% match on the first 6% of compensation or a non-elective contribution of 3% of compensation. If any of these criteria are met, the need for testing would be avoided.

Each of the bills (Chandler, Rostenkowski, and Pryor/Bentsen & Cardin) also recognize that the ADP rules themselves must be simplified for those employers who will not use the safe harbors. Each bill simplifies the rules to some degree. The Chandler bill does it best by permitting employers to use the prior year data in running the 401(k) plan test, but not making other changes to the test. The Rostenkowski bill also requires the use of prior year data, which simplifies testing. But it eliminates the ability to "average" the contributions of highly compensated employees which, as described earlier, limits contributions by middle income earners, not the highest earners.

Finally, the Chandler and Pryor/Bentsen & Cardin bills would fix the "correction" feature of the ADP/ACP test so that employees with the highest *dollar* contribution—not *percentage* contribution—would have their deferrals reduced.

(Sec. 104, Chandler; Sec. 105 Pryor/Bentsen & Cardin; Sec. 302, Rostenkowski.)

Definition of Highly-Compensated Employee

The Problem:

The statutory definition of "highly-compensated employee" and the proposed regulations implementing this definition impose significant data collection and processing difficulties for plan sponsors, which completely outweigh any benefit thereby achieved. The policy objective—eliminating discrimination—can be achieved in a *much* simpler manner.

In addition, one of the most difficult problems which employer plan sponsors face today is the inability to provide benefits to employees who are considered highly-compensated for purposes of the Internal Revenue Code but not for purposes of an excess benefit plan under Title I of ERISA. This group of employees (earning over $60,535 in 1991) may have their benefits cut back in order to satisfy nondiscrimination requirements, but may not have these lost benefits made up through nonqualified unfunded plans. Title I of ERISA permits such plans only for "a select group of management and highly-compensated employees," and does not provide definitions for these purposes. Unless the term "highly-compensated employee" under Title I is defined the same as in Code section 414(q), these employees may never receive their full benefits. The U.S. Department of Labor has indicated that it does not intend to define the term to be the same as in the Internal Revenue Code.

The Solution:

Gridlock calls for simplification of the definition of "highly-compensated employee," by defining it with reference to a single level of compensation (between the indexed levels called for in the current definition), and including 5% owners. In addition, *Gridlock* recommends permitting the employer to choose the determination period (plan year, tax year or calendar year) and to elect to use the current or prior year's data, making it a single year test.

These suggestions would significantly simplify nondiscrimination testing for all plans. An alternative to employer election of the determination period would be to require that the group of highly-compensated employees be determined using calendar year data, and that plans be tested for the plan year or fiscal year based on employees who were highly compensated during the previous calendar year. Of course, indexing the dollar limits in the definition is critical. We also suggest that indexing of all amounts in the Code be done by reference to an index available in the third quarter of the calendar year, so that revised limits would be known as of each January 1.

Further, ERISA should contain a definition of "highly-compensated employee" which is the same as the definition in the Code. This would permit employers to provide full benefits to all employees, even those highly compensated employees at the lower end of the compensation range whose benefits are limited by Code provisions and who may not be eligible for nonqualified unfunded plans unless the ERISA definition is the same.

(Secs. 101 and 102, Chandler; Secs. 101 and 102, Pryor/Bentsen & Cardin; Secs. 303 and 304, Rostenkowski)

Leased Employees/ Aggregation of Employers

The Problem:

Many of the key provisions of the Code which govern qualified plans are applied to the entire controlled group of employers. The rules for aggregating employers under common control for these purposes are inordinately complex. In addition, for many of these provisions, the employers must treat "leased employees" as "employees" to determine whether or not their plans are discriminatory. The proposed leased employee rules are, many think, some of the most difficult rules ever proposed by the IRS.

The Solution:

The rules for determining the identity of the "employer" under Code sections 414(m) and (o), and for identifying leased employees under Code section 414(n) must be simplified. We suggest the addition of some safe harbors under Code section 414(m), so that organizations could apply a "bright line" percentage test to determine whether or not they should be aggregated. All of the simplification bills would redefine the term "leased employee" to include only individuals who perform services under the control of the recipient —an approach advocated by the APPWP.

(Sec. 301, Chandler; Sec. 301, Pryor/Bentsen & Cardin; Sec. 301 Rostenkowski)

Minimum Distribution of Benefits

The Problem:

One of the most complicated areas of pension law involves the distribution of benefits to plan participants. We have called these rules the "Goldilocks provisions"—the benefit may not be too little or too much, too early or too late; like Goldilocks and her porridge, every participant/ taxpayer must find the distribution which is "just right." Code section 401(a)(9), which governs commencement of distributions and minimum distributions, is a mass of charts and tables, calculations and special rules, all to implement a policy which no longer really exists due to the 1986 repeal of the estate tax exclusion: the prohibition against using retirement plans as an estate planning vehicle.

The Solution:

The minimum distribution rules should be repealed. In the alternative, they might be modified as suggested in *Gridlock,* to apply only to participants who have total account balances over a specified amount (such as $750,000) or only to 5% owners of the employer, and to simplify substantially the calculations involved.

Whatever simplification is discussed, lawmakers should keep in mind the overriding principle that the distribution rules should be understandable by the individuals who will receive the money.

(Sec. 202, Chandler; Sec. 203 Pryor/Bentsen & Cardin)

Rollover Rules

The Problem:

The current restrictions on partial rollovers and rollovers of employee contributions add complexity and limit portability, and create an incentive for participants to spend distributions rather than saving them for retirement.

The Solution:

Gridlock argued for the elimination of all restrictions on rollovers from qualified plans into IRAs, so that a participant receiving a distribution of any amount from a qualified plan would be permitted to rollover that amount into an IRA and thus keep it in a qualified retirement vehicle. Such a change would encourage participants to save retirement funds for retirement and would enhance portability. This easy, obvious simplification should not only be noncontroversial, but would be a major step forward in making retirement distributions "user friendly." The 1991 bills all would eliminate most restrictions on partial rollovers. The Chandler bill allows the rollover of employer and employee contributions. The other two measures allow only employer contributions to be rolled over.

(Sec. 201, Chandler; Sec. 201, Pryor/Bentsen & Cardin; Sec. 101, Rostenkowski)

Maximum Benefit Limitations

The Problem:

The Code imposes a 15% excise tax on individuals each year whose distributions from qualified retirement plans exceed a certain amount. This excise tax, under Code Section 4980A which came into being in 1986, originally was intended to replace the complex combined plans limitations of Code section 415(e) with a simpler and more equitable scheme for limiting retirement income (*Tax Reform for Fairness, Simplicity, and Economic Growth; the Treasury Department Report to the President*, Volume 2 pg. 351, November 1984). However, as finally enacted, the excise tax does not replace the combined plans limitations but is applied *in addition* to them, and it is neither simple nor equitable. This is a classic case of duplicative rules which are aimed at a single policy objective. Moreover, the excise tax punishes good investment performance in defined contribution plans. Not only is the application and calculation of the excise tax so complex that even tax professionals and IRS personnel may misconstrue the rules, but it is also redundant and contrary to other policies, and poses severe difficulties for any individual potentially subject to it.

The Solution:

The 15% excise tax of Code Section 4980A should be repealed. If, however, the excise tax is preserved in any way, the combined plans limitation of Code section 415(e) should be deleted. The record keeping requirements of this test are enormous. One large APPWP member company has estimated that it requires 60 to 70 hours to obtain the data and make the calculations for *each* individual affected. This company performs the calculations only for retirees; to do so for all 100,000 of its employees would require an entire staff of employees working full time. This complication arises because the defined contribution portion of the calculation requires historical data which includes loans from the plan and compensation received and allocations made in each year back to the 1950 when the plan came into being. Elimination of this test would not only simplify the law and the administration of retirement plans, but would also raise revenue as it would permit additional funds to be paid out of qualified plans instead of through nonqualified arrangements.

Separate Line of Business Rules

The Problem:

The Tax Reform Act of 1986 provides that employers who have *bona fide* separate lines of business may elect to satisfy the coverage and nondiscrimination rules separately with respect to their separate lines. The IRS recently proposed regulations defining separate lines of business. Under this proposal, employers who operate a centralized headquarters, where staff functions (*e.g.*, legal, accounting, payroll) for all of their other lines of business are performed, will be unable to qualify for separate lines of business treatment. In general, the proposed IRS regulation requires that each separate line have a workforce and management structure 90% of which performs services exclusively to the line of business, but considers any employee who provides more than negligible services as an employee of each of the lines he serves. This, in effect, makes it impossible for a business with centralized functions to satisfy the IRS proposed regulations.

In addition, the IRS proposed regulations require that each plan of the separate lines satisfy the new proposed nondiscriminatory classification tests *on an employer-wide basis*, and that if the employer wishes to test one plan on a separate line of business basis it must allocate all employees to qualified separate lines of business. These rules would make the statutory provision virtually meaningless, as only a very few employers will be able to satisfy them.

The Solution:

The APPWP proposes a threefold change to simplify these rules. First is the deletion of Code section 410(b)(5)(B), the nondiscriminatory classification precondition. Thus, each plan of a qualified separate line of business would be tested for coverage based only on employees of the separate line. Second, in allocating employees for purposes of the separate employee workforce and separate management tests, each employee would be allocated (in accordance with special rules) to only one line of business. Third, a special rule for headquarters employees (*i.e.*, employees who perform no more than 50% of their services for any one line of business) would be provided, under which an employer may treat its headquarters as a separate line of business and allocate all headquarters employees to that line, provided that at least 60% of the headquarters employees are non-highly compensated. This 60% requirement would be lowered if the concentration of highly-compensated employees of the employer in its headquarters is less than 85% of the employer's highly-compensated employees.

(Sec. 318, Chandler)

Nondiscrimination Rules

The Problem:

On May 10, 1990, the IRS issued proposed regulations intended to govern discrimination in qualified retirement plans under Code section 401(a)(4). The intent of this proposal, as stated in the preamble to the proposed regulations, was to consolidate *and simplify* existing rules, as well as to reflect new statutory provisions and legislative history and to provide an integrated framework for applying the nondiscrimination provisions of the Code.

For some plans, the rules fulfill this promise. However, despite the expressed intention of simplifying the rules, the proposed regulations impose substantial additional complexity upon all but the few "plain vanilla" plans which can meet the allowable safe harbors. The vast majority of plans currently in existence will fail to satisfy one of the safe harbors provided in the proposed regulations, and must then pass a general nondiscrimination test. Under this general test, a plan satisfies Code section 401(a)(4) only if no single highly-compensated employee has an accrual rate greater than that of *any* nonhighly compensated employee. In order either to meet this test or to avoid it, the proposed regulations permit plans to be restructured into component plans, each of which may then be tested separately, provided each component separately satisfies the minimum coverage rules set forth in regulations issued under Code section 410(b).

Not only are the restructuring rules (and even just the data collection for the general test in the absence of restructuring) inordinately complicated, but such a worst case test was not mandated by the changes made by the Tax Reform Act of 1986 (TRA '86) nor is it supported by any published position of the IRS issued prior to TRA '86. The fact that *one* highly-compensated employee can cause a plan to be disqualified cannot be supported under the statute or legislative history of TRA '86!

The Solution:

A far better approach would be to replace the worst case test with an *averaging* test under which plans would satisfy the nondiscrimination requirements if the average accruals for the non-highly compensated employees equal or exceed the average accruals for the highly-compensated employees. Such a rule would result in substantial simplification, because it would avoid the need for restructuring in most cases. Of course, some administrative difficulty would remain, because individual accrual rates would still have to be determined and averaged annually, but the complicated artificiality of restructuring would, for the most part, be unnecessary. More importantly, it would permit the continuation of most large plans that have been deemed nondiscriminatory for years, without requiring enormous effort and expense annually to prove what they have known all along—that they, in fact, are nondiscriminatory.

(Sec. 317, Chandler)

Other Nondiscrimination Issues

A number of additional nondiscrimination issues have arisen as regulations have been proposed to implement TRA '86. These include:

Mandatory Disaggregation of Employees Covered By Collective Bargaining

The Problem:

Under proposed coverage regulations and final 401(k) regulations, the portion of a plan that benefits employees who are included in a collective bargaining unit and the portion of the plan that benefits noncollective bargaining unit employees must be treated as separate plans for purposes of the coverage and nondiscrimination rules. This will cause plans covering at least 70% but less than 100% of the employer's non-highly compensated employees to fail the coverage ratio test if a significant percentage of the non-highly compensated employees covered by the plan are collectively-bargained employees. In addition, this rule causes enormous difficulty for section 401(k) plans which cover both unionized and non-unionized employees.

The Solution:

To solve the problem of union disaggregation, the law should permit plan sponsors to elect to include employees in a collective bargaining unit (who are covered under the plan) for testing under the discrimination rules.

(Sec. 310, Chandler)

Social Security Bridge

The Problem:

The proposed Social Security integration regulations prescribe reductions in the maximum permissible excess and offset allowances for plans that provide unreduced benefits commencing before a participant's Social Security retirement age. Because there is no exception for Social Security bridge payments (which provide additional benefits for early retirees until their Social Security benefits begin), plans that provide for such bridge payments do not meet the integration rules or satisfy any of the nondiscrimination safe harbors. This is the case even though the plan essentially is not integrated for benefits payable before normal retirement age, and only integrates benefits after Social Security payments commence.

The Solution:

To continue to allow plans to provide Social Security bridge payments, they should not be treated as unreduced benefits commencing before the participant's Social Security retirement age for testing permissible disparity under a plan, and should be eligible to be considered in testing most valuable accruals under Code section 401(a)(4).

(Sec. 311, Chandler)

Uniform Retirement Age

The Problem:

The proposed nondiscrimination regulations under Code section 401(a)(4) provide several safe harbor rules for determining whether the benefits under a defined benefit plan are nondiscriminatory. In order for a plan to use the safe harbor rules, the regulations provide that the plan must use a uniform retirement age for purposes of calculating the employee's benefits. The employee's Social Security retirement age is not treated as a uniform age; accordingly, a plan that fully integrates its benefit with Social Security will be unable to use any design-based safe harbor without restructuring. The general nondiscrimination test for plans not satisfying a safe harbor also requires that benefits be determined by reference to a uniform age, so fully-integrated plans will have difficulty meeting the general test as well.

The Solution:

The law should be amended to make the Social Security retirement age (rather than age 65) the maximum permissible normal retirement age;

and should permit that age to be used in testing discrimination and determining vesting under the plan.

(Sec. 312, Chandler; Sec. 311, Rostenkowski makes changes for purposes of vesting and distribution only, not for nondiscrimination.)

Intracorporate Transfer of Employees

The Problem:

Frequently employers have different plans within a controlled group of corporations, for example because the controlled group has acquired various corporations which maintained their own plans, or because the corporation has separate plans for union and non-union employee groups. Many plans provide that employees who move within the controlled group of corporations or change their status accrue a benefit under the plan based on all service with the employer as a whole, offset by the pension earned by the employee under the other plan or plans of the employer in which he has participated. Because the current benefit earned by the transferred employee will not be uniform compared to the benefit earned by other employees covered by the transferee plan (due to the accrual based on past service and the offset of benefits accrued under the original plan), the plan will fail to pass the safe harbor formulas under the nondiscrimination regulations.

The Solution:

To solve the problem of transferred employees, coverage of employees who are transferred between plans should be specifically treated as nondiscriminatory, since a transferred employee will earn no greater benefits from the employer as a whole than other employees who do not transfer between plans.

(Sec. 314, Chandler)

Rate of Pay

The Problem:

The IRS has issued proposed regulations to define compensation for purposes of the tax qualification standards. The regulations specify several methods for determining "compensation." Many employers, as an administrative convenience, use a rate of pay, (*e.g.* weekly, monthly or yearly), rather than the actual amount of pay received. This is easier both from a record keeping as well as a testing point of view, and has traditionally been permitted. However, some Treasury representatives have indicated that all acceptable definitions of compensation under section 414(s) must use *actual* compensation, and use of a rate-of-pay definition may no longer be permissible.

The Solution:

The law should be amended to permit plan sponsors to use a rate of pay definition of compensation to test for discrimination.

(Sec. 313, Chandler)

Special Grandfather Rule for Integrated Plans

The Problem:

TRA '86 modified the Social Security integration rules, reducing the permitted disparity between benefits based on compensation above the Social Security wage base and benefits based on compensation up to the wage base. These new rules are generally effective for plan years beginning after December 31, 1988. In the case of a final pay defined benefit pension plan that is frozen as of January 1, 1989, and that was integrated in accordance with prior law, benefits earned as of the date the plan was frozen may not be calculated based on the final average pay of the participant when the participant retires. Rather, benefits must be based on compensation as of the date the plan was frozen.

The Solution:

To grandfather frozen, integrated final average pay defined benefit pension plans, the law should permit such plans to calculate benefits under the benefit formula in existence on the effective date of TRA '86 based on final average pay.

(Sec. 315, Chandler)

Defined Benefit Plans with Employee Contributions

The Problem:

Proposed regulations provide rigid and strict rules on testing discrimination for defined benefit plans with employee contributions ("contributory plans"). Indeed, the regulations provide an exception from these discrimination rules for a contributory plan where employee contributions cease after plan years beginning after December 31, 1990; thereby recognizing that such plans are likely to be discontinued rather than comply with the new discrimination rules. However, contributory plans which comply with the regulations, and can show that the benefits provided under the plan are nondiscriminatory, are penalized.

Under the rules governing contributory plans, an employee's own contributions are credited with interest at 120% of the federal mid-term rate, generally until the employee's normal retirement date. This rate of interest will continue to accrue even after the individual is no longer employed. The amount accumulated at this assumed rate of interest will be treated as a minimum benefit which must be paid to the participant even in those cases where such minimum benefits will exceed the amount promised under the plan to the participant. Employers should not be required to guarantee a rate to employees which is higher than a rate the plan can achieve over the long term, or higher even than the rate the Pension Benefit Guaranty Corporation (PBGC) will guarantee.

The Solution:

To solve the problems of contributory plans, the rate of interest to be credited to employee contributions should be the PBGC rate, and the benefit from employee contributions accumulated at this rate should not exceed the employee's accrued benefit under the plan without regard to the assumed interest on employee contributions.

(Sec. 316, Chandler)

Other Issues

Other issues which were addressed in *Gridlock* and which remain valid today include the following: repeal of minimum participation rules; repeal of the top heavy rules; conforming the Code section 401(k) hardship rules to those for other profit sharing plans; elimination of the tax on nondeductible contributions; amendment of the provisions for the tax on prohibited transactions; and deletion of the remaining Keogh plan rules for self-employed individuals which differ from the rules for other qualified plans.

The suggestions made in *Gridlock* in these areas would lead to simplification and clarification of pension policy and should be enacted.

For more information contact the APPWP at 1212 New York Avenue, N.W. Suite #1250,
Washington, D.C. 20005 (202) 289-6700

July 12, 1991

NOTE TO: Howard C. Weizmann
Executive Director
Association of Private Pension and Welfare Plans

FROM: Gordon P. Goodfellow
The Wyatt Company
Research and Information Center

SUBJECT: Your Request for Information on the Effects of Employer Matching Rates on Participation and Deferral Rates for Non-Highly Compensated Employees

This is response to your request for information on the effect of the employer matching rate on rates of participation in and deferrals to plans with a 401(k) arrangement.

The data for the following tables were obtained in 1991 from the Wyatt COMPARE℠ survey that is currently underway. The data in the first table represent companies that responded to questions about both their ADP and participation rates for non-highly compensated employees. The second table shows results for companies that reported either value. Because employee deferrals may be affected by employer non-matching contributions, I excluded plans with such employer contributions from the analysis. In the first table, the deferral rate for participants may be found by dividing the ADP rate by the decimal participation rate.

If you have any questions, please call (508-4606).

Attachments

Average Values of the ADP and Participation
Rates for Plans with 401(k) Arrangements by the Rate
by the Rate of Employer Match on Employee Deferrals*
(For Respondents Reporting Both Rates)

Employer Matching Rate**	ADP Rate	Participation Rate	
0%	1.68%	57%	(13)
1-25%	1.63%	61%	(16)
26-50%	2.68%	67%	(58)
51-99%	3.62%	69%	(16)
100%+	3.46%	72%	(25)

* The number of plans is shown in parentheses.
** Maximum matching rate if it varied.

Average Values of the ADP and Participation
Rates for Plans with 401(k) Arrangements by the Rate
by the Rate of Employer Match on Employee Deferrals*
(For Respondents Reporting Either Rate)

Employer Matching Rate**	ADP Rate		Participation Rate	
0%	1.62%	(15)	54	(36)
1-25%	1.57%	(18)	60%	(32)
26-50%	2.71%	(63)	68%	(85)
51-99%	3.69%	(20)	69%	(19)
100%+	3.69%	(29)	72%	(42)

* The number of plans reporting a value is shown in parentheses.
** Maximum matching rate if it varied.

RESPONSES OF THOMAS C. WALKER TO QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question #1: It has occurred to me that the mandatory transfer provision could have a potentially negative effect on both employer and employee alike. By this I'm referring to additional burdens this would impose on employers in terms of increased liability in selecting IRA's and also to new fees that may be imposed by banks on employees who want to withdraw their money. Do you see any potential conflict or problem here?

Answer: I understand the desire of Congress to attempt to retain assets contributed to a tax deferred retirement plan, in the retirement system for the use the tax code allowed it to be contributed for . . . retirement. The current 10% excise tax was legislated to discourage pre-retirement use of these funds, and has apparently been found lacking. The proposal to mandate transfers will not, in my opinion, stop the individual who is determined to convert these dollars to current use. It will, however, be very profitable to the institutions providing IRA's. Let me explain.

A terminating employee who really wants to retain these assets for retirement has numerous options available and should have no problem. This person is going to use the current system to save these dollars regardless of whether it is mandatory or not. The person who wants his or her money now, for whatever reason, will not be prevented from getting access to the funds. He will, however, get less if mandatory transfers are legislated. The IRA provider will be the only winner. The person who wants the money will be forced to establish an IRA, pay the set-up costs for the account, terminate the account and pay the termination fees, and then get what is left. If these fees consume 15% of the assets, why not simply increase the excise tax to 25%? Then, at least, the shrinkage to the individual would be a government gain rather than fees that will pay administrative costs for banks and insurance companies.

Please understand, I am not recommending an increase in the excise tax. I believe that would discourage participation and that makes no sense either, considering our abysmal national savings rate.

My point is, a person who wants to retain retirement funds for retirement will do so. Those who don't, won't. If you lock voluntary contributions up, these people won't voluntarily make the contribution. Are we, as a country, better off encouraging savings? I believe so.

I am also deeply disturbed by the requirement that an employer, lacking direction from a terminated employee, must choose an IRA for that terminated employee and transfer assets. The fiduciary liability question is not addressed in the proposed legislation but I have trouble believing that an upset ex-employee wouldn't prevail in the courts if the IRA chosen should fail to achieve rates of return equal to other options that could have been chosen by the bad guy . . . the ex-employer. Not only did this poor person lose his or her job, his retirement assets were depleted as a result of his ex-employer's choice of IRA accounts. Bad law. Fiduciary liability has to stop at some point. Under current law, it stops when assets are distributed (for the future), and this makes good sense. Please don't burden the employers of our country with ongoing responsibility for the personal funds of ex-employees. Most ex-employees are ex-employees because of problems with the ex-employer. There is just too much emotion involved with the termination of employment to think that these emotions won't get tangled up in mandatory transfer decisions. This is an idea whose time should never come.

Question #2: I would be interested in any comments or thoughts you might have on the need to simplify Form 5500. I have had a number of complaints about the complexity, cost, and necessity of this form.

Answer: Having just completed the filing of three hundred or so 5500's, I can respond to this question with gusto. Since we file as many of these as we do, we do not struggle with the complexity quite as much as an employer who files one a year. We know what data will be required and simply build the accumulation of the data into our systems. Cost, however, is a big consideration for us. Attached to this response as Exhibits A, B, and C are pages from the 1988, 89, and 90 Form 5500. I have highlighted the year to year changes in data that these forms require. Although these changes do not appear to be oppressive, they in fact are. Looking at Exhibit A (Page 5 from the 1988 Form 5500), and comparing it to Exhibit B (Page 5 from the 1989 Form 5500), you see several differences. An allowance for doubtful accounts was added to item 34b which isn't serious. The addition of items XI through XVI to item 34c was a serious problem, however. The problem comes not in breaking this information out for the current year, but rather in having to go back to the prior year and rework all that year's data. Column (a) should be last year's column (b) period. If a re-formatting is required, it should only be for the current year. We can accumulate data currently to fit any format. We can't go back to prior years and rework that data without great expense. If item xi was sufficient when we filed the 1988 forms, then it should be sufficient as the starting point for 1989.

The change in 1990 (Exhibit C) was not as dramatic. In fact, it doesn't require any new information. It simply changes the order. No big deal, right? Wrong. Again, a change in format, even if it is only a change in the order, requires redoing prior years' data. This is truly "make work" stuff with no value to the government or anyone else. These kinds of changes, that don't really provide any meaningful new information, cause anger and resentment in those of us who must do the grunt work.

In a less specific comment, much of the information required in the 5500 series of forms is not information that a business would normally have for their own use. Many of the questions are not applicable to most businesses, but force the business owners to do a lot of research, or hire expensive outside help, to even interpret the question. Attached as Exhibit D is Page 3 of the 1990 Form 5500. I have highlighted some questions that I believe the average business owner, employing 125 people, would have to research or pay a consultant to answer. The Form 5500 is required for all employers with more than 100 employees. This number is too low to require sophisticated information like this from. Perhaps a possible solution is allow the Form 5500-C/R series to be used by employers of up to 1,000 or so. At that size the business requires personnel (for other purposes than 5500 filing) who would or could handle these filings.

As to necessity, I don't believe these forms should be eliminated. They facilitate the collection of data as to total asset size, participants, and benefit levels that are meaningful to all of us who work within the system. They most certainly could be simpler, which would reduce employer costs.

Question #3: I wonder if you would comment on discrimination testing and how we might prevent middle income earners from being disadvantaged in planning for their retirement.

Answer: One of the truly inequitable situations that proposed legislation creates is caused by the "no single highly compensated person can make a contribution greater than the average non-highly compensated group." The net effect of this is not to restrict the truly highly compensated, but rather the middle income person. Let me pose an example. Let us assume that we have an employer with 200 employees. Of these 200 employees, 20 are highly compensated (over $60,535) with one person earning $222,220. The average contribution by the non-highly compensated for this example is 2%. This means the highly compensated, under the proposed law, would each, individually, be restricted to an amount not to exceed 4%. Our bottom highly compensated person would be limited to a contribution of $2,421.40 while our truly highly compensated, contributing 3.859% would hit the dollar cap of $8575.00. The person who earns $60,500 (not highly compensated) could put in over 14% and reach the $8575 dollar cap but the additional $35 in earnings reduces the lowest of the highly compensated to less than 1/3 of that in this example. The advantage of averaging the highly compensated with the non-highly compensated provides some relief from this.

One of the problems with the economic life cycle in our system is that we earn our lowest incomes when we are young and raising our families, buying our first homes, and can least afford to save. When we reach our 50's, our earnings tend to be higher than they have ever been, our homes are paid for, our children are educated and gone, and we can now save. The problem is, small amounts saved at older ages do not have time to grow meaningfully. We must recognize that the last 10 or 15 years of our working lives are when we have the greatest earnings power, and thus savings power, and we need to encourage maximum savings. Usually, the $60,535 earner is in those later years. It makes no economic sense to discourage savings.

I realize that many people consider $60,535 big bucks no matter what age it is earned, but that simply isn't so anymore. Why not use the $222,220 limit from other parts of the law as the single measure rather than arbitrarily picking some lower number to satisfy some vague conception of "fat cats."

Question #4: There seems to be a difference of opinion between those who believe that an employer match could provide an adequate safe harbor, and those who believe that low-wage workers would not be sufficiently attracted by a match to participate in a plan. What are your thoughts on requiring an employer contribution as a safe harbor?

Answer: All the empirical data suggest that employees at all earnings levels participate in direct proportion to the employer match. Requiring employer contributions as a part of safe harbor legislation will create more participants (to the extent of the required employer contribution) but will not cause employees to save any of their own money. The question then becomes not one of whether low-wage earners will participate with their own money if employer contributions are required, but rather whether the public policy should move towards requiring employer contributions (in addition to Social Security) to our national retirement system.

I placed in the written record earlier a study by the Wyatt Company which very clearly demonstrates that voluntary employee contributions are directly related to the generosity of the employer match. I think that those who say the lower paid won't respond to an employer match do these people a disservice, as well as insulting their basic intelligence. Our experience with the plans we work with belies these comments. We have many plans that have 100% employee participation, all voluntary. None of the employers we work with (200 mid-western agricultural cooperatives) are interested in the safe harbor approach currently proposed.

If the politics of the situation requires a mandatory employer contribution to create a safe harbor, and if the safe harbor is required to pass pension simplification, and if the inclusion of the safe harbor provisions does not complicate complying without their use, then I am not opposed. I just don't think they will lead to a large increase in the number of employers sponsoring plans. Apparently the GAO agrees because I believe they put a minimal cost on the safe harbor provisions.

This completes my response to the questions posed by Senator Grassley. Thank you for the opportunity to include this in the final written record.

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"). We at NRECA believe that there is a critical need for simplification of the laws affecting qualified retirement plans. Accordingly, we applaud the leadership shown by Chairman Pryor in holding this hearing and in introducing legislation (S. 1364) that would significantly reduce the complexity of the retirement plan rules. We are also appreciative of the leadership role being played by Chairman Bentsen in cosponsoring that legislation.

Our testimony today is in support of the Pryor-Bentsen bill. We believe that enactment of this bill would provide historic simplification of the rules regarding qualified retirement plans.

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 the Pryor-Bentsen bill.

The Pryor-Bentsen bill, 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 Pryor-Bentsen bill. However, we do not by any means intend to imply that we do not support the provisions of the bill not discussed or that we view such provisions as unimportant.

Our specific comments focus on the following areas: section 401(k) plans, voluntary employees' beneficiary associations ("VEBAs"), rollovers, and simplified employee pensions ("SEPs").

Section 401(k).

In our view, the centerpiece of the Pryor-Bentsen 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, section 401(k) 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.

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 the Pryor-Bentsen bill does. In general, the bill provides a safe harbor under which 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. The bill also provides an alternative safe harbor under which 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 the Pryor-Bentsen bill are the correct ones. (For example, the bill 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 the bill 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 with respect to section 401(k) plans on the rule described above. However, we are equally enthusiastic in our support of other provisions of the bill relating to section 401(k) plans. The more prominent of these other issues are noted briefly below.

Section 401(m) nondiscrimination rules -- The Pryor-Bentsen bill provides that, with respect to employer matching contributions, the section 401(m) nondiscrimination rules are deemed satisfied under a safe harbor provision similar to the one described above with respect to the section 401(k) nondiscrimination rules. We support this provision. We also recommend consideration of an expansion of the safe harbor provision to apply to after-tax employee contributions in addition to employer matching contributions.

Definition of highly compensated employee -- We support the bill's modification of the definition of a highly compensated employee.

Distributions from section 401(k) plans -- The bill contains a provision correcting a "glitch" in the manner in which the distribution rules apply to rural cooperative section 401(k) plans. We support this provision.

Employer eligibility for section 401(k) plans -- We support the bill provision under which nongovernmental tax-exempt organizations would be permitted to maintain section 401(k) plans. We also recommend consideration of an additional provision that would permit state and local governments to maintain section 401(k) plans.

Use of prior year data -- We recommend for consideration a proposal under which the section 401(k) and 401(m) nondiscrimination rules (other than the safe harbor provisions) would, at an employer's election, be applied based on the preceding year's data with respect to the employer's nonhighly compensated employees. We believe that this proposal would contribute substantially to the administrability of plans subject to the section 401(k) and 401(m) nondiscrimination rules.

Base compensation -- We support the bill provision that would allow employers to use employees' base pay in applying the applicable employee benefits nondiscrimination rules. This proposal would significantly simplify the administration of the nondiscrimination rules.

VEBAs.

In general -- The Pryor-Bentsen bill 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 Pryor-Bentsen 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 the Pryor-Bentsen bill 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 opposed the VEBA provision contained in the Pryor-Bentsen bill on three bases: (1) the provisions would essentially enable VEBAs to operate as insurance companies without being subject to the Federal tax rules applicable to insurance companies, (2) VEBAs were not intended to benefit large groups of employees, and (3) the provisions would cause a loss of Federal tax revenues. We address each of these three arguments below.

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 the Pryor-Bentsen bill, 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.

The Administration's second objection is based on its assertion that VEBAs were not intended to benefit large groups of employees. There is absolutely no basis in Treasury's own regulations for this position. In outlining what groups of employees may participate in a common VEBA, the Treasury regulations contain no rules with respect to the size of the group. For example, under the Treasury regulations, a national conglomerate with 200,000 employees can clearly maintain a single VEBA for all of its employees. It is difficult to understand why Treasury would object to a VEBA covering, for example, 50,000 employees of small employers on the grounds that such a VEBA is too big while its own regulations permit large employers' VEBAs to cover far greater numbers of employees.

The Administration's third objection is that the VEBA provision would cause a loss of Federal tax revenues. Our response to that objection is very simple: we at NRECA are prepared to work with Members of Congress and their staffs and with the Administration to develop proposals to pay for this important health care provision.

Clarification -- Implicit in the Administration's objections to the VEBA provision is the view that the provision would represent a major change in the law. We do not agree. There is no authority with precedential value articulating a definition of "affiliation" inconsistent with the VEBA provision. We believe that the VEBA provision in the Pryor-Bentsen bill is simply a clarification, albeit a very important one, 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 the Pryor-Bentsen bill, by definition, does not permit any VEBA not permitted under present law.

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 a 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 the Pryor-Bentsen bill, 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.

Rollovers.

The Pryor-Bentsen bill would generally eliminate all restrictions on an employee's ability to roll over a distribution from a qualified plan, other than a minimum distribution required under section 401(a)(9) or a distribution of after-tax employee contributions. However, we recognize that these provisions may cause a substantial loss of Federal tax revenues. Accordingly, we believe that a slightly more restrictive rollover provision may well strike a more appropriate balance between simplification and the desired revenue effects.

SEPs.

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 the Pryor-Bentsen bill 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 nondiscrimination rules applicable to such pre-tax employee contributions and to matching contributions are deemed satisfied under the same safe harbor provisions that the bill would apply to the section 401(k) and 401(m) nondiscrimination rules (as described above, regarding minimum levels of matching contributions or nonelective contributions). In addition, the Pryor-Bentsen 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 Pryor-Bentsen 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 $30 billion. Its largest member company, Principal Mutual Life Insurance Company, is currently the sixth largest life insurance company in the nation ranked by premium income.

The Principal Financial group serves 946,000 individual policy owners, 63,306 group employer customers, 22,112 pension employer customers, and 48,332 mutual fund share-holder accounts. It handles 60,000 full-service brokerage accounts and 48,332 mutual fund shareholder accounts. In all, 7.5 million customers (businesses, individuals and their dependents) rely on the companies of The Principal Financial Group for their financial services needs.

Our main purpose today is to discuss the effect of the Employee Benefits Simplification and Expansion Act of 1991 (S. 1364) on smaller qualified pension plans. We will define "smaller plans" as plans involving the under 500 employee market.

The smaller end of the retirement plan market has been our main point of emphasis for many years. The Principal traditionally sells more retirement plans and group annuity contracts each year than any other insurance company. During 1990, for example, we sold over 2,500 contracts to fund pension and profit sharing plans.

Smaller 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 and its agent or broker to design a plan that will fit its needs. Retirement plans for small employers must be sold; they are not bought. That is why pension simplification is so fundamentally important. Employee Benefit Research Institute (EBRI) studies show that only 18% of employers with less than 25 employees have plans, and only 53% of those employers with 25-99 employees have plans. There is little wonder, then, why plan coverage throughout the nation has slipped below 50%. A recent Social Security Administration study shows that plan coverage is now below the 1974 pre-ERISA level. As a result, we must increase pension coverage among small employers. Having simpler rules (and rules which are not going to be changed each year) is the first step in this process.

The Principal strongly supports S. 1364, The Employee Benefits Simplification and Expansion Act of 1991. 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. The Principal feels very strongly that this measure is an excellent start to overall simplification. It offers badly needed relief to many overwhelmed plan sponsors, especially smaller ones, throughout the nation. We heartily recommend its passage.

S. 1364 deserves special attention because of what it intends to do -- simplify compliance for plan sponsors so they can concentrate more on what they do best -- running their own businesses. We believe the bill will allow all sponsors to spend less time and money on administering their plans.

We note that there are two other proposed bills, HR 2730 - The Pension Access and Simplification Act of 1991, and HR 2641 - The Employee Benefits Simplification Act of 1991, which share many similarities with S. 1364 and the Bush Administration's POWER proposal. We trust this bodes well for the likelihood that some form of pension simplification bill will be enacted in the 102nd Congress. In fact, we feel that several provisions of HR 2730 and HR 2641 would, if added to S. 1364, make an even bigger impact on pension simplification.

As this Subcommittee 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 enactment 17 years ago, an average of ONE NEW LAW PER YEAR has been passed that directly and significantly affects pension plans. These laws - and the corresponding regulations to interpret them - have greatly complicated maintenance of a qualified plan. (See Attachment #1 which lists the qualification requirements necessary to maintain a qualified §401(a) plan.)

There is no consistent or comprehensive plan or policy behind these laws. In fact, there is often duplication and overlap, such as the combined §415 limits and §416 top heavy rules. Sponsors have been forced to spend more and more money on administrative, recordkeeping, and compliance issues. Many of these measures 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, there are fewer resources for new or increased benefits for existing participants. In addition, employers who don't currently sponsor a retirement plan are not encouraged to establish one. This bill rightly starts the pendulum swinging the other way.

SURVEY OF PENSION PLAN SPONSORS

Over the last few weeks, The Principal surveyed 150 of our customers to get their views on pension simplification. We have detailed data which we will be happy to share with your staff. Here are a few highlights of the more important findings.

- Over 70% of the plan sponsors are in favor of simplification. Those who are neutral on the issue feel that way because of their skepticism that real simplification will be achieved.

- Over 86% of these customers have 401(k) plans. Their main concerns are the amount of data reporting they must do, the complications of the 401(k) and (m) tests and the task of determining the highly compensated employees.

- S. 1364, HR 2641, and HR 2730 each propose to simplify 401(k) and (m) testing. Of the three proposals, the plan sponsors were generally more favorable to HR 2730's proposal to limit highly compensated employees' deferrals based on the average of non-highly compensated employees' prior year deferrals. Almost 80% favored any approach that could eliminate 401(k) and (m) testing.

  The proposals in S. 1364 and HR 2641 to simplify 401(k) and (m) testing were not as favored. Only about 20% favored any particular approach.

- There was strong interest in simplifying the highly compensated employee definition, the family aggregation rules, and the age 70½ required distribution date.

- Almost all the plan sponsors favor easing the restrictions on rollovers to other qualified plans or IRAs. Many said they wanted to help their employees continue to save for retirement. However, an overwhelming number of the plan sponsors strongly opposed requiring employers to transfer distributions to another plan. They felt that decision should remain with the employee.

- The plan sponsors supported several revenue raisers to pay for simplification. 61% supported increasing the excise tax on early distributions from 10% to 15% while 42% favored eliminating 5 and 10-year lump sum averaging. We found that plan sponsors were very willing to support measures to fund simplification.

SPECIFICS OF THE BILL

We offer the following comments on S. 1364:

ISSUE	PROPOSED CHANGE	COMMENTS/SUGGESTIONS
1. **Simplified Distribution Rules**		
• Liberalize rollover rules by deleting 50% minimum required amount	• Will allow participants to roll over any part of a plan distribution (except after-tax employee contributions) and encourage saving for retirement years.	• Strongly support. Recommend that after-tax employee contributions also be eligible for rollover treatment.
• Eliminate 5-year averaging on cash payments. Preserves TRA '86 transition elections	• With liberalized rollover rules and lower income tax rates, the need for lump sum averaging should be lessened.	• Support. True simplification would eliminate the TRA '86 transition elections.
• Trustee to trustee transfers	• Will encourage saving for retirement by requiring employers to transfer distributions from existing plans to another qualified plan or IRA if the distribution is more than $500, unless the participant has a hardship, is 55 or older, or dies.	• Support. This provision will help preserve benefits until retirement. However, from our survey results, we've found that most employers do not support this provision. (See Attachment #2 for supporting statements.)
• Required beginning date	• Changes date distributions must begin to the later of age 70 or the actual retirement date, unless employee is a 5% owner.	• Support. This will allow most employees to delay receiving benefits until they actually retire.
2. **Increased Access to Pensions**		
• Simplified plans for employers	• Bill allows employers with up to 100 employees to set up a plan. Salary reduction SEPs are allowed even if less than 50% of employees defer. Nondiscrimination testing not necessary if adopt 401(k) and (m) safe harbors.	• Support the effort to encourage smaller employers to start plans. We feel this change may not be enough, though. Employers find the 100% vesting requirement on employer contributions restrictive. We suggest using the same vesting rules as §401(a) plans. Simplifying the 401(k) tests, as provided in HR 2730, should do more to open up plans. (See Attachment #2 for supporting statements.)
• Allow 401(k)'s for tax-exempt organizations	• Opens up 401(k) plans to these organizations. TRA '86 had shut them out.	• Strongly support. Employees of these organizations should be allowed to make 401(k) deferrals. We encourage allowing governmental organizations to have 401(k) plans as well.

ISSUE	PROPOSED CHANGE	COMMENTS/SUGGESTIONS
3. **Misc. Provisions (Highlights)**		
• Leased employees	• Replaces "historically performed" test with direction or control test.	• Strongly support. A much more common sense approach to the leased employee rules.
• 401(k)/(m) safe harbors	• Nondiscrimination testing isn't required if the employer either: 1) matches 100% of first 3% of deferrals and 50% of next 2%, or 2) contributes 3% of compensation for all eligible non-highly compensated employees.	• Safe harbors are welcomed. However, many employers-small or large-may find the required matching percentage too high. The 100% vesting requirement may be too restrictive. This may not be an attractive option for small employers. We'd prefer simplified testing rules, such as tests based on the prior year's compensation data as proposed in HR 2730. NOTE: The Principal questions whether there is a need for 401(k)/(m) nondiscrimination testing. (See Attachment #2 for more thoughts on this issue.)
• Corrective distributions	• Excess contributions first allocated to highly compensated employee with highest dollar amount of contributions.	• Strongly support. A more equitable method of allocating excess deferrals.
	• Extension of 2 ½ month deadline for corrective distributions to avoid 10% excise tax.	• No provision, but strongly recommend the due date for corrective distributions of excess deferrals/ contributions be extended to last day of following plan year in order to avoid the 10% excise tax. This corresponds to general requirement that refunds be made within this same time period to avoid plan disqualification. Would ease administrative burdens on plan sponsors and their service providers.
• Simplified highly compensated employee definition	• Change to 5% owner or annual salary of more than $50,000 (indexed). Eliminates family aggregation rule for family members of non-5% owners.	• Strongly support. Recommend that the family aggregation rule be eliminated entirely.
• Cost of living adjustments	• Announce in advance of calendar year, based on quarter ending previous 9/30. Round off to nearest $1,000 (or $100 on elective deferrals).	• Strongly support. True simplification.
• Minimum participation rule	• Would apply only to defined benefit plans. Lowers minimum number benefiting to lesser of 25 employees or 40% of all employees.	• Support.

POTENTIAL REVENUE RAISERS

The Principal recognizes there is a need to replace any real tax loss caused by pension simplification. The Principal offers the following potential revenue raisers as they relate to qualified plans that may be tapped (in addition to the elimination of lump sum averaging) to help offset any revenue loss from pension simplification.

- Increase the excise tax on early distributions under §72(t) from 10% to 15%. 61% of the plan sponsors in our survey favored this option.

- Increase the excise tax on excess distributions under §4980(A) from 15% to 20%, but only if that excess distribution is not taken as part of a steady stream of payments made over the life of the participant.

- Consider lowering the §415(b)(1)(B) 100% limit for defined benefit plans to around 80% - 90% of final average pay. Most retirement studies indicate that a plan's replacement ratio of 80% to 90% - the post-retirement income level when compared to pre-retirement income - is adequate to maintain an equivalent standard of living after retirement. 20% of the plan sponsors in our survey supported this option.

SUMMARY

Beyond commenting specifically on the legislation, we 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. A 1989 Social Security Administration study shows that coverage within the active work force has shrunk to 46% percent. The study shows that smaller employers (under 50 employees) especially are 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 to prepare just 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 is merely an estimate as to how much time is needed to prepare the "average" annual report. The lack of pension coverage creates heavier demands for Social Security benefits, especially since our national savings rate is currently low. This legislation 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 feels our nation's voluntary private retirement system is sound. Even though, as mentioned, percentages are down, according to Department of Labor statistics 51 million full-time American workers are covered by some type of pension plan. All told, these plans hold nearly 2 trillion in plan assets -- assets which will be available to help today's American workers enjoy their retirement years. Because our voluntary system is basically strong, we urge Congress to use caution and restraint when studying new proposals that would negatively affect retirement plans. Bills such as S. 1364 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.

In conclusion, enactment of a strong pension simplification bill will do much to ease administration of and expand access to pension plans. Minor simplification changes will not be as effective in encouraging small employers to establish pension plans. To create an attractive environment for small plan sponsors, Congress needs to encourage banks, insurance companies, and others to develop, market, and promote plans geared specifically to small employers. Legislation which truly simplifies plan compliance rules will do much to further this goal.

Attachment #1

IRC §401(a) BASIC QUALIFICATION REQUIREMENTS

The Internal Revenue Code sets qualification requirements for retirement plans. The following is a brief summary of those §401(a) qualification requirements:

Rule	Summary
§401(a)(3) - Minimum coverage rules, found in §410(b)	**Ratio Percentage tests** - percentage of non-highly compensated employees benefiting has to be at least 70% of the percentage of highly compensated employees benefiting OR: **Average Benefits tests** - average benefit of the non-highly compensated must be at least 70% of the average benefit of the highly compensated employees. (Must first meet classification test - benefit a reasonable, nondiscriminatory class of employees)
§401(a)(4) - Plan can't discriminate in favor of the highly compensated	Meet 1 of 5 safe harbors - safe harbors cover a majority of plan types, including 401(k); Target and flat benefit defined benefit plans (e.g., 50% of pay) may find meeting the safe harbors difficult. OR: Meet general rule - no highly compensated employee can accrue a higher benefit than any non-highly compensated employee
§401(a)(5) - Permitted disparity (integration), found in §401(l)	Plans are allowed to provide a limited difference between contributions/benefits for the non-highly compensated employees and the highly compensated employees (to reflect contributions to Social Security)
§401(a)(7) - Vesting rules, found in §411	Minimum vesting standards - 5-year cliff or 7-year graded
§401(a)(9) - Minimum distributions	Plan benefits must begin April 1 of year following age 70½ and must be of a minimum amount
§401(a)(10) - Other rules (top heavy), found in §416	If the plan is top heavy (key employees accrue more than 60% of the benefits or contributions), non-key employees must receive a minimum contribution or benefit and also meet minimum vesting schedule
§401(a)(11) - Joint and survivor annuities, found in §417	Plans (other than some profit sharing plans) must offer a qualified survivor annuity, payable to the spouse (both pre- and post-retirement)
§401(a)(16) - Maximum contribution/benefits, found in §415	Defined benefit plans can't provide an annual retirement benefit greater than $90,000 (indexed); Defined contribution plans limit annual contributions to the lesser of $30,000 or 25% of pay
§401(a)(17) - Can't count compensation in excess of $200,000	Benefits/contributions based on pay can't reflect any pay in excess of $200,000 (indexed)
§401(a)(26) - Minimum participation	Plan must benefit the lesser of 50 employees or 40% of all employees of the employer
§401(a)(30) - Limit on employee deferrals, found in §402(g)	An employee's deferrals to a 401(k) plan can't exceed $7,000 (indexed) per year

OTHER RELATED BASIC QUALIFICATION RULES

Rule	Summary
§401(k) - Average deferral test	Plan must limit average deferral percentage of the highly compensated employee group to a certain percentage of the non-highly compensated employee group
§401(m) - Average contribution test	Plan must limit employer matching and any employee nondeductible contributions for the highly compensated employee group to a certain percentage of the non-highly compensated employee group
§402 - Taxation of distributions	Plan must report distributions and taxable amounts to participants and the IRS
§404 - Deductibility of contributions	Plan contributions are tax deductible up to certain limits
§411(d)(6) - Protected benefits	Plans can't take away benefits (or options) already earned by participants
§412 - Minimum funding	Pension plans (money purchase and defined benefit) must meet minimum funding rules; includes a requirement to make quarterly contributions
§414(b),(c),(m),&(n) - Special definitions - controlled groups, affiliated service groups, leased employees	If the sponsor is part of a controlled group or affiliated service group, all employees must be considered as a single group in testing for nondiscrimination, coverage, and minimum participation
§414(s) - Compensation	Benefits or contributions must be based on a uniform, nondiscriminatory definition of compensation

Attachment #2

SUPPORTING STATEMENTS

Trustee to Trustee Transfers

The Principal supports the proposed changes to the distribution rules. We feel the changes to encourage rollovers of partial distributions to an IRA or qualified plan or that encourage plan-to-plan transfer are positive changes. These changes should encourage and make it much easier for terminated employees to save more 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 (e.g. $5,000 or a percentage of the account balance) 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 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).

HR 2742 currently offers a similar provision. It requires a plan sponsor to roll over a distribution to another qualified plan or an IRA if the distribution is more than $500, unless the employee is age 55, has a hardship, or dies. We support this provision as we feel it will encourage plan participants to conserve their savings for retirement.

To emphasize that a good portion of plan assets aren't being saved for retirement years, in 1990 alone, The Principal paid over $565 million in cash benefits to plan participants at termination of employment while paying just $498 million in retirement annuities in that same year. In 1989 and 1990 combined, we paid just over $1 billion in cash benefits to plan participants at termination of employment. (We paid another $78 million in cash retirement benefits in 1990.) These figures show that The Principal's universe of 22,000 plans collectively paid nearly as many pre-retirement benefits as they did retirement benefits. Indeed, we have found many employers do little to discourage their former employees from taking cash. While ~~some of the~~se 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.

A vast majority of our plan sponsors surveyed (95%) are in favor of making it easier for plan members to roll over plan distributions to another qualified plan or to an IRA. They were in favor of encouraging members to save for retirement. We do note, however, that most opposed requiring the employer to transfer the distribution to another qualified plan or IRA.

Simplified Plans For Employers

The Principal supports the general move toward increased access to pension plans found in S. 1364, HR 2730, and HR 2641. Each opens up SEPs to employers with no more than 100 employees. S. 1364 and HR 2641 ease the requirements for offering a SAR-SEP.

Unfortunately, we do not believe these changes will significantly increase coverage among small employers. The SEP and SAR-SEP proposals are unpopular with employers for the following reasons:

(a) Immediate 100% vesting requirement.

(b) Plan eligibility after one year, rather than the current 3 out of 5 year rules. (Employers do not wish to bring employees into the plan more quickly.)

(c) The safe harbor provisions to eliminate the nondiscrimination testing require an employer contribution which plan sponsors perceive to be too expensive.

Our experience shows that many prefer to sponsor a §401(a) qualified plan instead. For example, we have approximately 10,000 §401(k) plans. Of these, approximately 50% are sponsored by employers with less than 25 employees. These plan sponsors chose not to offer SEPs for the reasons mentioned above. In addition, of these 10,000 §401(k) plans, 85% are sponsored by employers with less than 100 employees. These plan sponsors are also unlikely to offer SEPs if the threshold is increased from 25 to 100 employees.

Again, we feel simplified testing rules under a §401(a) plan, based on the prior year's data, will have a more positive impact on the willingness of employers to sponsor retirement plans.

401(k)/(m) Safe Harbors

As mentioned in Item #3 of the specifics on the bill, we believe §401(k)/(m) testing could be eliminated without significant damage to the pension system. The $7,000 (indexed) maximum deferral amount alone already limits possible abusive situations substantially, as does the overall $200,000 (indexed) limit on annual compensation.

§401(k) plans aren't set up by an employer to maximize employer contributions on behalf of the highly compensated employees. An employer could provide larger contributions tq its highly compensated employees under an integrated profit sharing plan (and avoid §401(k)/(m) testing) than it could under a §401(k) plan that includes both employer matching and discretionary contributions. As a result, why single out §401(k) plans for special nondiscrimination testing?

We find that many plan sponsors have great difficulty in understanding, let alone applying, the current average deferral and/or average contribution percentage tests. In addition, the §401(k)/(m) tests are costly for employers, especially the smaller ones that don't have sophisticated payroll or recordkeeping systems. These smaller employers most likely must hire outside firms to perform the tests for them.

In our survey, plan sponsors indicated that 401(k)/(m) testing was time consuming and complex. Most said they rely heavily on The Principal to perform and explain the tests.

The cost of performing 401(k)/(m) nondiscrimination tests is generally 6-8% of the overall plan recordkeeping charge. As a service provider, it generally takes us 5 hours to perform the nondiscrimination tests. At a flat $50 per hour, each plan must pay $250 for the tests. In 1990 we found that of the 6,200 401(k) plans we helped test for our clients, 1,190 plans failed their nondiscrimination tests (19.2%). This was after sending each customer a mid-year projected test and suggesting to some of them that they limit deferrals for the rest of the year.

The average refund was only $350-$400 per person with an average of 5 employees requiring refunds (total plan refund of $2000). Thus, the money spent by the plan sponsor to correct supposed abuse - which even if it exists is minimal - is a high percentage when compared to the amount of money refunded. The $250 testing charge is 12.5% of the amount refunded. Again, that is a significant cost to the employer, especially when considering the small amount of the refunds.

Responses of Larry Zimpleman to Questions Submitted by Senator Charles E. Grassley

1. Q **Mr. Zimpleman, I realize that everyone now accept the need for pension law simplification. Nevertheless, I would appreciate your assessment of how important simplification will be on pension plan formation by small employers. Are we doing to see a very big effect, a modest effect, or what exactly?**

A The Principal believes pension simplification would have at least a modest positive impact on pension plan formation by small employers. Small employers do not have the financial resources or the staff to assist them in designing and updating qualified pension plans. They want affordable plans, particularly now when other employee benefit costs, such as health care, are rising. The pension simplification changes would ease the burdens enough to have a modest increase in the number of plans started by small employers. Our survey said 63% of our customers believe these changes will simplify the administration of their pension plans.

As we've said before, retirement plans for small employers must be sold; they are not bought. If we can provide a cost-efficient plan that is easy to understand and administer, we believe more small employers can be sold pension plans for their employees.

2. Q **Is The Principal concerned about the apparent move by employers away from Defined Benefit arrangements to more of an employee-paid approach. Some have suggested this is an alarming trend. Do you agree, and can you offer an explanation for this?**

A Yes, The Principal is concerned about the trend away from employer-pay defined benefit plans to employee-pay plans. There is a perception among employers and others in the benefits industry that the Department of Treasury has a bias against defined benefit plans (evidently, some policymakers in Treasury feel smaller employers set up defined benefit plans only to benefit a few key employees). Consequently, small employers are reluctant to start-up or even maintain defined benefit plans.

We recently surveyed 50 terminated defined benefit plan sponsors. This survey provided us with some insight on this subject. 88% of these employers replaced their terminated defined benefit pension plans with a defined contribution plan, most often with a 401(k) plan. 71% of these employers felt the defined contribution plan would be less costly and easier to administer.

Other reasons the employers gave for terminating their benefit plans included (i) the expense of funding and administering the plan (such as PBGC fees) and (ii) the plan's overfunded status prohibited additional contributions to be made (iii) the cômplexity of current laws and regulations, and (iv) the difficulty in explaining the plan to employees. The move away from defined benefit plans, we feel, is not always done with the best interests or needs of the employee work force in mind Too often, it is simply an administrative cost/burden decision alone.

3. Q **Do you think simplification will result in an increase in Defined Benefit plans specifically? I ask because it is argued by some that the decline in Defined Benefit plans has sources other than pension law complexity. I refer, for example, to the argument that labor force mobility, stock market gains, and tax law changes might all have encouraged formation of more Defined Contribution plans than Defined Benefit plans.**

A We doubt that pension simplification will encourage many, if any, plan sponsors to retain or start defined benefit plans. We feel that there are additional issues which affect defined benefit plans that must be addressed (funding limits, accrual rules, PBGC concerns, etc.). As mentioned earlier, employers have numerous reasons for moving away from defined benefit plans; the complexity of regulations is only one such issue.

In our terminated defined benefit plan survey, many employers did say they felt defined contribution plans better met the needs of their employees. These employers didn't necessarily have full replacement ratio comparisons between the two types of plans, but their general perception was that defined contribution plans may be better suited for their employees. Factors such as younger employees and the mobility of the group did influence these employers. In addition, 401(k) plans are the "in" plan at the moment. Employees have a better understanding of the benefit under a profit sharing or 401(k) plan and often ask their employers about such plans.

Other factors such as the funding limit changes under OBRA 1987 make defined benefit plans unattractive to employers. In our survey, many employers said their plans were overfunded under the newer OBRA 1987 rules so they could no longer make deductible plan contributions. As a result, they replaced the plan with a defined contribution plan to which they could contribute each year. Ultimately, many issues affect an employer's decision to sponsor a defined benefit plan.

4. Q **In recent statements on pension simplification, AARP has argued that the definition of a highly compensated employee could be reduced from the $60,000 level proposed in the Bentsen/Pryor Bill.**

I have been visited by businesspeople who tell me that people at this salary level are really middle management in many businesses. They argue that this group of employees gets hurt by the proposed changes to this definition in the bill, while the truly compensated employee making six figures is hardly affected at all. This is because the six figure employee would cap out under the proposed definition, while the middle-managers find their contribution reduced well under the cap in the event that the lower wage employee contributions are not sufficient.

If we reduce the $60,000 level, would this now have the effect of severely limiting what middle level employees can save and further more make their personal pension planning more difficult?

A The Principal does not support reducing the definition of highly compensated employee below the $60,000 (indexed) level in the Bentsen/Pryor bill. As you noted, reducing this level would severely limit the amount middle management employees could save for retirement. In a 401(k) plan, particularly, these employees' elective deferral contributions are limited to amounts far below the $7,000 (indexed) maximum deferral. The highly compensated employees' deferrals are based on the amount deferred by the non-highly compensated employees. A 3 percent deferral limit on an employee making $60,000 results in an $1,800 contribution. The same limit on an employee making $200,000 results in a $6,000 contribution. You can see how this penalizes the middle management employee who meets the highly compensated employee definition.

5. Q **401(k) and (m) average deferral and average contribution tests were changed as part of the Tax Reform Act of 1986 to limit potential abuse by highly compensated employees, and also to limit revenue loss.**

You stated that The Principal questions the need for these tests - which is obviously a step beyond the proposals we are addressing today. What assurances do we have that if these tests were dropped, this wouldn't lead to abuse in favor of highly paid employees, and in turn, cost the government revenue?

A The Principal believes §401(k)/(m) testing could be eliminated without significant damage to the pension system for the following reasons:

a. The $7,000 (indexed) maximum deferral amount limits possible abusive situations. A highly compensated employee who makes $200,000 could defer only 3.5% of compensation before reaching the $7,000 deferral limit.

b. The overall $200,000 (indexed) limit on annual compensation restricts the amount of elective deferral contributions available to a highly compensated employee.

c. The §416 top heavy rules require a minimum contribution to be made for all eligible non-key employees under the plan in the event the plan is top-heavy. A plan is top-heavy if the total of the key employees' accounts is more than 60% of the total accounts of all employees under the plan.

d. §415 rules limit the amount of benefits an employee may receive each year. Annual contributions to a profit sharing or §401(k) plan are limited to the lesser of $30,000 or 25 percent of a participant's compensation.

e. Other plans can be designed to put in larger dollar amounts for older employees who are most likely to be highly compensated; such as target benefit plans, weighted average profit sharing plans or defined benefit plans. An employer could also provide larger contributions to its highly compensated employees under an integrated profit sharing plan than it could under a §401(k) plan that includes both employer matching and discretionary contributions.

We want to emphasize that in terms of benefitting highly-paid employees, 401(k) plans--as they are structured today--are the most restrictive plan type. Eliminating 401(k)/(m) testing is only a small step in trying to equalize the choices that a plan sponsor makes about the plan best suited for him/her.

6. Q **I think you said that Principal supports the mandatory transfer provisions of the Bentsen/Pryor Bill. A lot of concern has been expressed to me about this.**

Some people think that requiring employers to decide where the mandatory roll-over would go is excessive, both because of the administrative burden it creates, and because it would raise questions of fiduciary liability.

It is also argued that the mandatory roll-over just generates fees for IRA providers given that the employee can still get the money from the IRA to which it has been transferred.

Can you comment?

A The issue here is the mandatory nature of the requirement. Many employers are opposed to that. The Principal supports the mandatory transfer provisions in the Bentsen/Pryor bill, because we favor any means to encourage participants to preserve their benefits until retirement. As we've noted before, The Principal has paid over $1 billion in 1989-1990 alone to plan participants who have terminated employment before retirement. We are concerned that much of this money is not being saved for retirement.

Some argue mandatory transfer would create administrative burdens and questions of fiduciary liability. A plan could set up specific procedures to transfer the employee's account in situation where the employee does not request a specific transfer. The employer could transfer the benefit to an IRA or keep the assets in the plan, using a funding vehicle that would pass along the administrative costs to the terminated employee. These procedures would ease the administrative burden and meet fiduciary liability standards.

It is true that an employee could later withdraw the money from an IRA. However, if the money is not immediately available at termination of employment, the employee may put more thought into the decision to withdraw the money, and may ultimately decide to leave the money in the IRA for retirement. Such a "cooling off" period may preserve more retirement dollars. For those who decide they do want the money, then the 10% early withdrawal penalty (if applicable) and IRA provider fees would result.

7. Q **I have received complaints that the form 5500 is more complicated and costly to complete than is really necessary. I am told that much of the information required is of little use to either participants or the government.**

Would you agree with that?

A Yes. We feel the 5500 annual reporting forms can and should be revised and simplified. We especially urge that the Form 5500R filed by under 100-employee plans 2 years out of every 3 be returned to its original purpose - a simple registration statement (hence the "R" in 5500R). In addition, we'd suggest that the 5500R be more like the 5500EZ -that as long as plan assets didn't exceed a specific dollar value ($100,000 on EZ, perhaps more on the 5500R since that plan would have more participants) not be required to file a 5500R at all. The plan would still file a 5500C every 3 years anyway.

Over the past 4-5 years, the IRS and DOL have made continuous changes to the 5500R and it is now much more like the 5500C that is to be filed by smaller plans every third year. These changes add little meat to the agencies' enforcement capabilities and do add a burden to plan sponsors.

Quite frankly, the Form 5500 itself (100 or more plan participants) is so technical that most plan sponsors have an outside recordkeeper such as Principal complete it. Or, they will have their auditor do the form as part of its annual ERISA plan audit. It takes us (the "experts") about 8-10 hours to complete a 5500 form per plan.

We also agree that the information seems to be of little apparent use by IRS/DOL. Until very recently, the agencies had virtually no way to gather and analyze the data reported on the 5500s. The agencies have started an edit-check system that helps them follow up on incomplete, or incorrect reports, but we don't feel they have the capabilities of analyzing specific trends in pension plans or of identifying possible areas of violation. We understand that the agencies are working to improve the 5500 Annual Reports and would certainly be willing to provide in depth suggestions and recommendations to you, your staff, or the agencies.

8. Q Do you think we should try to get this form simplified as part of our pension simplification project?

A Yes. Pension simplification should be expanded to amend ERISA to simplify plans' reporting requirements.

9. Q Do you have any specific suggestions as to what kinds of things could be eliminated on this form? Or could you provide suggestions to us in writing?

A Yes. Here is a brief rundown. As mentioned in #7, we would be please to provide further, in depth suggestions.

Form 5500		5500 C/R	
#6	Questions are a hodge-podge of miscellaneous items, with no clear reasons as to why this data is needed.	#6c	Same comment. Suggest that all questions relating to "plan features" be combined in one section instead of being scattered throughout the form.
#7	Is this detail necessary? Why not make it like #7 on 5500R?	#8-16 (5500R)	Question why this data is needed on a 5500R at all. Reporting it once every 3 years should suffice.
#9/10	Instructions on mergers don't jive with the questions.	#9/10	Instructions on plan mergers don't jive with the question.
#11/12	Funding arrangement and plan benefit codes are extremely limited for the products being offered today.	#11/12	Same comments as #11/12 on 5500
#18	This is a poorly designed question, especially for plans funded by group annuity contracts.	#18	Same comment as #18 on 5500
#22	This question on the coverage rules can be simplified.	#22	The coverage question can be simplified.
#25	Example of questions being added over the years instead of redesigning the form to put all Section 401a compliance questions under one section. The permitted disparity question is stuck towards the end of the form (see questions 6, 11, 12, 15, 16, 17, 19-21, 31, et al). Then we'd suggest having a separate section related to ERISA questions.	#25	Same comment as #25 on 5500
#28a	This question was added recently and seems irrelevant.		
#29/30	Better answered by the plans auditor; not on the Form 5500 itself.	#29	Too technical for the typical smaller plan sponsor.

10. Q **Finally, why should a self-employed individual with a Keogh plan have to file out a separate form like this?**

A We see no reason for an owner-employee to file a 5500 report if the plan covers only owners/partners and/or their spouses. ERISA specifically excludes these plans from its reporting requirements so the DOL doesn't require this data. However, the IRS required these plans to file a Form 5500EZ in the mid-1980s. We recommend it be discontinued.

11. Q **Please feel free to express any other concerns you may have regarding pension simplification.**

A Other Comments· There has been some criticism on the proposal to eliminate 5- and 10-year lump sum averaging. Opponents have argued this will result in higher taxes for workers. We do not agree. A recent survey conducted by the Profit Sharing Research Foundation and The Gallup Organization seems to refute the argument that taxes will be raised. According to the survey, nearly 60 percent of workers who are eligible to receive lump sum distributions from qualified plans keep all their money in tax-deferred status. In addition, many other participants deferred at least part of their distribution by putting it into an IRA or another plan and taking the rest in cash. As such, they lose the ability to lump sum average the cash portion of their distribution under existing taxation rules already. Finally, the survey found that 87 percent of those age 55 and older elected to defer distributions of $50,000 or more.

This survey shows that participants seem to be choosing to roll the distribution over to either an IRA or another qualified plan, leave the distribution in the prior employer's plan, or purchase an annuity. If the majority of participants are not electing lump sum distributions, repeal of the lump sum averaging provisions will not raise taxes, on the average, for plan participants.

COMMUNICATIONS

ALASKA INDUSTRIAL HARDWARE,
Anchorage, AK, September 26, 1991.

Senator DAVID PRYOR,
Russell Senate Office Building,
Washington, DC.

Dear Senator Pryor: The Employee Benefits Simplification and Expansion Act that you introduced with Senator Bentsen addresses my concerns quite well in regards to pension plan rollovers and distributions.

Under the current law, a situation could arise as described in my letter dated November 16, 1990, that could leave a plan participant no option but to take a partial distribution and pay taxes on it including a 10% penalty tax, or worse yet, receive a non-cash lump-sum distribution that would trigger income taxes and the 10% penalty with none of the distribution available in cash to pay the taxes and no means to roll the distribution over tax free.

Under the proposed legislation partial distributions could be rolled over to another qualified plan or to an IRA, thus giving a participant the means to continue their retirement account. Also, instead of giving a participant a noncash lump-sum distribution, periodic distributions could be made that would qualify to be rolled over.

This legislation would enable and encourage participant's to continue their retirement accounts when they voluntarily or otherwise leave their current employment. I can say for myself and the employees at Alaska Industrial Hardware, Inc. that we support this legislation and hope that it is passed into law this session.

Yours Truly,

JEFF C. BARTENSTEIN, *Secretary-Treasurer.*

STATEMENT OF THE AMERICAN COLLEGE OF RADIOLOGY

The American College of Radiology, representing over 20,000 physician and medical radiation physicist members, appreciates the opportunity to present our comments with respect to pension simplification.

The American College of Radiology, in concert with the American Medical Association, the American College of Emergency Physicians, the College of American Pathologists, and the American Society of Anesthesiologists, has worked diligently with Congress to develop a solution to some of the ambiguity created by the "employee leasing" rules proposed by the Treasury Department in 1987.

The anti-discrimination rules were designed to ensure that employees who are not highly compensated are nonetheless eligible to participate in the same tax-favored pension plans that employers offered to themselves and their "key" employees. However, circumvention of the rules was possible by utilization of employee leasing arrangements rather than traditional employer/employee relationships. In the extreme, an organization could discharge its own employees, create a separate corporation to hire these same individuals, and lease the services of those individuals through the newly created organization that employs them. The new organization would not typically offer coverage in a qualified retirement plan, while the previous employer would continue to enjoy his or her benefits and meet the anti-discrimination rules. Although practices like these were rare, we welcome its elimination. Fortunately, because of major reforms in qualified plan rules over the last several years, the potential for these and other abuses has been substantially reduced.

The employee leasing rules of section 414(n), however, create what we believe are unintended hardships in limited, but important, circumstances. With respect to radiologists, who are hospital based medical doctors and who frequently provide professional services to hospital patients, section 414(n) could cause a portion of a hospital's employees to be included in the qualified retirement plan if these physicians conduct part of their medical practice in a hospital. This scenario essentially prevents the physician (or physician's group) from creating a plan—or causes the physician to terminate an existing plan for himself and other true employees—since it becomes economically impossible to include such a large body of participants.

Of the legislative proposals introduced to date, the ACR believes that Senate Bill 1732, introduced by Senator Thomas A. Daschle, would alleviate many of the concerns that our organization has with respect to I.R.C. section 414(n).

Senator Daschle's bill, while substituting a "control" test for the current statutory "historical" test, provides for an important safe harbor which helps clarify the dilemma caused under current law with respect to the treatment of hospital-employed radiologic technologists and ancillary personnel. The safe harbor provides that an employee is a "leased employee" only if the principal purpose of an organization ıs to provide the services of leased employees. Under such a scenario, hospital employed radiologic technologists would not be included in the radiologist's plan since the principal purpose of their employment is to provide services for the benefit of the hospital and its patients—not for the benefit of a physician like a radiologist. Further, Senate Bill 1732 would protect hospital employees by requiring that, in order for the safe harbor to apply, employees should be covered by a qualified pension plan that offers "significant retirement benefits."

The ACR appreciates the opportunity to submit these comments to the subcommittee. Additional information may be obtained from the ACR at (703) 648-8975.

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September 26, 1991

The Honorable David Pryor
United States Senate
Washington, D.C. 20510

Re: Comments On Pension Simplification In Conjunction With The September 27, 1991 Hearings To Be Held By The Senate Finance Subcommittee On Private Retirement Plans And Oversight Of The Internal Revenue Service

Dear Senator Pryor:

Thank you for your letter of September 19, 1991, inviting comments on pension simplification in conjunction with the hearings scheduled on September 27 by your Subcommittee.

I have enclosed a statement prepared by Bruce Cheever, an air pilot employed by Federal Express Corporation, addressing a matter of pension simplification that is of great importance to air pilots who have chosen not to be represented by a union.

Simply stated, Section 410(b)(3)(B) of the existing Code permits air pilots who have elected to be represented by collective bargaining to have a tax-qualified plan tailored to their specific needs, but denies similar treatment to air pilots who have elected not to be represented by collective bargaining. The disparity of treatment between union and non-union pilots under the existing rule disadvantages non-union air pilots and their airline employers. Furthermore, the existing rule introduces comusion into an air pilot's decision whether to elect collective bargaining representation.

Mr. Cheever's statement urges the Senate Finance Committee to amend Section 410(b)(3)(B) by eliminating its union-representation requirement, in the interest of fairness and simplicity, in order to allow all air pilots, whether or not represented by a union, the opportunity to ask for and receive tax-qualified plans specifically tailored to their collective needs. Such an amendment would simplify the law by eliminating the confusing disparity of treatment under existing law and would make the rule fair for all air pilots.

The amendment to existing law that Mr. Cheever's statement urges the Senate Finance Committee to adopt is contained in Section 309 of H.R. 2730 -- a pension simplification bill introduced by Chairman Rostenkowski earlier this year, which is pending before the House Ways & Means Committee.

If you or your staff have any questions regarding this proposal, please call me at (202) 639-6523 or Mr. Bruce Cheever at (901) 797-4850. Again, thank you for the opportunity to submit this statement.

September 26, 1991

STATEMENT SUBMITTED BY BRUCE CHEEVER IN CONNECTION WITH HEARINGS ON VARIOUS PENSION SIMPLIFICATION PROPOSALS TO BE HELD BY THE SENATE FINANCE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

I wish to thank the members of the Subcommittee for the opportunity to submit this statement regarding pension simplification. I am Bruce Cheever, an airline pilot employed by Federal Express Corporation. I have been with Federal Express since 1978 and am currently serving as Chairman of the Flight Advisory Board (the "FAB"). The FAB is a steering committee of Federal Express pilots, elected by their fellow airmen at Federal Express. The FAB's function is to represent the Federal Express pilots' interests with the Company and the airline industry in all matters attendant to their professional lives. The scope of the FAB encompasses such areas as work rules, compensation, benefits, training, flight safety and line operations.

Pension benefits are important to air pilots, given the occupational rigors and uncertainties attendant to their careers. Existing tax rules governing qualified pension plans recognize the unique occupational circumstances of air pilots. Section 410(b)(3)(B) of the Internal Revenue Code ("the Code") permits an airline employer to provide a pension package for its air pilots that is tailored to their unique occupational, disability and retirement requirements. This section allows a plan to rule out all non-pilot employees of the airline employer for the purpose of determining whether that plan, tailored exclusively for all air pilots, satisfies the non-discrimination rules of the Code. However, under Section 410(b)(3)(B) as currently written, the separate-testing treatment is extended only to pilots' pension plans that are established or maintained under a collective bargaining agreement between a union representing the pilots and the airline employer.

Simply stated, existing law permits air pilots who have elected to be represented by a union to have a tax-qualified plan tailored to their specific needs, but denies similar treatment to air pilots who have elected not to be represented by a union. This disparity of treatment between union and non-union pilots under the existing rule disadvantages non-union air pilots and their airline employers.

In the interest of fairness and simplicity, I urge the Senate Finance Committee to amend Section 410(b)(3)(B) by eliminating the union-representation requirement in order to allow all air pilots, whether or not represented by collective bargaining, the opportunity to ask for and receive tax-qualified plans specifically tailored to their unique needs. Such an amendment would simplify the law by eliminating the confusing disparity of treatment under existing law and would make the rule fair for all air pilots.

The amendment to existing law that I am urging the Senate Finance Committee to adopt is contained in Section 309 of H.R. 2730 -- a pension simplification bill introduced by Chairman Rostenkowski earlier this year, which is pending before the House Ways & Means Committee. I submitted written testimony on this amendment to the Ways & Means Subcommittee on Select Revenue measures in conjunction with hearings held by that Subcommittee in February 1990. A copy of that testimony is attached as an Exhibit.

It is important to make one thing perfectly clear. This is not a labor issue, it is solely an equity issue. The proposed amendment is not an anti-union amendment. If the proposed amendment is enacted, it would have absolutely no adverse effect on union pilots' ability to continue to be beneficiaries of pension plans tailored to the unique occupational circumstances of pilots.

Whether or not pilots of an airline elect to be represented by a union depends on a variety of factors that are separate and apart from federal income tax considerations. On three occasions -- 1975, in the fall of 1989, and just this past summer -- the air pilots of Federal Express Corporation have elected not to be represented by a union. Federal Express enjoys a national reputation for fostering a corporate culture that totally honors employees as individuals and addresses their needs. The Federal Express philosophy of People-Service-Profit and its internal employee grievance procedures are benchmarks in the industry. The Federal Express pilot group has the highest percentage of minority and women aviators in the airline industry.

I believe that all pilots would agree that the core intent of Section 410(b)(3)(B) -- that is, allowing pilots' pension plans to be tested separately from plans provided to airline employees who are not air pilots -- is entirely justified. The airline pilots' strict professional competence requirements, special medical/health qualifications, and peculiar industry requirements create a definitely unique occupational environment. Airline pilots' careers can indeed suffer a dramatic, unplanned degeneration caused by such factors. Thus, in reality, airline pilots do have a much greater risk of a curtailed career than employees in other occupations. It is proper, therefore, and in the spirit of fairness and equity, that Section 410(b)(3)(B) provide an airline employer the capability to provide their pilot employees with a separate disability and retirement program.

However, I believe that union and non-union pilots would also agree that it is clear that these factors which justify a rule like Section 410(b)(3)(B) for airline pilots apply equally to all airline pilots, whether or not they are represented by a union. In this regard, I call your attention to another provision in the pension rules addressed specifically to air pilots -- Section 415(b)(9) -- which provides a special rule based on the FAA retirement-age requirement for air pilots. This age 60 mandatory retirement rule applies to all pilots, whether or not they are represented by a collective bargaining agent.

In situations where an airline employer, such as Federal Express, creates a work environment that results in its air pilots choosing not to elect union representation, the union-representation requirement of existing section 410(b)(3)(B) places those pilots and their employer at a significant fiscal disadvantage. I believe that existing law is unfair and discriminatory in that regard, and on behalf of Federal Express and its pilots I strongly urge the enactment of section 309 of H.R. 2730 in order to correct the inequitable and confusing operation of section 410(b)(3)(B) as it is written in the Code today.

In closing, I would like to thank all the members of the Subcommittee for their consideration of this amendment.

EXHIBIT

STATEMENT OF MR. BRUCE CHEEVER
FEDERAL EXPRESS CORPORATION AIR PILOT AND
CHAIRMAN OF THE FLIGHT ADVISORY BOARD
TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HEARINGS ON MISCELLANEOUS REVENUE ISSUES
REGARDING A PROPOSAL TO AMEND SECTION
410(b)(3)(B) OF THE CODE

FEBRUARY 21, 1990

Mr. Chairman and Members of the Subcommittee:

INTRODUCTION

I am Bruce Cheever, an airline pilot employed by Federal Express Corporation. I have been with Federal Express since 1978 and am currently serving as a Captain on the Boeing 727 aircraft. During my twelve years with the Company I have served in various capacities in addition to flying. My job duties have included serving as a flight instructor, check pilot, Chief Flight Instructor and Flight Safety Advisor to the Vice President of Flight Operations.

Currently, I am serving as the Chairman of the Flight Advisory Board (FAB). The FAB is a steering committee of Federal Express pilots, elected by their fellow airmen at Federal Express. The FAB's function is to represent the Federal Express pilots' interests with the company and the airline industry in all matters attendant to their professional lives. The scope of the FAB encompasses such areas as work rules, compensation, benefits, training, flight safety and line operations. In my capacity as Chairman of the FAB I will endeavor to present to you the interests and needs of my fellow pilots at Federal Express as they pertain to a proposal pending before the Ways and Means Committee to amend Section 410(b)(3)(B) of the Internal Revenue Code (the Code).

As it exists today, Section 410(b)(3)(B) of the Code permits an airline employer to script a tax-qualified pension package for its air pilots that is tailored to their unique occupational and disability requirements. However, existing Section 410(b)(3)(B) allows this result only where the air pilots have entered into a collective bargaining agreement in accordance with Title II of the Railway Labor Act. In other words, under existing Section 410(b)(3)(B), air pilots who have chosen to be represented by a union can have a tax-qualified pension plan tailored to their specific needs, but air pilots who have chosen not to be represented by a union cannot. The proposed amendment pending before the Ways and Means Committee is designed simply to eliminate this union-representation requirement of Section 410(b)(3)(B) to allow all air pilots the opportunity to have tax-qualified plans tailored to pilots' needs, whether or not the air pilots are represented by a union.

POSITION OF FEDERAL EXPRESS PILOTS

It is the position of the Federal Express pilots that the unique, restrictive professional requirements applicable to airline pilots totally justify the core intent of Section 410(b)(3)(B) as it applies to tax-qualified pension plans for airline pilots. However, it is further our position that this section's union-representation requirement interferes with the core intent of 410(b)(3)(B) by discriminating unfairly against and penalizing non-union airline pilots and their airline employers. Therefore, the Federal Express pilots support the proposal to amend Section 410(b)(3)(B) to eliminate its union representation requirement.

DISCUSSION

In considering Section 410(b)(3)(B) and the proposed amendment to eliminate its union-representation requirement, it is important to first address three decidedly unique aspects of the airline pilot profession.

FEDERAL REGULATION OF OCCUPATIONAL REQUIREMENTS AND STANDARDS.

There are very few professions whose membership is so strictly mandated and governed by an entire body of specific government regulations. I am referring to the Federal Aviation Regulations. Of course, many industries are closely monitored by the Federal Government. Rarely, however, are the professional skills and qualifications of individuals within these industries subject to such stringent licensing and recurrent monitoring requirements. At least annually, and in some categories semi-annually, the airline pilots' professional capabilities and competence are rigidly examined by FAA designated check pilots. The current FAA regulations require mandatory retirement for airline pilots at age 60, unlike other professional occupations.

PHYSICAL AND HEALTH REQUIREMENTS.

The airline pilots profession has strict, semi-annual medical/health requirements mandated by statute. Failure to pass comprehensive medical examinations results in the loss of an Airman's Medical Certificate with the corresponding prohibition from performing duties as an airline pilot. There is another facet of the pilots medical/health risk which is less obvious, but equally debilitating. The skies in which the aviator performs his profession are uniquely and historically, a hostile environment. Nothing quite the same is encountered in any other licensed occupation. This hostile environment can impact an aviators' health and subsequent participation with severe consequences. The results stemming from temporary, everyday medical anomalies can be vastly different and more costly for an airline pilot because of his operating environment. Fatigue, stress and other similar disabilities can easily have fatal impact in the life of an airline pilot. In no other private sector profession can health/medical variances create such immediate, total and terminal loss of income and career.

IMPEDIMENTS TO LATERAL MOBILITY.

Within the airline industry an airline pilot's experience and seniority is defined and respected only within the professional ranks of his individual company. He enjoys no professional rank or status with any other airline company in the industry. His skills, experience, or competence are not transferable laterally to another airline. Should an airline cease operation for whatever reason, the airline pilot may seek employment within the industry. But his only option will be to start completely over at the bottom of the profession. The loss of compensation, benefits, and prestige is unparalled by any other professional group.

The airline pilots' strict professional competence requirements, special medical/health qualifications, and peculiar industry requirements create a definitely unique professional environment. Airline pilots' careers can indeed suffer a dramatic, unplanned degeneration caused by such factors. Thus, in reality, airline pilots do have a much greater risk of a disabled career than employees in other occupations. It is proper, therefore, and in the spirit of fairness and equity, that Section 410(b)(3)(B) provide an airline employer the capability to provide their unique high-risk employees with a separate disability and retirement program. However, it is clear that the factors enumerated above which justify a rule like Section 410(b)(3)(B) for airline pilots apply equally to all airline pilots, whether or not they are represented by a union.

To digress briefly and make an important point, Federal Express and her pilots are not anti-union, and the Federal Express pilots see no downside effect on their fellow airmen who are union members as a result a proposal to amend 410(b)(3)(B) to eliminate its union-representation requirement. Our support for this matter is simply a matter of requesting that members of a common profession receive equal status and treatment under the Code, regardless of their choice of labor affiliation. Whether or not a group of professional airmen choose collective bargaining has absolutely no impact on the risk exposures to which all professional pilots are subject. Both groups of airline pilots face equal professional, medical, and economical risks under the Federal Aviation Requirement's and the rulemaking of the Federal Aviation Administration. Certainly the qualifications, performance criteria and penalties are the same for both union and non-union aviators.

Whether or not a group of employers choose to be represented by a union depends on a variety of employment factors that go well beyond federal income tax considerations. Federal Express enjoys a national reputation for fostering a corporate culture that totally honors individual employees and addresses their needs. The Federal Express philosophy of People-Service-Profit, its' internal employee grievance procedures, the Guaranteed Fair Treatment (GFT), its employer compensation and benefits packages, are all benchmarks in the industry. The Federal Express pilot group has the highest percentage of minority and women aviators in the airline industry.

As a result of the recent Federal Express acquisition of Flying Tiger, the combined pilot force of the merged carrier had the opportunity in the fall of 1989 to elect union representation. The factors described above led the combined pilot force to vote to remain non-union by over sixty percent (60%). To the Flight Advisory Board, the Federal Express pilots, and Federal Express Corporation, the issue of the proposed amendment to Section 410(b)(3)(B) is not a labor issue; it is strictly a tax and pension issue.

The Federal Express pilots believe Federal Express is the type of employer who, if the law permitted, would choose to take advantage of the provisions of Section 410(b)(3)(B) in order to provide security and benefits to offset the unique high risks of its' aviators. However, as a result of our employer having created a work environment in which we, as air pilots, have chosen not to elect union representation, the tax laws have placed us and our employer at an immense fiscal disadvantage in terms of our ability, as a group of high risk employees, to be protected through separate disability and pension plans.

The Federal Express Pilots, and the Federal Express Corporation strongly support the proposal before the Ways and Means Committee to amend Section 410(b)(3)(B) of the Internal Revenue Code to allow separate testing for air pilots tax-qualified pension plans regardless of union representation. In closing, the Federal Express pilot's and the Corporation would like to take this opportunity to thank all members of the Ways and Means Committee for their consideration of this proposal. Particular thanks to Messrs. Ford, Anthony and Sundquist for their sponsorship and effort on this proposed amendment.

Statement of the American Society of Pension Actuaries

The purpose of this statement is to comment on the Employee Benefits Simplification and Expansion Act of 1991 (S. 1364 introduced in the United States Senate by Senator David Pryor and Senator Lloyd Bentsen) in the context of the overall effort to simplify the pension laws and expand pension coverage.

This written statement, submitted for inclusion in the hearing record, is divided into three main categories:

- The complexity of the regulatory process
- Pension benefit security
- Additional suggestions to expand coverage and simplify the pension laws

The extreme complexity of our pension laws has been a significant factor in retarding pension coverage, particularly with respect to small businesses. The American Society of Pension Actuaries applauds the efforts of Senator Pryor and Senator Bentsen to simplify the complicated assemblage of laws affecting retirement plans.

COMPLEXITY OF THE REGULATORY PROCESS

This section of our written comments is divided into two subsections, the regulations covering pension plans and the retroactive application of new standards established by the Internal Revenue Service (IRS).

Many of the provisions of the Employee Benefits Simplification and Expansion Act of 1991 (S. 1364) are necessary due to the complexities introduced by the regulatory process. Examples of these complex rules abound. The final regulations on discrimination testing, permitted disparity, and plan coverage were recently issued. All of these regulations are effective for the plan year beginning after December 31, 1991. This provides practitioners and plan sponsors only three months to review hundreds of pages of detailed regulations, determine the alternatives available, test results, decide on new benefit structures, and communicate the decisions to the plan participants. If the results of all of this testing is to terminate the plan, and if the plan is a defined benefit plan covered by the Pension Benefit Guaranty Corporation, the ninety days is reduced to less than 30 days from now, since we need at least a sixty-day notice to participants for plan terminations.

Many of the provisions of the Tax Reform Act of 1986 were to be effective for the first plan year beginning in 1989. Final regulations on specific provisions of the Internal Revenue Code (IRC) were mandated to be completed in August of 1988. Now, three years later, many of the required regulations are still not finalized, yet voluntarily issued regulations that modify the intent of the law have been finalized.

Due to the delay of these regulations, plan sponsors have been forced to suspend benefit accruals through a series of complicated Model Amendments and notices to employees.

Final regulations under the discrimination provisions of the IRC § 401(a)(4), which were issued on September 12, 1991, completely changed the method by which discrimination testing is to be performed. This change was made contrary to specific congressional intent as reflected in the legislative history. Title XI, Section B(1) of the Conference Report indicates that discrimination testing should be based upon projected benefits. Pension practitioners and plan sponsors must wade through a series of complicated cross references and testing procedures in the regulations which base discrimination testing on annual accruals. This accrual basis approach to discrimination testing has no basis in law.

The penalties for failure are draconian in nature. Failure under § 401(a)(4) is deemed to be failure under § 410(b), which means that the plan is disqualified and the total present value of accrued benefits for Highly Compensated Employees becomes taxable. There are safe harbors that cannot apply to the majority of plans. As a practical matter, optional restructuring is available only to large employers. The concept of discrimination testing on benefit accruals has permeated other regulations such as the integration rules, coverage rules, etc., making all of these overly complex.

The § 401(a)(9) distribution rules were made exceedingly complex in the regulations, especially when coordinated with Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) § 242(b)(2) elections, grandfather elections, excise taxes under § 4980A, and minimum death benefit distribution rules.

We have seen provisions in this Bill which have been added in order to correct the regulations. Discrimination testing is modified under the average deferral percentage (ADP) tests. These provisions had to be addressed due to a regulatory process that significantly expands the scope and complexity of the law and contracts the universe of plan sponsors able to meet the qualification requirements.

We strongly recommend that the regulatory process be completed as intended, with emphasis on promptly issuing simplified rules which would make compliance by plan sponsors as simple as possible. We also strongly recommend that this Subcommittee conduct periodic oversight hearings on the regulatory process, on at least a semi-annual basis.

ASPA supports the following provisions contained in S. 1364:

- *The new rollover provisions for qualified plan distributions*
- *The elimination of the forward averaging provisions and death benefit exclusion*
- *The new eligibility requirements for Simplified Employee Pension Plans (SEPP)*
- *The changes in the definition of compensation*
- *The delay in the date for adopting plan amendments*
- *The requirements for Trustee to Trustee transfers*
- *The minimum required distribution changes*
- *The provisions covering cost of living adjustments, elimination of half year requirements, elimination of differences between plans for self-employed individuals and corporate plans, contributions for disabled employees*
- *The repeal of the prohibition for state and local governments and tax exempt organizations to maintain cash or deferral arrangements*

In addition to the complexity issues, the retroactive application of new standards by the IRS has had a significant effect on new plan formation and the maintenance of existing plans.

Harsh and unjustified audits have retroactively applied new standards to determine deductible amounts. These small plan actuarial audits have created significant problems for small business sponsors of defined benefit plans. These audits have sent a message to all small businesses to be wary of continuing or establishing a pension plan, lest that plan be subject to retroactive attack by the IRS. To alleviate this problem, as well as to preclude other retroactive changes in announced positions by the IRS, we recommend that the following amendment to the Taxpayer Bill of Rights be incorporated into S. 1364:

Proposed Amendment to Taxpayer Bill of Rights

Section 7811 of the Internal Revenue Code is hereby amended to add a new Section(g), which shall become effective upon enactment.

(g)(1)

Upon application filed by the taxpayer, the Taxpayer Ombudsman shall issue a Taxpayer Assistance Order requiring the cessation of any efforts to collect additional taxes, interest or penalties in any case, whether at the audit, appellate or litigation level, where the Taxpayer Ombudsman concludes that the disallowance is based on standards inconsistent with the standards enunciated by the Service at the time the deduction was taken. A standard shall be deemed to have been enunciated by the Service if it is contained in a regulation, revenue ruling, revenue procedure, technical information release or any other document utilized by the National Office of the IRS to convey its positions to the public. A standard shall also be deemed to have been enunciated if it is contained in the Internal Revenue Manual and the relevant portion of that Internal Revenue Manual is publicly released. A standard shall be deemed to have been enunciated from the time it is publicly released until the time it is specifically repealed or modified by another document which is publicly released.

If multiple issues are involved in a case, wherein some of the deductions were disallowed based on standards inconsistent with those previously enunciated, then such Order shall only apply to the deductions based on inconsistent standards.

(g)(2) **Appeal**

A taxpayer may appeal a determination of the Taxpayer Ombudsman that a deduction was not based on standards inconsistent with those previously enunciated to the Assistant Director for Agency Compliance and Evaluation of the Office of Personnel Management, who shall have the authority to direct the Taxpayer Ombudsman to issue a Taxpayer Assistance Order under the provisions of Section 7811(g)(1).

BENEFIT SECURITY

Benefit security issues are a serious concern for most small plans. The risk is diminished significantly when someone is watching and assisting in reporting the transactions. We strongly advocate the concept of a Defined Contribution Specialist to review and certify defined contribution plans. Coverage requirements, the § 401(k) testing, forfeiture reallocations, and permitted disparity rules are very complicated. An error can cause plan disqualification and/or a significant amount of work to correct. Unlike a defined benefit plan which can self-correct, once an error occurs in a defined contribution plan, account balances, payments, and forfeitures carry forward that error for all participants.

Investments are a key concern. Since most small employers act as their own trustees, they commonly are "sold" investments. Often times we find tax shelters within a pension plan, and limited partnerships of real estate or gas and oil. Many plans have invested in instruments issued by insurance companies that are not financially sound. We suggest that small plan sponsors should have four alternatives to choose from, as follows:

1. Have a mandatory annual audit.
2. Restrict investments to selected categories, e.g., government securities, publicly traded securities, mutual funds meeting specific criteria.
3. Appoint an independent fiduciary to hold or manage assets.
4. Apply for an exemption from these requirements.

We suggest two additional items. In these current economic times in the Northeast, we have seen a significant number of business failures and personal bankruptcies. Federal law should make it clear that ERISA preempts the bankruptcy court so that pension assets cannot be seized, have liens placed against them, or in any way be attached. Obviously, there should be certain limitations so that abusers cannot hide behind this protection.

Lastly, we recommend that the protection provided by the Retirement Equity Act of 1984 to spouses be extended to SEPPs and individual retirement income accounts.

ADDITIONAL SIMPLIFICATION AND EXPANSION SUGGESTIONS

A study by the Office of Research and Statistics, Social Security Administration, released in August 1989 by the Department of Health and Human Services, demonstrated that there has been a significant decline in pension coverage in the 1980s, from 50 percent of workers in 1979 to 44 percent in 1988, and that this decline has been most acute in the defined benefit area. Subsequent statistics indicate that this decline in coverage is not only continuing, but accelerating. In Fiscal Year 1989, according to data from the IRS, the number of defined benefit plan terminations rose by 37 percent. In Fiscal Year 1990, there were more than seven times as many defined benefit plan terminations as new plans established. Furthermore, in 1990, for the first time, there was also negative net growth of defined contribution plans. The trend of declining pension coverage is particularly alarming when our aging population makes the need for adequate retirement income progressively more important. It should be noted that small businesses are least likely to have a pension plan, making the problem of assuring an adequate retirement income most severe for employees of small businesses. According to recent Department Labor statistics, only 20 percent to 25 percent of small business employees are currently covered by pension plans.

New plan formation is certainly curtailed by the complex rules developed through the legislative and administrative process which are definitely directed against small businesses. The top heavy provisions, family aggregation rules, inclusion of five percent owners in the definition of highly compensated, special distribution rules for five percent owners, special rules for unincorporated businesses, and small plan actuarial audits are applicable only to small business.

The non-discrimination rules under Section § 401(a)(4) will cause another round of small plan terminations. The small employer cannot feasibly make use of the general test under these proposed regulations because of the cost involved and the instability of the small group. The safe harbors are much more restrictive than the general test. The result is a significant bias against small business. These requirements also curtail benefit coverage for small employers that are owned by larger employers.

Unfortunately, most of the simplification proposals now pending before the Congress address only employee savings provisions. As is often mentioned in discussing this nation's retirement income policy, we traditionally think of our policy as a three legged stool: Social Security, employer sponsored plans, and personal savings. However, a fourth leg has emerged: Continued employment past normal retirement age.

Though simplification is a cornerstone to developing expanded coverage of retirement plans to small businesses, expanding the SEPPs as proposed under the Pension Opportunities for Worker's Expanded Retirement (POWER) proposal will not provide the desired results. SEPPs have not been widely used for the following reasons:

- Any employees who work three out of the last five years, *even though they are not full time employees*, must be covered.

- The discrimination rules under salary reduction, simplified employee pension plans are more strenuous and complicated to compute.

- Currently marketed investment vehicles are extremely limited.

- Employees have access to funds prior to retirement age.

- Several employer categories are excluded from establishing a SEPP because the IRS Model Plan does not permit adoption by an employer if the employer had a prior qualified plan.

Over the last several years, there have been several disincentives placed in the path of new plan formation. We believe the following disincentives should be eliminated:

- *Complex discrimination rules using benefit accruals*
- *Quarterly contributions for small defined benefit or fully funded plans*
- *Complex rules in computing PBGC's additional premiums*
- *Family aggregation rules*

- *Multiple interest rate requirements*
  - *Funding standard interest rate*
  - *Quarterly contribution interest rate*
  - *Current liability interest rate (modify for plan termination basis)*
  - *Actuarial equivalence*
  - *PBGC interest rates*
  - *Adjustments for PBGC premiums*
  - *High interest rate for mandatory employee contributions*
- *Top Heavy Rules*
- *Unfair restrictions with respect to five percent owners*
- *Programs such as the small plan actuarial audit program*
- *Differences for self-employed and other business entities in retirement planning*
- *The notice to interested persons and summary annual report requirements*
- *Adjustments for PBGC premiums*
- *High interest rate for mandatory employee contributions*
- *Maximum limitations under combined plans (IRC § 415(e) calculations)*
- *Coverage requirements under IRC § 401(a)(26)*

We also support a modification of the current liability calculations to limit assets to 150 percent of the assets needed in a standard termination.

Additional incentives to encourage new plan formation are as follows:

- Social Security offsets with primary insurance amounts should be added back in
- Permit annual waivers of benefit accruals for key employees
- Clarify current IRS position for complete cost-basis recovery for any insurance products
- Provide for past service credits on an unlimited basis
- Provide that the § 4972 excise tax can be waived for reasonable cause [same language as § 6659A]

We commend the efforts to simplify the non-discrimination testing of qualified plans providing § 401(k) and § 401(m) features. The simplification of the definition of Highly Compensated Employees is a necessity. Increasing the compensation to a greater amount such as $65,000 (indexed) is also recommended. We note, however, that this may increase the number of people considered Highly Compensated Employees. We also support using look back provisions to determine Highly Compensated Employees and providing discrimination testing for the Average Deferral Percentage (ADP), as well as any other discrimination testing. The provisions that each Highly Compensated Employee meet the ADP test adds needless complexity, especially in the larger plans. Simplification of these tests from the current three-level test to a one-level test will provide reasonable results and still encourage employers to promote retirement savings to employees.

Under § 401(k) plans, the Highly Compensated Employees have an incentive to encourage the non-highly compensated to save and participate. We should continue to support this incentive. We agree with the need to make discrimination testing in § 401(k) plans a simpler process. We are concerned, however, that attempting to simplify this process through safe harbor approaches based on mandatory employer matching contributions may diminish the incentive to encourage participation by non-highly compensated employees. We believe that a better approach would be to simplify the discrimination tests, rather than create a safe harbor based on the availability of matching contributions.

Simplifying the distribution provisions, especially in light of the desire for increased pension preservation, is strongly favored. In prior positions, the American Society of Pension Actuaries indicated its support for an increase in the penalty tax for premature withdrawals to encourage pension savings.

With only 13 percent of those participants who took a lump sum distribution in 1988 rolling over all or a portion to another plan or an Individual Retirement Account (IRA), we must take some measures to ensure better pension preservation and protection for old age security. We recommend that an employer, upon plan termination, be allowed to insist that all monies be transferred into another retirement plan sponsored by the employer which covers the employee and that such a lump sum transfer will not violate the anti-cut back provisions of IRC § 411(d)(6). We welcome the simplification rules pertaining to annuity distributions and computations of benefits provided for mandatory employee contributions in defined benefit plans.

We recommend that the rollover provisions of S. 1364 be expanded to allow for the rollover of employee after-tax voluntary contributions.

The requirement that participants receive distributions at age 70 should be eliminated. Often times, the cost of computing the options and providing the minimum distributions exceed the value of the benefits for older working employees. With the repeal of the favorable estate tax treatment under retirement plans, the required distributions at age 70 are no longer needed. Perhaps a repeal of all of § 401(a)(9) would be a significant simplification.

The changes in the definition of Normal Retirement Age to be consistent with the Social Security Normal Retirement Age is a significant simplification, especially in light of all the required discrimination testing. Changing this definition of Normal Retirement Age also is good retirement income policy.

CONCLUSION

Approximately 85 percent of the employees of large businesses are covered by retirement plans. Conversely, only 20 percent of small business employees are covered.

In order to expand pension plan coverage, we must take away the discrimination towards small businesses in the tax code. In addition, the tax laws, in a number of instances, are relatively straightforward, but are made tremendously complicated in the regulatory process. Take, for example, the permitted disparity rules for integration with Social Security. The rules in the Internal Revenue Code are straightforward. The 125 pages of corresponding regulations make the provisions incomprehensible to the nonprofessional and unworkable in many respects.

Similarly, the proposed regulations for distribution rules and separate lines of business, and the final regulations for discrimination rules and coverage requirements, are overly complex and biased against small businesses. In order to truly simplify, we must improve the regulatory process.

Lastly, there is a great concern given to providing the tax subsidies to the highly compensated. If we can provide reasonable incentives to those who will provide for others so that they can provide for themselves, then we can achieve greater pension coverage for the employees of small business.

As a nation, we will ultimately have to provide for the old age economic security for these employees. By providing incentives today for private retirement plans, we have the security of knowing that these benefits are being funded and that we are increasing the amount of money available for capital formation. If we do not provide for a viable private retirement system, the government will ultimately be called upon to provide additional retirement benefits at a far greater cost to our country.

STATEMENT OF THE AMERICAN TRUCKING ASSOCIATIONS, INC.

INTRODUCTION AND SUMMARY

The American Trucking Associations is 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 ATA's 51 state associations and 10 conferences representing different industry segments, combined with ATA's direct membership, totals roughly 33,000 businesses. Employee leasing tax rules are a significant concern to many of them, whether they use employees exclusively or also contract with independent owner-operators.

Subcommittee Chairman David Pryor has been in the vanguard of the pension tax simplification movement and understands well the need to fix employee leasing rules. It is heartening that so many other Committee members have now taken an interest in this problem. Both the Employee Benefits Simplification and Expansion Act (S. 1364), introduced by Chairman Pryor and Finance Committee Chairman Lloyd Bentsen, and S. 1732 introduced by Sens. Tom Daschle and John Chafee, address some of the shortcomings in the present definition of leased employees.

However, ATA believes the bills could be strengthened further by specifically excluding certain types of independent contractors from leased employee status. Additionally, it is equally important to ease current law's excessive and intrusive information-gathering and -sharing burdens.

Specifically, we believe the definition of leased employee in Internal Revenue Code section 414(n)(2) should be expanded by inserting after the period the following flush sentence:

> An independent contractor, or an employee of such person, providing services for the recipient is not a leased employee where performance of the services requires the supply and direct use of substantial physical assets and the incurring of substantial operating expenses by such person.

This language would make clear that individuals who supply substantial physical assets, such as trucks or construction equipment, in performing their services, are independent businesses and not employees of the service recipients for either employment tax or benefits purposes.

In addition, we suggest clarification through statutory or report language of other aspects of section 414(n) and two related provisions, sections 414(m)(5) (dealing with affiliated service groups) and 414(o) (dealing with other arrangements).

More fundamentally, we question whether employee leasing tax provisions really serve their intended purpose of assuring nondiscrimination in benefits or instead deter firms from offering benefits in the first place. We hope the Subcommittee will take a fresh look at the whole concept.

BACKGROUND

Congress added employee leasing tax rules to the Internal Revenue Code in 1982 after learning of professionals in private practice who had fired 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 limit retirement benefits to themselves without running afoul of the pension nondiscrimination rules of the period.

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 other 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, and
>
> (C) such services are of a type historically performed, in the business field of the recipient, by employees.

This definition appeared at the time to be reasonably straightforward, at least as far the trucking industry was concerned. 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 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). If adopted, the rules would have made leased employees out of thousands of owner-operators, even though they are independent contractors providing a service requiring the utilization of substantial operating equipment. Thousands of trucking company employees could also have been inadvertently deemed leased employees of their customers. We do not believe that Congress intended either of these results when it enacted the employee leasing standards in 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.

In 1989, the Committee reported out a bill (initiated by Sen. Pryor) and accompanying report language that significantly clarified Congressional intent. That language was not enacted, but it prompted further efforts to clarify the law.

CURRENT PROPOSALS

S. 1732 is the most comprehensive effort to date to overhaul employee leasing language. The bill would change all three parts of the definition of leased employees, create a new safe harbor for organizations not principally formed to lease employees, and bar retroactive applicability of regulations under section 414(n).

Probably the change that is of greatest significance to trucking is the elimination of the "historically performed" test in section 414(n)(2)(C) and its replacement by

> (C) such services are performed by such person under the control of the recipient.
>
> For purposes of subparagraph (C), control exists if the person's relationship to the recipient is substantially the same as that of an employee to an employer.

S. 1364 (and an identical House bill introduced by Rep. Benjamin Cardin, H.R. 2742) would change subparagraph (C) as shown but would not codify the additional sentence defining control. In addition, two House bills would make similar substitutions. H.R. 2730, introduced by Rep. Dan Rostenkowski, would change it to "(C) such services are performed under any significant direction or control by the recipient." H.R. 2641, introduced by Rep. Rod Chandler, would make it "(C) the recipient exercises primary control over the manner in which such services are performed." The comments that follow are directed at the House as well as Senate bills on the grounds that the language from any of them might be proposed in Committee markup or in conference.

S. 1732 provides the greatest certainty by defining control to be substantially the same as an employee-employer relationship. Such a definition should allow an individual who satisfies the requirements for independent contractor status for employment tax purposes to know that he or she is not a leased employee, an important degree of consistency.

All of the other bills leave control undefined and thus leave considerable uncertainty about whether many independent truck drivers would be leased employees of the carriers or shippers for which they drive. "Direction or control" is already at the heart of the 20 common-law factors the Internal Revenue Service uses to determine independent contractor or employee status. If the intent of these proposals is to codify the common-law standard for benefits purposes, motor carriers and truck owner-operators should not have too much difficulty knowing where they stand. However, if the bills are meant to inject a new standard at variance with the common-law tests, both carriers and drivers will feel whipsawed. Few will understand how a driver can be an independent contractor for employment tax purposes yet still be a (leased) employee for benefits purposes.

All drivers are subject to "direction or control" to the extent that they are told when and where to pick up and drop off loads. In addition, shippers, insurance companies, and federal and state regulatory agencies impose various requirements. Motor carriers in many cases have successfully adhered to these standards without violating the 20 common-law factors, as evidenced by an ever-growing number of IRS employment tax audits that have found carriers have correctly treated drivers as independent contractors. This success occurs because the drivers have a substantial investment (in a tractor that may cost $50,000 or more), clear risk of loss and opportunity for profit, and considerable latitude over loads, routes, stopping places, etc.

Unfortunately, these bills--other than S. 1732--fail to clarify that the same factors should be sufficient to keep these drivers from being leased employees. On the contrary, the official explanatory material on H.R. 2730 states that investment, risk of loss and other non-control-related factors would be disregarded for employee leasing purposes. As a result, many independent contractor drivers would be classified as leased employees. For many others, there would remain uncertainty as to whether the elements of direction or control exercised by the motor carrier or the shipper-customer were "significant" enough to make the owner-operator a leased employee of the carrier, the shipper or both.

Following are some specific suggestions to achieve greater clarification and certainty.

SUGGESTED CLARIFICATIONS

Exemptions for independent contractors

The simplest way to avoid the double-jeopardy situation described above is to state that independent contractors are not leased employees. S. 1732 appears to achieve that result.

A more limited solution distinguishes between service providers who supply substantial physical assets and incur substantial operating expenses from those who are largely supplying labor services. The former demonstrate an added degree of independence from control by the recipient through taking risk and responsibility for substantial assets and expenses. These factors should be sufficient to show that they neither want nor need to be treated as someone else's employees for benefits purposes any more than for employment tax purposes.

To implement this solution, ATA recommends amending section 414(n)(2) by inserting the sentence on page 2 of this statement.

This suggested language was developed by former Commissioner of Internal Revenue Randolph Thrower, now with Sutherland, Asbill & Brennan in Atlanta, based on his experience with the trucking industry both before and after his tenure in the IRS. The language is intended to draw a clear, understandable line at a point where Congress originally intended it: workers operating capital-intensive businesses for which they are personally at financial risk do not resemble employees and should not be treated as such for benefits purposes.

In addition, 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 control. 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.

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, the law could be clarified by substituting "a third party" for "any other person". An independent owner-operator providing his or her own services directly to a recipient without going through a "fleet operator" or other third party should not be seen as a leasing organization.

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," 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 the 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.

Such a change would be preferable to the standard proposed in S. 1732 of performing service "for at least 1,000 hours during a plan year of the recipient". This standard would require drivers or third parties to know the recipient's plan year, which may be different from a calendar year. For the sake of simplicity, service should be measured only on a calendar-year basis.

Record-keeping

Section 414(n)(3) lists over 20 other 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 with confidential information about pay, benefits, hours, length of service, age and other details, depending on the applicable benefit. Furthermore, companies must collect this information on all service providers from the day they begin work, since it may be impossible to know in advance which ones will meet the length of service or other standards, and impossible after they stop performing services to get information from them. 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 operation.

Furthermore, this record-keeping by and large serves no purpose. Few nonemployee truck drivers perform services for one company long enough to become vested in the company's pensions plan. 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). For instance, under the proposed rules for section 414(m)(5), van lines and their independently owned local agents might have to aggregate their workforces and plans for nondiscrimination testing because they mutually advertise, market, order, bill, train or engage in other "management functions." (Presumably, franchisors and franchisees could be caught in the same net.) Under the proposed regulations for section 414(o), former owners or partners would have to remain aggregated for benefits testing purposes with their previous business.

CONCLUSION

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.

Unfortunately, the present construction of these sections may 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.

We remain troubled by the prospect that even with a tighter definition of who is a leased employee, companies will be forced to ask service providers for information 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).

We have recommended several specific changes to make the law or Congressional intent clearer. We are pleased that so many members of the Finance Committee have shown an interest in fixing problems in the pension tax area, and we look forward to working together on solutions.

STATEMENT OF THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

The California State Teachers' Retirement System (CalSTRS), a defined benefit plan with 285,000 active members and 110,000 retirees, provides retirement benefits to all eligible California public school teachers from kindergarten through community college as well as to certain other employees of the public school system. CalSTRS welcomes this opportunity to express its views on S. 1364, the "Employee Benefits Simplification and Expansion Act", and to express its strong support to Chairman Pryor and the co-sponsors of S. 1364 in their efforts to simplify the rules governing pension plans, particularly as applied to governmental plans.

The ability of public pension plans to maintain compliance with the tax code provisions governing qualified plans has been rendered extremely difficult by the numerous changes in the law in recent years and by the almost overwhelming complexity of the existing rules. Chairman Pryor and the co-sponsors of the proposed legislation should be commended for taking substantial positive steps in the process of simplifying this difficult area. They deserve the wholehearted support of all plan sponsors and administrators, including those in the public sector.

I. Introduction

CalSTRS would like to focus its comments today on the provisions of the proposed legislation (Sec. 306) that deal specifically with governmental plans. CalSTRS strongly supports the provisions of Section 306 of the bill, which would substantially simplify the application to public plans of the limitations imposed under section 415 of the Internal Revenue Code. Section 415 limits the annual pension contribution or benefit level that an employer may fund under its qualified pension plan. These complex limitations were designed primarily to prevent abuses in the private sector. Because of the distinctive nature of the pension plans of State and local governments, the application of these complex limitations has been a constant source of problems.

In the past, Congress has tried to tinker with the application of the section 415 limits to governmental plans, most recently in the 1988 Tax Act which provided some protection in the form of a limited grandfather election for such plans. CalSTRS promptly sought to comply with these section 415 changes and elected grandfather treatment by persuading the California legislature to adopt the necessary changes to the State statutes that determine benefit levels for CalSTRS participants. However, the underlying structural problems in the application of section 415 to public plans have persisted for CalSTRS and other governmental plans, crying out for a permanent solution to resolve these underlying problems once and for all.

That permanent solution has now been developed as part of the legislation which the Subcommittee considers today. Section 306 has been carefully formulated, in consultation with the Congressional technical tax staffs, to address these section 415 problems experienced by public plans while avoiding any potential for abuse. We understand that the staff of the Joint Committee on Taxation has estimated that the provisions addressing these section 415 problems for public plans would have "a negligible effect on Federal fiscal year budget receipts." We applaud the efforts of Chairman Pryor and the co-sponsors to alleviate the difficulties we and other governmental plans have encountered in complying with the existing section 415 limitations.

II. The Distinctive Nature of Governmental Pension Plans Warrants More Flexible Application of Section 415

Subjecting governmental plans to the full range of the section 415 limitations is not warranted by the underlying rationale of section 415. Section 415 was designed in large part to prevent highly compensated individuals from building up huge tax-sheltered and tax-deferred balances in retirement plans, beyond their reasonable needs for retirement. In adopting section 415, the House Ways and Means Committee, after noting the vital role of tax-favored retirement plans, expressed its concern as follows:

> "However, after careful consideration, your committee has concluded that it is not in the public interest to make the substantial favored tax treatment associated with qualified retirement plans available without any specific limitation as to the size of the contributions or the amount of benefits that can be provided under such plans. The fact that present law does not provide such specific limitations has made it possible for extremely large contributions and benefits to be made under qualified plans for some highly paid individuals. While there is, of course, no objection to large retirement benefits in themselves, your committee believes it is not appropriate to finance extremely large benefits in part at public expense through the use of the special tax treatment. * * * These limitations [being adopted as section 415], which apply to both employees and self-employed people under qualified plans, have been designed to avoid abuse of the favored tax treatment to finance extremely large pensions." [H.R. Rep. No. 93-807, 93d Cong., 2d Sess. (1974), at 35.]

These kinds of abuses that the section 415 limitations were enacted to prevent are unlikely to be 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. In the case of CalSTRS, the benefits are prescribed by statutes enacted by the State legislature. The plan benefit structure, formula, and terms are applicable on a uniform basis across the 285,000 members of the CalSTRS plan. The benefit formula is set by statute and operates in mechanical fashion, with a statutorily-prescribed benefit accrual percentage for each year of service credit applied against the average level of salary which itself is set and limited by State or local job classifications, requirements, and restrictions akin to the Federal Civil Service system.

- 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. Moreover, 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.

- CalSTRS is subject to a State constitutional prohibition against reducing benefits and therefore has much less flexibility than a private plan to modify its benefit structure in response to changes in the section 415 limits.

- Governmental employers, including those that make contributions to CalSTRS, receive no tax benefit in the form of deductibility of contributions, unlike private employers who enjoy a significant tax subsidy for retirement plan contributions. Thus, rovenue considerations in respect of section 415 are of much less significance in the public plan arena, as further confirmed by the Joint Committee's revenue estimate of the proposed section 415 changes for public plans.

- Unlike private sector employees, CalSTRS members do not receive Social Security benefits 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 CalSTRS retirees and disabilitants than would be true of private sector employees.

In summary, CalSTRS, 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.

III. The Existing Section 415 Limits Continue to Cause Significant Problems for Governmental Plans

The limitations on defined benefit plans under section 415 have caused considerable problems for governmental plans and for CalSTRS in particular. CalSTRS has made substantial efforts to comply with section 415. CalSTRS 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, CalSTRS has incurred the "toll charge" attendant to the election and consequently must apply the section 415 limits for the future without the benefit of the $75,000 floor and other special rules available under current law that limit the amount by which permissible benefit levels must be reduced in the case of early payment of benefits, such as disability and early retirement. Even after this action, however, compliance with the existing section 415 rules continues to create significant problems for CalSTRS, in areas that do not involve the abusive situations that section 415 was enacted to prevent.

100 Percent of Compensation Limitation: Definition of Compensation

The first problem faced by CalSTRS under current section 415 arises from the interplay of the limitation on benefits payable of 100 percent of compensation with the definition of compensation used for section 415 purposes. In measuring compensation to determine an employee's retirement benefits, governmental plans often take account of section 403(b) annuity amounts, employee pension contributions that are "picked up" in accordance with section 414(h)(2), and section 457 deferred compensation plan amounts -- items that constitute in effect deferred compensation. The statutory definition of compensation used to determine the section 415 limits for Federal tax purposes does not take account of these compensation items of importance to governmental plans. This statutory definition is then utilized in the section 415(b) limitation which provides that benefits under a defined benefit plan cannot exceed 100 percent of the employee's average annual compensation over his or her highest 3 years. As applied to governmental plans such as CalSTRS this limitation can significantly reduce even relatively small pensions payable to employees with long periods of public service.

By way of example, CalSTRS has 285,000 active members. In 1989, about 6,800 cf those members retired. The average final compensation of these retirees -- as determined under the plan definition that includes section 403(b) and section 457 contributions and employee pension contributions "picked up" by the employer -- was approximately $39,500. Over 800 of those members (12 percent) had in excess of 35 years of service with CalSTRS, which on the basis of CalSTRS's 2 percent benefit accrual percentage for all members would entitle them to a pension of 70 percent or more of compensation. Accordingly, the average pension was in the range of $31,000.

As noted above, the section 415 definition of compensation excludes section 403(b) and section 457 contributions and employer "pick-up" contributions. In the case of CalSTRS, employer pick-ups would equal 8 percent of the employee's compensation. In addition, many of these retirees 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, and hence it is quite likely that many of them were in a position to defer some compensation via section 403(b) and section 457 plans as a means of saving for retirement.

Given the existing exclusion of the section 403(b) and section 457 contributions and employer "pick-ups" from the definition of compensation used for section 415 purposes under current law and the leveling effect of the three-year average used for purposes of computing compensation under section ^15(b), it becomes clear that many of these relatively low-paid, lengthy service retirees would be adversely affected by the existing 100 percent of compensation limitation. Yet, this action would be taken to reduce benefits to those who, in 1989, otherwise would have received an average retirement allowance of about $31,000 under the terms of the plan. This is clearly not the abusive situation that section 415 was intended to prevent.

S. 1364 would eliminate this problem by making the section 415 compensation definition consistent with the compensation definition used by governmental plans to determine retirement benefits and by making the 100 percent of compensation limitation inapplicable to governmental plans.

Disability and Death Benefits Under the Qualified Plan

A second problem area for governmental plans under current law relates to the payment of disability and death benefits. Governmental plans such as CalSTRS are somewhat unique in providing substantial disability and death benefits as part of the qualified retirement plan. In many cases, these benefits serve to replace workers' compensation, Social Security disability, and long-term disability benefits that are available to private sector employees outside of the pension plan. Accordingly, under current law the governmental plans' disability and death benefits may be impeded by the section 415 limits, whereas comparable benefits in the private sector clearly fall outside of the section 415 limits.

Application of the current law section 415 limits to these types of benefits under the governmental plan can create serious hardship for employees and their beneficiaries. Because these benefits are payable well before an individual reaches normal retirement age, the actuarial reduction in the dollar limitation of section 415(b) that is made when the benefit begins early can cause a substantial reduction in the amounts that otherwise would be payable under the terms of the plan to a disabled employee or to the beneficiaries of a deceased employee. Again, this appears to be an unintended effect of the section 415 limits and clearly does not involve an abusive situation.

The proposed legislation would eliminate this problem by explicitly removing the governmental plans' survivor and disability benefits from the section 415 limits. We understand that the I.R.S. recently has attempted to offer some clarification on this issue through informal guidance to a particular taxpayer. We believe that the need to resolve this issue once and for all -- particularly in light of the potentially disastrous consequences for the governmental plan's disabled and survivors -- warrants the statutory certainty of the provision included in the proposed legislation.

Qualified Governmental Excess Benefit Arrangement

The proposed legislation also includes a provision expressly permitting governmental plans to establish so-called qualified governmental excess benefit arrangements. This provision was worked out in close consultation with the Congressional tax staffs, including the Joint Committee staff, in an effort to address any concerns they might have. The purpose of this provision is to enable the governmental plans to resolve the dilemma they now face between compliance with the section 415 limits to avoid plan disqualification on the one hand and on the other hand compliance with State constitutional restrictions in many States which prevent a reduction in benefits once promised to the governmental employee. In essence, the proposal would permit the governmental plan to resolve this dilemma by paying a benefit out of the qualified plan up to the section 415 limit, with a non-qualified deferred compensation arrangement being used to pay the remainder of the benefit to which the employee is entitled under the plan and is strictly protected by State constitution. Thus, the qualified excess benefit arrangement in effect serves as an "overflow" mechanism to provide on a non-qualified basis benefits in excess of the section 415 limits for the limited number of employees whose benefits happen to exceed such limits simply by operation of the plan's regular benefit formula because, say, of particularly lengthy public service.

In enacting section 415 in the first instance, Congress clearly contemplated that such non-qualified arrangements could prove necessary as an "overflow" mechanism for benefits:

> "Finally, because the objective of the limits on contributions and benefits is to keep the tax advantages associated with qualified plans within reasonable bounds and not to restrict the amount of retirement benefits that may be paid to individuals under other arrangements, the bill specifically indicates that nothing in the provisions relating to such limits (or in the provisions of the bill which relate to minimum funding standards) is to be construed to require the disqualification of any plan solely because additional benefits are provided to the employee under nonqualified portions of the plans." [H.R. Rep. No. 93-807, supra, at 37.]

To prevent misunderstanding of what this proposal seeks to accomplish and how it is intended to operate, it is important to emphasize what the proposal is not. It is not a method of enabling governmental employees to elect to defer additional compensation. That is expressly barred by the proposal. It is not a method to enable a few highly compensated senior executives to enjoy special retirement benefits unavailable to the broad membership of the qualified plan. It is not some separate benefit plan for a select few. Rather, the purpose of the arrangement is to provide an "escape valve" by which the State can pay the sliver of benefits that happens to accrue to various employees under the regular plan benefit formula that is statutorily prescribed by the State across the broad full membership of the qualified plan which, in the case of CalSTRS, includes 285,000 participants. The regular benefit formula has a benefit accrual percentage set by State statute for the full membership. There is no eye-popping benefit accrual percentage that on its face portends a breach of section 415. The service credit rules are set by State statute for the full membership. The salary used to determine benefits is established by State and local government job classifications and guidelines applicable across-the-board. Unlike the private sector, the non-qualified excess plan arrangement is not a device to woo highly-paid executives away from a competitor with a lucrative retirement package. In the case of governmental plans, there is no conscious effort to exceed the section 415 limits by way of the excess plan.

The proposed qualified excess benefit arrangement contemplates an "overflow" of a sliver of benefits to the non-qualified arrangement. It does not contemplate an overflow of assets from the qualified plan to fund the payment of those non-qualified benefits. Participants in an excess benefit arrangement established by a governmental plan under the proposed legislation would be taxed in a manner similar to private excess benefit plans. If the qualified governmental excess benefit arrangement were unfunded as is commonly the case in the private sector, the employee would not be taxed until receipt of the benefits upon retirement because he or she would have simply the unfunded promise to receive benefits in the future. In those cases where the State or local government chose to fund the excess benefit arrangement, vested participants would be taxed on a current basis with respect to employer contributions in a manner similar to section 402(b)(1); in addition under the section 402(b)(1) rules, a participant who becomes vested (or whose vesting percentage increases) in the separate excess benefits trust would be taxed on the portion of his or her interest in the trust that becomes vested during the year. In that situation, the employee would face a current tax cost. Thus, the proposed qualified governmental excess benefit arrangement provides the employee with no tax-favored treatment. The section 415 limit remains intact, and the government's qualified plan avoids the prospect of disqualification. And again, the rules of current law would restrict any transfer of assets from the qualified plan to the non-qualified arrangement.

The history of well-meaning, but ultimately transient, "band aid" solutions to the section 415 problems encountered by governmental plans over the years is well known. The proposed legislation offers a lasting solution by addressing the underlying structural problems that section 415 has created for public plans. The proposed qualified governmental excess benefit arrangement plays the key role in making that solution a permanent one because it offers the government's qualified plan an "escape valve" to cope into the future -- on a non-tax-favored basis -- with the twin masters of section 415 and the State constitutional restrictions, without risking disqualification of the qualified plan simply because the across-the-board regular plan formula applicable to hundreds of thousands of public employees happens in a limited number of cases to compute through to benefits above the section 415 limits.

Conclusion

Once again, the California State Teachers' Retirement System strongly commends Chairman Pryor and the co-sponsors of S. 1364 for their valiant efforts to bring simplification to this complex area of the law.

Statement of Cap Gemini America

Thank you for requesting my comments on the pension simplification legislation that you introduced with Senator Bentsen.

Cap Gemini America is a leading American provider of information technology consulting services (also known as computer consulting). Headquartered in New York City, we employ 3,000 professionals in 40 cities throughout the U.S. Cap Gemini America is the American arm of Cap Gemini Sogeti, the fourth largest information technology company in Europe -- which is based in Paris.

Our client base includes both the Fortune 500 and many small and medium-sized companies. Representing many diverse industries, clients depend on us to design and implement information technology solutions to their business problems -- helping them to achieve and maintain a competitive advantage.

I have been Director, Human Resources of Cap Gemini America for over four years, with more than 10 years of service to the company. My department is responsible for, among other things, the design, implementation, and administration of our benefits programs, including our 401(k) retirement plan. Our benefits programs are important to us, and to our employees.

Here are my comments:

Discrimination Tests for 401(k) Plans

The proposal that is of primary concern to Cap Gemini America is the proposed change to the 401(k) discrimination testing provisions. Cap Gemini America offers a 401(k) to its eligible employees. We spend a great deal of time performing the 401(k) discrimination tests and correcting excess contributions and excess aggregate contributions.

Your proposed legislation adds a safe harbor to the ADP tests if the company makes a fully vested matching contribution of 100% of the first 3% of salary reduction contributions and 50% of the next 2% of salary reduction contributions. The employer may also satisfy a safe harbor by making a contribution of at least 3% for each non-highly compensated participant regardless of whether he or she makes any salary reduction contributions. If an employer fails to meet any safe harbor, the ADP and ACP tests remain unchanged.

We are anxious to see some reasonable changes made in this area. The tests are very time-consuming to the human resources department and unsettling to our employees. This is especially true when our mid-level managers and sales people, as well as some consultants, find out after the end of the year that they were unable to contribute most of their after-tax contributions and part of their salary reduction contributions. Also, the company is forced to choose between an excise tax or an adjustment to a prior year's taxable income for the employee.

However, I suggest that in most years, and for many companies, the proposed safe harbors will not be used because they are too expensive. I believe that a more appropriate solution is seen in some of the other pension simplification proposals. Permitting reliance on prior year results to limit salary reduction contributions for the current year will eliminate most of the uncertainty and time taken to perform the tests and to adjust employees' contributions. The other option is to simplify the test. The Rostenkowski proposal (of using two times the average deferral percentage contributed by non-highly compensated employees in the prior year as a cap on the contribution made by any highly compensated participant in the current year) will greatly simplify administration, but at the same time will unduly restrict contributions by any single highly compensated employee.

Of course, this restriction will not be so detrimental if the definition of highly compensated employee is changed to take most of middle management, and other employees of similar compensation levels, out. If that were the case, most truly highly compensated employees' contributions will be capped by the $8,475 limit. In fact, since the Tax Reform Act of 1986 added a limit of $8,475 on each individual's total salary reduction contributions, I must question whether the ADP and ACP tests are necessary any longer. I am aware that there are concerns that if the discrimination tests are eliminated, there will be no incentive to increase participation by non-highly compensated employees. Please be assured that as a human resources director, I strive to increase the participation of all eligible employees because I think it is vital that they save for their retirement. Eliminating the tests will not lessen this ambition.

Discrimination Testing of Matching Contributions

Your proposal suggests that no discrimination testing will be required for matching contributions if an employer meets the proposed safe harbors for salary reduction contributions. However, discrimination testing will still be required for after-tax contributions. Although we question whether the safe harbors (requiring fully vested matching or basic contributions) are practical, we would recommend that the safe harbors also be extended to after-tax contributions. I would even go so far as to suggest that no discrimination testing should be required for after-tax contributions. Even though after-tax contributions tend to be made by highly compensated employees, in an economy that needs to encourage personal savings the contributions should not be discouraged. In addition, the plan places other limits on the amount of after-tax contributions that can be made.

Definition of Highly Compensated Employees

Simplifying the definition of highly compensated employees would be a start in simplifying the testing process. Your legislation would simplify the definition to 5% owners and employees who earn $60,535 in the current year. A breakpoint of $80,000 would be more appropriate. As I have indicated previously, a break point of $60,535 is very low and treats middle managers, middle sales people, and some consultants as highly compensated employees. It would also greatly simplify the administration of the plan if we could determine who the highly compensated employees are at the start of the year, based on the prior year's compensation.

We also feel that family aggregation rules are unworkable for businesses the size of ours.

Required Transfers

There is one provision in your proposed bill that will greatly increase my administrative burden. As you know, the bill requires that a plan administrator directly transfer to an individual retirement account (or a qualified defined contribution plan) distributions in excess of $500, unless an exception applies. We would be required to give the participant some time to make an election of where the funds should be directed. If they failed to make an election we would be required to direct the transfer to an institution of our choosing. This could greatly increase my potential liability as plan administrator if I choose a bank or savings and loan institution that eventually fails. This is more responsibility than I think a plan administrator should be required to handle. We currently need to constantly review the investments we offer under the plan for our active participants and would not want the additional concern and potential liability for former participants. We would not be opposed to giving participants a choice to directly transfer their benefits to an individual retirement account or another qualified plan.

In summary, thank you again for giving me the opportunity to submit comments. I am hopeful that real simplification will result, and am encouraged by your interest and activity.

Sincerely,

Joanna Ellis

Joanna Ellis
Director, Human Resources

CHEVRON CORP.,
San Francisco, CA, September 24, 1991.

Hon. DAVID PRYOR, *Chairman,*
Subcommittee on Private Retirement Plans,
Committee on Finance,
U.S. Senate,
Washington, DC.

Re: September 27 Hearing on Pension Simplification

Dear Mr. Chairman: This letter contains comments of Chevron Corporation on certain pension simplification issues that will be considered in a September 27 hearing of your Subcommittee. We commend you for holding a hearing on this important subject, and commend all persons involved for their effort. We sincerely hope such efforts will continue.

Chevron is a multinational petroleum company headquartered in San Francisco, California. Our comments, submitted in accordance with Press Release H-39 of your Subcommittee, focus on the proposals to amend the definition of leased employee. A computer diskette of this statement is enclosed.

LEASED EMPLOYEE

The present rules regarding "leased employees" have been a longstanding concern of Chevron. In March 1989 we publicly announced our inability to interpret and apply the leased employee rules, after spending hundreds of thousands of dollars on this project and sending out about 12,000 letters requesting necessary information to companies with which we do business. Our frustrations with the present rules are documented in Attachment A. In April 1990, we submitted formal comments on this point to your Subcommittee in response to your request for ideas regarding pension simplification. Chevron representatives have met on numerous occasions with appropriate staff persons working in the employee benefits area to discuss the need for changes in the definition of leased employee.

A. Chevron Strongly Prefers the Sharper Statutory Language of H.R. 2641

We are extremely pleased that the leased employee problem has received an increasing amount of attention, and that all three of the major legislative pension simplification proposals—Mr. Rostenkowski's bill (H.R. 2730), your bill (S.1364), and Mr. Chandler's bill (H.R. 2641)—would address this problem. Each would replace the "historically performed" standard that has plagued prior efforts to make sense of this area. Although the proposed solutions are similar, we believe that the language in Mr. Chandler's bill, H.R. 2641, is greatly superior, because it would provide the clearest standard for the IRS and employers to apply.

1. Purpose of Rules

As you know, to be a "qualified" plan and receive tax benefits, a retirement program must satisfy certain "minimum coverage" standards. The basic idea is that a qualified plan may not cover only higher-income workers; it must also cover an appropriate percentage of lower-income workers. The fundamental question in making the technical calculations required by these rules is determining who to count. This is not a minor technical issue, it is critical and basic.

The natural place to start in determining who to count is the definition of a common-law employee. Unfortunately, most believe this definition by itself is not sufficient to prevent abuse. This is essentially because the common-law standards were developed for a different purpose, which is to make sure that some responsible person is withholding tax, remitting amounts promptly, and filing information reports. The common law standard is a vague facts and circumstances test with 20 factors, and there is no indication which factors are particularly critical or how many factors must be present. *See* Rev. Rul. 87-41, 1987-1 C.B. 296. Congress has restrained IRS from clarifying this area. *See* Section 530 of the Revenue Act of 1978. One result is that, where workers are leased from one company to another, the workers may be treated as common-law employees of the leasing organization even though the organization receiving the services controls the services to be performed and the manner in which they will be performed.

Many have suggested that the legislative history should state the specific abuse that the leased employee rules of section 414(n) are intended to prevent. We agree. *We believe the abuse is where a person or entity exercises the same degree of control over the manner in which the services of an individual are performed as over a common-law employee, yet does not count that individual as an employee for benefit* *testing purposes.* This is the potential abuse that threatens to undermine the minimum coverage rules. The legislative history should contain a statement of this type.

2. The Preferred Standard

H.R. 2641 would deem a person to be a leased employee if the recipient of the services "exercises primary control over the manner in which the services are performed." We strongly prefer this statutory language:

1. It squarely prevents the potential abuse.
2. It is a single factor test, not a vague, multi-factor test.
3. It is capable of being understood and applied by company representatives. It would allow managers to look around and ask one question—"who am I telling how to do their job like I would a common-law employee?"
4. It could be more readily enforced by the IRS as compared to more vague standards. Thus, IRS regulations would not have to be excessively overbroad and harsh. Our experience is that, where the statute is vague, the Service often takes an aggressive position to protect itself.
5. It clearly would not count as leased employees persons over whom a company has no real control, such as where certain repair or other services are "contracted out," and supervisors of the contract organization exercise primary control over the workers.
6. It is better to start with a sound statutory rule, and not rely totally on legislative history. The sharper statutory phrasing of H.R. 2641 would add significant legal clarity.

If Congress is nevertheless concerned that the statutory language of H.R. 2641 may not be sufficient to prevent abuse, then we suggest amending section 414(n) to give the Secretary of the Treasury authority to issue additional regulations regarding employee leasing to the extent necessary to prevent abuse. Some have also expressed concern about so-called "fire/leaseback" situations; we have no problem with a special rule counting persons as employees who terminate employment and then are leased back to their original company. We offered these suggestions in our April 1990 comments to you.

B. Technical Comment

We offer a final technical point on the leased employee rules, a point that we believe has not been publicly raised to date. Code section 414(n)(1)(B) states that any contributions or benefits provided by a "leasing organization" which are attributable to services performed by the recipient organization "shall be treated as provided by the recipient." (Emphasis added.) This implies that the recipient organization is somehow able to determine whether a leased employee is receiving benefits from the leasing organization, and the exact terms of those benefits. Exact information is necessary to apply the complex IRS rules regarding nondiscrimination. Unfortunately, as described in the Attachment, it is generally impossible to obtain exact details regarding another organization's benefits. Accordingly, we suggest that the word "shall" in Code section 414(n)(1)(B) be changed to "may."

OTHER COMMENTS

A. Section 401(k)/401(m) Testing

All agree that the present nondiscrimination tests under sections 401(k) and 401(m) are complex and administratively burdensome. However, Chevron has already invested considerable effort to develop systems to comply with these rules. We do not favor the proposal in H.R. 2730 that would require us to change these systems; such a revision at this date would only increase our administrative costs. It would also have the effect of further limiting deferrals by those persons who are "highly compensated employees" under the IRS rules but who are close to the threshold—in our case, persons earning $60,000 to $90,000.

The proposal regarding 401(k)/401(m) testing in H.R. 2730 would thus increase our administrative costs and reduce savings by certain employees. This is not a simplification, and this proposal should not be included in a simplification package.

If there is to be a change in this area, Chevron prefers the concept in your bill, S. 1364, of design-based "safe harbors," which would be a voluntary alternative to these existing nondiscrimination tests. Frankly, we are somewhat puzzled by the repeated objections of the Treasury Department to this concept; Treasury itself is proud of having included a variety of "safe harbors" to alleviate the complexity of its proposed nondiscrimination regulations under Code section 401(a)(4). There is no logical reason why the safe harbor concept should not be extended to the special nondiscrimination tests of section 401(k) and 401(m).

Again, we ask that any changes in this area be elective, at least for existing plans.

B. Disaggregation of Represented Employees

Under present law, an employer must disaggregate represented employees in applying the minimum coverage requirements to unrepresented employees, even if both groups are covered under the same plan. This disaggregation rule could cause an employer to fail the minimum coverage rules simply because various groups of workers are unionized. The very recent final IRS tax regulations regarding coverage contain only narrow and limited relief on this important point.

Chevron strongly supports the proposal (in H.R. 2641) that would allow employers to elect to apply the minimum coverage tests on an aggregate basis to represented and unrepresented employees covered under the same plan. We ask that such a provision be included in S. 1364.

C. Definition of HCE

Chevron supports the goal of simplifying the definition of "highly compensated employee," or "HCE." Although there would be some slight expense in revising procedures, that effort could be quickly recouped by expediting the tedious annual calculations in this area.

D. Definition of Retirement Age

Chevron supports the proposals to substitute social security retirement age for age 65 in the current definition of normal retirement age. This change would eliminate technical complexity and obstacles under present law.

E. Minimum Distribution Requirements

Under present law, qualified plan distributions must commence by April 1 following the year in which a plan participant attains age 70½ even if the participant continues working. We believe the complex rules in this area serve little or no purpose. They are confusing both to employers and to employees forced to receive retirement funds while they are still working. The potential for indefinite deferral of qualified plan benefits is an issue for only a few HCEs. The complex rules in this area should be scrapped or substantially narrowed.

We again appreciate the efforts of yourself and numerous others in this area, and hope that such efforts will continue. If you or your staff have any technical remarks or questions on these comments, please contact our outside counsel on such matters, Douglas W. Ell of Groom and Nordberg, Chartered, who may be reached at (202) 857-0620.

Very truly yours,

LOUIS FERNANDEZ, JR., *Vice President of Human Resources, Chevron Corp.*

STATEMENT OF THE COLLEGE OF AMERICAN PATHOLOGISTS

The College of American Pathologists is pleased to have this opportunity to share with you the College's views on the leased employee provision of the tax code. The CAP is a national medical specialty society representing 12,000 physicians who are certified by the American Board of Pathology. CAP members practice their specialty in community hospitals, independent medical laboratories, academic medical facilities, and other settings in which health care services are provided.

The leased employee provisions of the tax code [Section 414(n)] and implementing regulations are of significant concern to College members because they have the potential to severely limit pathologists' ability to participate in a tax-qualified pension plan. Other hospital-based physician groups also share these concerns and have joined with the College to propose a solution that will address our concerns.

The College supports appropriate efforts to prevent discrimination between highly compensated and non-highly compensated employees in tax-qualified benefit plans. We believe reasonable "anti-discrimination" rules that curtail abusive circumvention schemes are appropriate. However, regulations proposed by the Treasury Department in 1987 to implement this section of the tax code would result in unworkable and overreaching application of the leased employee provision. We believe a joint proposal developed by the College, the American Medical Association (AMA), the American College of Radiology (ACR), the American College of Emergency Physicians (ACEP), and the American Society of Anesthesiologists (ASA) will clarify the leased employee section of the tax code in a manner that prevents abuses but simplifies administration of the leased employee requirements.

The first part of our statement addresses the pathologist's role in the hospital. Then we explain why application of the leased employee rule is inappropriate in hospital laboratory settings. Finally, we focus on our proposal to modify the leased employee provisions of the tax ccde.

The Pathologist's Role in the Hospital

A pathologist is a physician who specializes in applying medical knowledge and judgment to the testing and analysis of biologic specimens in connection with the diagnosis and treatment of human disease. The services that pathologists provide in the hospital can be divided into four basic categories: medical services personally performed for individual patients, such as examination of biopsied tissue to determine whether it is malignant or benign; medical direction of the laboratory, either in a hospital or independent laboratory; service on medical staff committees of a hospital; and performance of autopsies.

Typically, a pathologist or incorporated group of pathologists enters into a contract with one or more hospitals. These pathologists may base their practices at the principal hospital whose patients they serve or in a separate office setting. Often pathologists who contract with hospitals are based in a separate independent laboratory and travel to the hospital to provide pathology services to patients. When they serve the patients of more than one hospital, pathologists travel from hospital to hospital on a regular schedule and must be available "on-call".

Pathologists commonly serve as medical directors of the hospital laboratory. In this capacity, they medically supervise technologists and other employees who operate lab equipment, screen the results of various procedures, and provide other support services. Typically, there may be as many as 20 hospital lab employees for each pathologist in a hospital laboratory.

As hospital laboratory medical directors, pathologists provide essential medical care to patients by designing protocols and establishing-parameters for the performance of clinical testing, delegating quality control responsibilities, and supervising laboratory personnel in the performance of their patient care duties.

For example, a pathologist who directs a hospital laboratory must establish a sequence of tests to be performed on the blood samples of patients suspected to be suffering from leukemia. The pathologist is required to select methodologies for an initial screening test and then to determine which subsequent tests or groups of tests should be performed, depending on the initial screening result. Several different combinations of tests could be performed, depending on the results of each stage of the testing profile. The pathologist's medical knowledge of hematologic disease processes is essential to the proper design of such testing profiles.

Although a hospital supplies space, equipment, and technical support staff, only a trained professional can provide the medical knowledge and specialized training necessary to assure proper functioning of a medical laboratory. Indeed, the pathologist must complete four years of medical school and five years of a residency training program in order to acquire the skills needed to direct a hospital laboratory.

Why Application of the Leased Employee Rule is Inappropriate in Hospital Laboratory Settings

Technical staff and other support personnel in the laboratory have traditionally been employed by the hospital; the hospital hires and fires these individuals and pays their salaries. The hospital determines their benefits and negotiates with their union, if such employees are unionized. Hospital laboratory employees are covered by the hospital's pension plan. The hospital bills patients (or their insurer) for the services of these employees. The pathologist does not pay the hospital for the services of these employees, nor does the pathologist bill for their services.

Under current law, leased employees are treated as though they are common law employees for purposes of certain retirement and welfare provisions of the tax code. We understand that Congress enacted Section 414(n) to prevent abusive circumvention of anti-discrimination rules that require employees who are not highly compensated to be eligible to participate in the same tax-favored pension plans that employers establish for themselves and their key employees. In what has been cited as an example of an abusive circumvention scheme, an organization could discharge its own employees, create a separate organization which would hire the discharged employees, and "lease" the same employees from the separate organization. The new organization would not typically offer the same coverage in a qualified retirement plan, while the previous employer would continue to enjoy higher benefits and meet the anti-discrimination rules.

To our knowledge, College members and other hospital-based physicians have not been involved in these schemes. Hospital laboratory employees historically have been the hospital's employees; there has not been a movement by hospital-based physicians to change the employment status of personnel to circumvent anti-discrimination rules. Pathologists who own and operate independent laboratories that are separate from the hospital do employ laboratory technologists and other support personnel; in these instances, these employees are covered by the pathologist's tax-qualified plan.

Regulations proposed by the Treasury Department to implement the leased employee section of the tax code would require pathologists to bring hospital laboratory employees under their pension plans. Pathologists would have to include these individuals in determining whether that plan meets the non-discrimination provisions of the Internal Revenue Code. In most cases, the pathologist would have to provide the difference between what the lab employees would receive under the pathologist's plan and what they receive under the hospital plan. This requirement would cause a number of unintended problems:

1. Loss of Pathologists' Plans. The ratio of lab employees to pathologists is very high. As a result, the cost of including hospital lab employees in the pathologist's plan is likely to be substantial relative to the cost of including the pathologist and the pathologist's common law employees in the plan. The administrative costs of determining the amount of benefit that would have to be made available for hospital lab employees would be so great that many pathologists would be forced to terminate their plans just to avoid these costs. For these two reasons, many pathologists would be likely to terminate their plans. The losers would be not only pathologists, but also employees of pathologists who would no longer be covered by a qualified plan.

2. Special Problems in Rural Areas. In rural areas, pathologists frequently provide medical services for several hospitals. The hospital lab employees they medically supervise participate in different plans with different benefit structures. Pathologists in these situations would have to make the necessary comparisons not just with one hospital but with many.

3. Enormous Administrative Complexity. Determining the difference in benefits between a pathologist's plan and a hospital's plan would be prohibitively expensive. The costs would be multiplied if one of the plans were a defined benefit plan and the other were a defined contribution plan. In addition, the details of the hospital's plan might be unavailable to the pathologist. Thus, determining the amount of benefit, if any, that would have to be made for hospital lab employees would be an enormously complex and costly task.

4. Other Adverse Impacts. To the extent that pathologists and other hospital-based physicians maintain pension plans, the result of these regulations would be that hospital employees in a single hospital would receive different benefits depending on the hospital department in which they work. A lab employee would be under one set of benefits, an X-ray technician under another, and an operating room nurse under yet another. The inevitable result is unequal benefit determinations and dissension among hospital employees.

Our Proposed Modification of the Leased Employee Rule

The leased employee rules of Section 414(n) create what the College and other physician groups believe are unintended hardships. For example, Section 414(n) could cause all of a hospital's laboratory personnel to be included in a pathologist's tax-qualified plan. The College has worked with AMA, ACR, ACEP, and ASA to develop a legislative proposal to amend Section 414(n), which Senators Daschle and Chafee have introduced as S.1732. We believe S.1732 will address our concerns but will not create new opportunities for circumventing the tax code's anti-discrimination provision.

As you are aware, recently introduced pension access and simplification proposals would substitute a "control" test for the current law's "historically employed" test to identify leased employees. The control test language varies somewhat in each proposal. We do not oppose the control test; indeed, our legislative proposal also includes a control test. However, given that good medical practice requires physicians to exercise medical and clinical direction of hospital employees, we are concerned that a control test will cause hospital employees to be considered leased employees of pathologists and other physicians who practice in hospitals. Therefore, we urge adoption of S.1732 as an amendment to the Employee Benefits Simplification and Expansion Act, introduced by Senators Pryor and Bentsen. S.1732 would, in addition to establishing a control test, achieve the following:

1. Provide a More Precise Definition of Leased Employee. ~~Our proposal~~ S.1732 includes a more precise definition of leased employee to make it clear that a

legally binding "contract" is required before leased employee status can occur. In order to clarify that any true contract pursuant to which one or more persons is leased to a recipient is covered under the statute, further important stipulations have been added: (a) oral or written contracts are covered, (b) there must be payment for services by the service recipient, and (c) the payment may be made directly or indirectly to the leasing organization. We believe that these changes clarify the requirements without providing loopholes that would allow the improper exclusion of some individuals.

2. Expand the Current Safe Harbor. The safe harbor provision has been substantially expanded. The current safe harbor does not provide meaningful relief when applied to organizations whose principal purpose is not the provision of the services of leased employees to other organizations. Further, many organizations cannot meet the technical requirements of the existing safe harbor provision because leased employees would constitute more than 20 percent of the recipient's non-highly compensated work force.

   To address these issues, we have included two safe harbors in our proposal, that have been incorporated into S.1732. A new meaningful safe harbor is provided for individuals employed by organizations whose principal purpose is not the provision of leased employees to recipient organizations. The existing safe harbor is preserved for organizations that do have as their principal purpose the provision of services of leased employees to recipient organizations. These organizations are often referred to as employee-leasing companies.

   Compliance with the requirements of Section 414(n) will be complex and time consuming, and record-keeping and the sharing of data (much of which is of a confidential nature) between the employer and various recipient entities will be difficult and costly. These burdens should not be placed on employers who are not principally in the business of leasing employees. Also, where the employer is not principally in the business of leasing employees, it is inappropriate to require some employees (such as those whose work may benefit the recipient) to receive greater benefits than those granted to other employees. This would lead to hiring and retention problems, employee dissatisfaction and confusion. The proposed expanded safe harbor provisions would substantially reduce administrative burdens and costs while continuing to curtail abusive situations.

3. Require Prospective Application. Because of the extreme confusion that the current statute and proposed regulations have caused, we believe it is fair and appropriate to include a provision preventing detrimental retroactive application of the statute. Accordingly, S.1732 includes a new provision that would cause pension plans that were in compliance under the existing statute or that would have been in compliance under the proposed statute to be qualified for the period in question. Further, this provision establishes an effective date no earlier than the later of the date of publication of final, temporary or proposed regulations or rulings or the date of the enactment of the act.

Summary

The College supports appropriate rules to curtail abusive circumvention schemes designed to avoid "anti-discrimination" requirements for tax-qualified pension plans. However, we are concerned that efforts to implement the leased employee section of the tax code as it currently stands would result in unworkable and overreaching regulations. The College believes a joint proposal developed by the College, the American Medical Association (AMA), the American College of Radiology (ACR), the American College of Emergency Physician (ACEP), and the American Society of Anesthesiology (ASA) and introduced in the Senate by Senators Daschle and Chafee as S.1732 will clarify the leased employee provision of the tax code in a manner that prevents abuses and simplifies administration of the leased employee requirements. We urge committee consideration and adoption of S.1732.

STATEMENT OF THE COMMONWEALTH EDISON COMPANY AND THE EDISON ELECTRIC INSTITUTE

INTRODUCTION

Commonwealth Edison Company is an investor-owned electric utility serving 3.2 million customers in the northern third of Illinois, including the City of Chicago, and has nearly 20,000 common law employes.

The Edison Electric Institute (EEI) is the association of electric companies. Its members serve ninety-six percent of all customers served by the investor-owned segment of the industry. They generate approximately seventy-eight percent of all electric energy in the country and provide service to more than seventy-four percent of all ultimate customers of electricity in the nation.

Commonwealth Edison Company and EEI support simplification of the employe benefits rules because many provisions of the Internal Revenue Code have increased the administrative burden imposed on employers while having little effect on the amount of benefits ultimately furnished to employes. In particular, we believe that Congress should simplify the leased employe rules to relieve employers of the enormous administrative burden created under these rules. The sponsors of the Employee Benefits Simplification and Expansion Bill of 1991, S. 1364, which was introduced by Chairman Bentsen on June 25, 1991, are to be commended for the bill's significant change to the leased employe rules.

BACKGROUND

Under the current leased employe rules, individuals who perform services for an employer (recipient) and meet the definition of a leased employe are required to be treated as employes of the recipient for purposes of determining whether the recipient's plans are qualified for certain tax benefits. To be considered a leased employe of the recipient, an individual must not be a common law employe of the recipient and must meet three other requirements. First, the individual must provide services pursuant to an agreement between the recipient and a third party. Second, the individual must provide services to the recipient on a substantially full-time basis for at least one year. Third, the individual's services must be of a type historically performed by common law employes in the business field of the recipient.

SECTION 301 OF S. 1364

Section 301 of the bill would replace the third requirement, the "historically performed" test, with a control test. Under this test, an individual would be considered a recipient's leased employe only if the individual performing the services is under the control of the recipient. This test more accurately reflects the original intent of the leased employe rules because only individuals who perform services similar to the services performed by the recipient's common law employes would be the recipient's leased employes. Commonwealth Edison Company and EEI support this change.

PROPOSALS TO LESSEN ADMINISTRATIVE BURDEN

Even though the control test change contained in the bill is both desired and needed, it does not directly address the administrative burden imposed by the leased employe rules. We urge Congress to enact two additional changes to the leased employe rules that will greatly reduce this burden.

First, legislation is needed to provide that workers who are members of a collective bargaining unit ("union employes") and who perform services for a recipient pursuant to an agreement with an unrelated third party are not leased employes of the recipient. The current requirement that a recipient treat union workers who satisfy the definition of leased employe as its common law employes does not result in any additional plan coverage for any of those union workers. Nevertheless, the recipient is required to incur the expense of gathering employment data to determine if any of the union workers have satisfied the requirement that they perform services for the recipient on a substantially full-time basis for at least one year.

The basis for this proposal is that the most fundamental of the plan qualification rules permits an employer to exclude union employes in determining whether its plan discriminates in favor of highly compensated employes, as long as the plan does not benefit any union employes.[1] The unstated rationale for the exclusion is that the federal government should not interfere with the collective bargaining process by mandating whether or to what extent retirement benefits must be provided to union employes. The definition of union employes who may be excluded does not require that the employer maintaining a plan be a party to the collective bargaining agreement covering the union employes.[2] Rather, the law merely requires that the collective bargaining agreement be between employe representatives and one or more employers.

Congress could not have intended that a recipient would be required to provide qualified plan benefits to union employes outside of the collective bargaining process. The purpose of the leased employe rules is to prevent a recipient from excluding from plan coverage workers who would be covered if they were common law employes of the recipient. Because an employer is not required to provide benefits to union employes unless the collective bargaining agreement so provides, the policy underlying the leased employe rules is not frustrated by excluding union employes from the definition of leased employe.

[1] If the plan benefits union employes, or if a separate plan is maintained for the benefit of union employes, all nonunion employes may be disregarded in determining whether the plan satisfies the nondiscrimination rules with respect to the union employes. See Code Section 413; Proposed Treasury Regulation Sections 1.401(a)(4)-1(c)(6); 1.410(b)-6(e)(1).

[2] In most cases the collective bargaining agreement is between an employer and an international union. For example, employes of a tree trimming company whose services are used by Commonwealth Edison are represented by the International Brotherhood of Electrical Workers.

Accordingly, if retirement benefits are the subject of good faith bargaining with a leasing organization, the employer who is the recipient of the union employe's services should be able to exclude such employes in determining whether its plans satisfy the nondiscrimination rules. Such an exclusion would significantly reduce a recipient's administrative costs of maintaining qualified plans.

The second change to the leased employe rules that we urge Congress to enact is a provision permitting a recipient to disregard its leased employes in determining whether its plans are qualified if the number of leased employes performing services for the recipient is less than 10 percent of the recipient's common law employes. If a recipient with a large workforce has such a small number of leased employes, the recipient should be relieved of the enormous task of collecting from unrelated third parties the detailed employment data that is necessary for it to determine whether any of its contract workers is a leased employe[3].

This proposal is a straightforward safe harbor similar to the recordkeeping exception under the proposed regulations under Section 414(n) of the Code for recipients who have a de minimis number of leased employes. Under the regulations, a recipient is not required to maintain employment records for its leased employes if their number is less than 5 percent of the number of the recipient's nonhighly compensated workforce.[4] Because the recordkeeping exception operates as an exclusion, the basis for the exception must be that if a small percentage of a recipient's workforce is comprised of leased employes, the recipient's intent in hiring such workers is not to increase the benefits it may provide to highly compensated employes.

Although this proposal would increase the number of leased employes that may be excluded under present law, it greatly simplifies the conditions under which a recipient may exclude leased employes. In addition, the increase in the number of leased employes that may be excluded is necessary to provide a recipient with a reasonable margin of error for those workers who escape identification because, for instance, they provide installation or maintenance services in connection with an asset purchase contract or for some other valid reason do not come to the attention of the personnel department. The proposal does not enable a recipient to provide its highly compensated employes with benefits that would be significantly greater than is possible under the proposed regulations; it merely provides recipients with some assurance that they are complying with the

[3] Although we believe that this proposal to exclude leased employes if their number is less than 10 percent of a recipient's common law employes is not abusive regardless of the size of the recipient's workforce, the change is really needed in the case of a recipient with a large workforce. Thus, if Congress decides to limit the applicability of this exception, we suggest that it be available to recipients with more than 500 employes.

[4] The proposed regulations also require that all plans of a service recipient provide that all leased employes are not eligible to participate and that none of the plans of the service recipient is a top-heavy plan. See proposed Treasury Regulation Section 1.414(n)-3(a)(2)(ii).

law. Moreover, the proposal does not undercut the policy underlying the leased employe rules, and significantly reduces administrative costs.

Furthermore, the proposal would recognize that, in the case of large employers such as electric utilities, there are valid reasons to use the service of independent contractors and outside firms to supplement their normal workforce during peak periods or to perform services that are seasonal in nature. For example, when a new electric generating station or transmission line is being constructed the services of engineers and construction workers are required, but once the project is completed their services are not required any longer. Also, due to weapons training and certification requirements by the Nuclear Regulatory Commission, Commonwealth Edison Company chooses to use the services of outside security firms to provide the required security of its nuclear generating facilities because Edison does not have the expertise in that important area.

CONCLUSION

Commonwealth Edison Company and EEI sincerely appreciate this opportunity to present our views on the leased employe rules. Your consideration of our concerns and proposals is appreciated. Because our proposals greatly reduce the cost of maintaining a qualified plan without sacrificing the underlying principles of the leased employe rules, we urge this Committee to support these proposals and include them in any pension simplification legislation that may be enacted.

STATEMENT OF EASTMAN KODAK COMPANY

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to submit comments on behalf of Eastman Kodak Company on pension simplification. My statement will address specific provision in S. 1364, the Employee Benefits Simplification Act, introduced by Senators Bentsen, Pryor, and others, as well as H.R. 2730, the Pension Access and Simplification Act of 1991, introduced by Chairman Rostenkowski of the House Ways and Means Committee and H.R. 2641, the Employee Benefits Simplification Act of 1991, introduced by Congressman Chandler and others. I will direct my comments to only a few specific provisions in each bill. Most of my comments discuss those provisions in the bills affecting the final pension coverage and nondiscrimination regulations as they relate to Kodak's retirement plans.

Kodak Plan--General Background

Treating all levels of employees equally for retirement benefits is Kodak's long standing general philosophy. Kodak therefore maintains one defined benefit pension plan, the Kodak Retirement Income Plan (KRIP), for the great majority of its employees without regard to business unit or location. (Sterling Drug Company employees participate in KRIP under the formula carried over from their own plan prior to acquisition by Kodak in 1988.) The KRIP was adopted in 1928 and currently covers more than 70,000 active employees and 30,000 terminated vested and retired employees and their beneficiaries (plus the roughly 5,000 Sterling participants).

Since 1981, the KRIP benefit formula has provided a pension at age 65 (normal retirement age) for each year of participation of 1.3 percent of pay up to the integration level and 1.6 percent of pay over the integration level. The benefit formula is designed so that in combination with social security it replaces on an after-tax basis a participant's final pay at the lower salary levels.

The following examples of final pay replacement on an after-tax basis (including social security) are illustrative:

Age 65/35 Years of Service	Age 62/30 Years of Service
$30,000 = 100%	$30,000 = 87%
$50,000 = 92%	$50,000 = 78%
$100,000 = 75%	$100,000 = 64%
$200,000 = 62%	$200,000 = 53%

Kodak has historically provided a partially subsidized early retirement benefit. Prior to September 1, 1990, the KRIP provided a 100 percent benefit at age 60 with 30 years of service. For earlier retirements, there was a 5 percent per year actuarial reduction from eligibility for a 100 percent benefit. Age 55 was the minimum early retirement age.

September 1, 1990 KRIP Changes. On September 1, 1990 significant (and costly) improvements were made in the plan. A 75/85 early retirement benefit was added, giving participants with a combination of service and age of 75 a 50 percent benefit and participants with a combination of service and age of 85 a 100 percent benefit. A lump sum optional form of benefit was also added for all participants. These improvements were made to reflect Kodak's need for a more flexible and mobile workforce to meet the competitive demands of emerging technologies.

Specific Comments

1. Average accruals under the 401(a)(4) regulations

On September 19, 1991, final regulations under Code sections 410(b) and 401(a)(4) were published in the federal register. The Treasury Department and the Internal Revenue Service reiterated a statement made in the final regulations that these rules are designed to provide a single coordinated approach to the nondiscrimination rules prescribed in the Code for qualified retirement plans.

Under section 410(b), an employer's plan must meet a minimum coverage requirement. This requirement can be met in one of two ways:

(1) **70 percent ratio percentage test.** The percentage of nonhighly compensated employees (NHCEs) benefitting under the plan (stated as a percentage of all nonexcludable NHCEs) is at least 70 percent of the percentage of the highly compensated employees (HCEs) benefitting under the plan (stated as a percentage of all nonexcludable HCEs).

(2) **Average Benefits Test.** The plan meets a two pronged test:

(a) **Nondiscriminatory classification test.** The plan covers a classification of employees that (i) is a reasonable bona fide business classification and that (ii) satisfies either an objective safe harbor test or an unsafe harbor test.

(b) **Average benefits percentage test.** Under all plans of the employer, the average benefits of the NHCEs as a percent of compensation equals at least 70 percent of the average benefits of the HCEs, as a percent of compensation.

In addition to satisfying section 410(b), under Code section 401(a)(4) a plan must not discriminate in favor of HCEs. Under the general rule as set forth in the final regulations and as adopted in the final regulations, a plan satisfies this test only if there is *no* HCE under the plan with an accrual rate that exceeds the accrual rate for *any* NHCE. In applying the general test under the final regulations, the employer must identify, for each HCE benefiting under the plan, the group of employees consisting of that HCE and all other employees (both highly compensated and nonhighly compensated) with equal or greater normal and most valuable accrual rates ("a rate group"). Thus, depending on their accrual rates, employees may be included in more than one rate group. A rate group must be determined for each HCE benefiting under the plan. Each rate group so identified must satisfy the requirements of section 410(b) as though it were a separate plan. A number of safe harbors are provided, some of them design-based. These are so restrictive, however, that many plans, particularly plans of large employers with subsidized early retirement benefits and other types of individualized plan designs like Kodak, will not meet them. Such nonqualifying plans must be tested under the general rule.

Problem with the final test

The basic problem with the final section 401(a)(4) test is that a plan can flunk if *any* HCE accrues a bigger benefit than *any* NHCE in any year. This means that if a formula produces nonuniform accrual rates for employees of different ages and lengths of service, a plan may at some point fail. Any plan covers HCEs and NHCEs of varying ages and lengths of service; if the accrual rate is nonuniform it is very likely that in some year one HCE will have a higher accrual rate than some NHCE. Most defined benefit plans have accrual rates that are to some degree contingent on age and years of participation--and therefore nonuniform.

Just about the only kind of defined benefit plan with a uniform accrual rate, unaffected by contingencies of age and service, is one with a normal retirement age of 65 (regardless of when participation begins), with no subsidized early retirement benefit, no caps on years of credited service, and no actuarial increases for individuals who work past the normal retirement age. Plans with enhanced benefit features are certain to have nonuniform accrual rates; a common example is seen in plans with subsidized early retirement based on a combination of age and years of service (such as the Kodak plan). Differing most valuable accrual rates occur in such plans for the simple fact that individuals hired at younger ages with potentially longer periods of service will be nearer to the time of full unreduced early retirement than others; they will accrue early retirement (*i.e.*, most valuable) benefits faster than individuals hired at older ages who are projected to have relatively shorter periods of service.

For example, consider the following plan of employer X. The plan is a defined benefit plan that provides a benefit at age 65 equal to 1 percent of compensation, times a participant's high 3-years average compensation, times years of service. A subsidized early retirement benefit is available equal to 100 percent of the normal retirement benefit for participants whose age and service equals a total of 75 years. The plan covers the following participants:[1]

Participant	**Compensation**	**Age At Hire**
A	$75,000	35
B	$40,000	30
C	$40,000	35
D	$40,000	50

While the normal accrual rate is nondiscriminatory[2], the most valuable rates may be discriminatory under the final regulations. This is because A's most valuable accrual rate (that is, for

[1] This participant group could either be the actual employer population or it could be merely one component of a restructured "plan."

[2] The plan's benefit formula may for any number of reasons not meet any of the design based safe harbors under the proposed section 401(a)(4) regulations. For instance, the compensation definition may not comply with the necessary requirements for safe harbor treatment because of the use of a rate of pay definition that does not qualify under section 414(s). Another provision making use of a safe harbor unavailable would be the granting of benefit service credit for service with a 50% owned joint venture.

early retirement benefits) is greater than D's most valuable accrual rate (for early retirement benefits). This is attributable to the fact that A will be eligible for unreduced early retirement at at 55, while D will not be eligible for unreduced early retirement until age 62-1/2.

Use of average accrual rates would solve the problem

Restructuring is an inadequate solution.*The most basic problem unsolved by the restructuring rules of the final regulations is the highly arbitrary nature of the test.* Because of his or her age and service with the employer, a highly compensated employee may accrue a benefit at a higher rate than *any* NHCE under the plan. This means a plan with a nondiscriminatory design can fail to pass merely because of accidents in the composition of the ages and lengths of service of plan participants. Because the result is the accidental outcome of a plan's demographics, a plan that has passed in any one year--or many years in a row--may fail to pass in any year.

The Kodak plan is an example of this points. Among the 70,000 employees covered by the plan, one is a relatively lower paid HCE who began work with Kodak at the age of 16 and is now in his young 30's. His most valuable accrual rate (the rate at which he is earning a subsidized early retirement under the 75/85 early retirement feature added in September of 1990) is projected to vastly outpace the most valuable accrual rate of all but a few NHCEs. Restructuring does not help this problem, because an insufficient number of NHCEs happen to have this individual's particular work history.[3] The benefit accrued by this single individual could disqualify the whole plan, even though subsidized early retirement is available to all on a nondiscriminatory basis.

H.R. 2641 (Chandler) would permit a plan to pass if the average accruals of HCEs were no greater than the average accruals of NHCEs. Kodak strongly supports this approach. Under this test, if a plan has a nondiscriminatory design, the accidental occurrence of a high accrual rate for a small number of HCEs will not disqualify the plan.

Why is an average accrual rule unacceptable to the Treasury and the Service? The preamble to the final regulations reasons that "averaging can produce arbitrary results, particularly in the case of small and medium-sized employers." What about large employers that have complex defined benefit pension plans that have been in existence for more than 50 years? These plans may and often do have very special provisions added over the years that are difficult if not impossible to eliminate. These provisions include special vesting and benefit accrual service, special definitions of compensation, etc., that preclude use of any safe harbor. Testing such plans under the general test will be extremely complex, time-consuming, and expensive and for what purpose? In any given year, the general test might not be passed for any number of valid reasons and, in such case, the entire plan would face disqualification. To what end?

The final regulation's general nondiscrimination test is complicated, expensive and arbitrary and must not be allowed to stand. It should be replaced or at least supplemented with an averaging rule.

An average accruals test--or a modified average accruals test--will prevent discrimination as well, at much less cost, than the final test

Some have objected that to permit a test for average accruals would defeat the policy objectives of the final section 401(a)(4) test: to forestall an unjustly high accrual rate by a few HCEs, and to prevent the "hiding" of disproportionately generous benefits for a few HCEs behind the otherwise acceptable average accrual rates of other HCEs. Viewed in this light, the final test is consistent with the overall thrust of other parts of the rules governing qualified plans (for example, the section 415 limits and the $200,000 compensation limit under section 401(a)(17)).

But if this is the purpose of the final rule, it accomplishes its objective very badly. That is, the final test is complex, costly and arbitrary in its results, but these disadvantages are not justified by any significant reduction in discrimination. In fact, because the rule is so rigid, drafters of the final regulation have included looseners to offset its harshness. These looseners permit really egregious discrimination, especially by small plans. At the same time, the basic test can by accident disqualify plans providing very good benefits to rank and file employees. If Congress is concerned with enforcing fairness in pensions, this goal could be accomplished just as well, and at much less cost, by a rule permitting testing of average accruals, accompanied by a simple rule to prevent disproportionately generous accruals for a small number of highly paid individuals. These points are explored in the next few paragraphs.

Without testing average accruals, a de minimus failure can disqualify even a plan providing very generous b2nefits to rank and file employees. This statement has

[3] The number of NHCEs is insufficient for the KRIP to meet the 70% ratio percentage test of section 410(b).

already pointed out how accidents of demographics can cause a plan to flunk the final test. This can happen even if on average benefits provided to NHCEs are significantly more generous than those required under the minumum coverage rules. For example, even if an employer plan provided benefits for NHCEs that were twice as generous (as a percent of pay) as the benefits provided for HCEs, the plan could be disqualified because of one failure involving a de minimus amount of benefits.

De minimus accidental disparity should not be offensive in benefits that are available without discrimination. Of course, Congress wouldn't have retained section 401(a)(4) if its objectives were merely to ensure that benefits in the aggregate satisfied some target. But it seems that if in the aggregate a plan delivers significant benefits to nonhighly paid employees--benefits in excess of the minimum required under section 410(b)--and if on average high paid employees accrue the same benefit as low paid employees, it does not offend public policy if a very small number of highly paid employees receive high benefit accrual rates.[4] This appears fundamentally different from a small plan designed with the specific intent of benefitting only a few top management personnel, and which is in fact available in a discriminatory manner.

While final test does little to increase fairness of plans such as the Kodak plan, it permits significant discrimination elsewhere. If the intent of the final rules is to deny the opportunity of a small number of highly paid employees to design discriminatory benefit packages, they fail spectacularly in their objective. A provision of the regulation permits defined contribution plans to be tested on a defined benefit basis (and vice versa).[5] The result of this rule may in certain circumstances be viewed as discriminatory. Under this rule, a highly paid professional can easily design a defined contribution plan in which contributions for herself are more than four times the contributions (as a percentage of compensation) for any nonhighly paid support staff in the plan. This disparity is allowed even though defined contributions plans have none of the policy safeguards associated with defined benefit plans: notably, risk shifting, and a tax on excess reversions. This feature of the regulations is being touted in estate planning magazines as a significant wealth accumulation device for owners of small business.

This particular feature of the final regulations is not an accidental oversight, but part of the overall package of features designed to soften the impact of the substantive rule by allowing greater design "flexibility." This is a significant symptom of the Section 89 syndrome: A rigid numerical rule is accompanied by a myriad of adjunct rules and exceptions, all designed to make the basic rule politically more acceptable. But the effect of all these rules is twofold: First, they create a complicated and expensive test. Second, they have unintended results--in this case, ludicrous results. To my mind a rule is not defensible when it potentially disqualifies a plan such as Kodak's, that covers large numbers of nonhighly compensated employees, with enhanced benefits that are available to all. At the same time, it deliberately blesses an estate planning technique for high income professionals with inadequate plans.

If Congress wishes to prevent undesirable discrimination, a better rule would permit averaging of accruals, but with a limitation on accruals by any high paid employee. The final rule accomplishes little in the way of real reduction in discrimination, and accomplishes this meager result at great cost. This problem is intrinsic with the basic final rule. Matrix restructuring (the type of restructuring prescribed by the regulations) is an inadequate solution. Permitting testing of average accruals would avoid these problems. If Congress is concerned that testing average accruals would permit accrual of inequitably rich benefits for some high paid individuals, a simpler approach would address this problem directly. For example, one rule might limit the accruals of any NCE in the plan to a multiple (for example 200%) of the average accruals by the NHCEs.

A similar solution is suggested by the pension simplification pamphlet prepared by the staff of the Joint Committee on Taxation[6] The pamphlet suggests that *each* NHCE accrue a benefit no less than the average benefit accrued by the HCEs.

While I believe this kind of approach is useful, I am concerned about the exact rule as suggested by the Joint Committee staff. The biggest problem with the final approach is that it doesn't work for most plans.[7] It can work only if all the NHCEs accrue a benefit at a *uniform* rate that is equal

[4] This assumes that the accruals come from plan features that are available to a nondiscriminatory group of employees and that the benefitted employees themselves are not in the position to influence the benefits package.

[5] This testing methodology is not new. It merely follows longstanding Service and Treasury policy which is consistent with the section 401(a)(4) statutory mandate that there be no discrimination in favor of highly compensated employees in "contributions or benefits."

[6] Simplification of Present Law Tax Rules Relating to Qualified Pension Plans, prepared by the Staff of the Joint Committee on Taxation, JCS-24-90. August 6, 1990.

[7] There are many reasons why a participant may not accrue a benefit in a particular year. For example, a participant may be required to work 1,000 hours to get an accrual so that any participant who does not have 1,000 hours in a year will accrue no benefit.

to or greater than the average accrual rate of all HCEs. The uniformity requirement is absolute. If the average NHCE accrual rate equals the average HCE accrual rate, *no* NHCE can accrue at a lesser rate. This is true even in a plan in which the average accrual rate of the NHCEs vastly exceeds the average of the HCEs, so most NHCEs accrue bigger benefits than most HCEs. Even in this plan any NHCE that accrued a lower rate than average could potentially disqualify the whole plan.

In addition, the philosophy underlying the rule is a new departure from traditional pension policy. The fact that certain individual NHCEs receive low benefits is not the explicit concern of pension policy even as reformulated in the Tax Reform Act of 1986, provided that *on average* low paid employees in a (restructured) plan receive a benefit commensurate with that received by high paid employees. This can be seen in the essential structure of the coverage rules, which permit an employer to exclude a significant number of low paid employees from any pension participation at all. For example, an employer that covers all of its HCEs in a single plan can exclude up to 30 percent of its NHCEs. The pension coverage and nondiscrimination rules have been designed first to ensure that aggregate benefits are spread fairly among high paid and low paid employees, and second to ensure that no high paid employee receives an unfairly rich pension benefit compared to the employer's rank and file. But except for top heavy plans, the rules have not been designed to ensure a minimum benefit for each NHCE

Because of these objections, I believe a more acceptable variant of the Joint Committee staff suggestion would involve a cap on the permissible accrual of any HCE. This rule might be particularly effective if combined with the restructuring rules. Many defined benefit pension plans provide benefits to employees of different divisions, locations, plants, etc., under different formulas. These varying benefit formulas may provide vastly disparate benefits. The restructuring rules under the final 401(a)(4) regulations have been designed to deal with this type of situation. If the restructuring rules were permitted to be applied before the application of the suggested variant of the final Joint Committee staff rule, there may well be a workable alternative to the general rule of the final regulations.

2. Rate of pay

In 1990 the Treasury also issued proposed and temporary regulations defining participants' compensation for purposes of the pension nondiscrimination rules under section 414(s). The proposed rules prescribed an acceptable definition of compensation and several safe harbor definitions. In addition, an employer could use any definition of compensation provided it was reasonable and did not by design favor highly compensated employees. In addition, the definition had to satisfy an objective test for discrimination.

A definition passes this test only if the percentage of compensation included under the alternative definition for HCEs (as a percent of compensation calculated under the basic method) does not exceed by more than a de minimus amount the percentage of compensation included for NHCEs (as a percent of compensation calculated under the basic method). Put another way, the alternative definition can't include a higher proportion of pay (as calculated under the general rule) for HCEs than for NHCEs.

However, under the proposed regulations, employers were required to use actual compensation, rather than rate of pay--even if the use of rate of pay would be nondiscriminatory. The Treasury and the Service recognized that use of a rate-of-pay formula by a plan facilitates plan administration and may, in fact, be reasonable and nondiscriminatory under specified conditions. Consequently, the final regulations published in the federal register of September 19, 1991 permit rate of pay (referred to as rate of compensation in the regulations) as an alternative definition under section 414(s). However, to limit possible distortions, the regulations require that if rate-of-pay compensation is used for purposes of section 414(s), amounts based on the employee's rate of pay can only be credited under the formula for 30 days after an employee terminates employment (or is otherwise absent without pay). The final regulations also provide that compensation credited for benefit accrual purposes during an unpaid absence from service for a reason other than termination from employment can satisfy section 414(s). While under the final regulations compensation may be credited indefinitely for absence from service due to military duty or jury duty, compensation may only be credited for a period not to exceed 6 months for any other absence.

These restrictions on the use of rate of pay add to the complexity of the rules without having an effect on discrimination. A brief description of the Kodak plan may explain this point. Under the Kodak plan's compensation formula benefits are based on a participant's high 3-years *actual* compensation, generally excluding bonuses paid to eligible employees based on company performance (defined as a return on assets). In certain limited situations, however, actual compensation is adjusted upward for any affected participant to take into account a participant's rate of pay. These situations include but are not limited to breaks in service because of unpaid leave for military duties, parental leave, and family leave; and reduction in pay because of disability. These absences may, in certain cases, exceed 6 months.

In these types of situations, Kodak provides benefits based on an individual's rate of pay before the break in service. We believe that allowing Kodak to define compensation as rate of pay to accommodate this practice would greatly reduce the testing burden of the new rules. H.R. 2641 would require that employees' rate of pay be among the acceptable definitions of compensation included in Treasury regulations under section 414(s). Kodak supports this provision, provided that the legislation make clear that rate of pay may be used for absences exceeding 6 months. Of course, as for any other alternative definition of compensation, rate of pay should be acceptable only if it is reasonable and nondiscriminatory, and meets the objective test set forth in the final regulation. Kodak believes that the use of rate of pay by its plan in these situations would satisfy all these principles.

The Joint Committee Staff pamphlet on pension simplification notes that some observers "argue that the compensation used for plan testing purposes should be actual pay, not approximations thereof." If the use of rate of pay is nondiscriminatory in design and in effect (as defined under the objective test), it is difficult to see an overwhelming public policy justification for the use of actual pay, rather than a reasonable approximation. As with other elements of the rules, I believe a balancing test in this case is appropriate. *A blanket rule applied even in a nondiscriminatory context that excludes the use of rate of pay and imputed pay for absences longer than 6 months promotes only very small increases in accuracy in return for an enormous increase in the cost of the test.*[8]

An alternative approach would be to expand the rule provided in S. 1364 and H.R. 2641 governing contributions to a qualified plan for an employee who becomes permanently and totally disabled. Under the provision as proposed in the two bills, if a plan provides for continuation of contributions on behalf of all participants who are permanently and totally disabled, contributions may be based on participants' pre-disability compensation without regard to whether the participant is highly compensated. A similar rule could be fashioned for plans that provide benefits based on pre-leave compensation for all employees who are absent for a variety of reasons, including family leaves. Because the rule would be available only if the employer adopted the practice with respect to all employees in like situations, it would not be discriminatory.

In his statement before the House Ways and Means Subcommittee on Select Revenue Measures, Assistant Secretary Gideon expressed concern that the proposed modification would permit plans to make contributions during disability only during years when the only disabled participants in a plan are highly compensated, and to delete the contribution provision in years when the only disabled participants are nonhighly compensated. Kodak would support a reasonable rule prohibiting abuse or manipulation of this provision.

3. Social Security Supplements

Kodak also supports the provision of H.R. 2641 that would modify the final regulations governing the use of social security supplements. For any employer that provides generous early retirement benefits, as does Kodak, the use of social security supplements is a rational way of providing benefits for individuals who have not attained social security retirement age. Social security supplements deliver benefits to those participants most in need of benefit supplementation (early retirees) without inappropriately raising the replacement income ratios for benefits provided after normal retirement. Without using social security supplements, it can be difficult to provide a generous early retirement package and still avoid a benefit formula that delivers a replacement ratio (when social security is included) in excess of 100 percent for benefits after social security retirement age.

Reversing a contrary position taken in the proposed regulations, the final regulations permit employers to take certain social security supplements into account for purposes of nondiscrimination testing under section 401(a)(4) and for purposes of satisfying the section 401(l) permitted disparity rules. Kodak appreciates the changes made in the final regulations. By limiting the extent to which an employer may take social security supplements into account to what has been defined as a qualified social security supplement, however, the regulations did not go far enough.

We believe that it is appropriate to treat the entire value of social security supplements like subsidized early retirement benefits, rather than as ancillary benefits, for purposes of testing plans for discrimination. With one notable exception (discussed below), social security supplements are treated like early retirement supplements for every other provision of the Code. They are treated as early retirement subsidies for purposes of the funding rules of section 412; the limitations on contributions and benefits of section 415; and the calculation of liabilities under section 401(a)(2). Like early retirement subsidies, social security supplements are guaranteed as retirement benefits under Title IV of ERISA. The two are treated the same under the Age Discrimination Act in Employment (ADEA).

[8] If a nondiscriminatory definition of rate of pay cannot be used in testing for nondiscrimination under section 401(a)(4), other compensation data will need to be gathered to perform the required tests. This can greatly increase administrative costs.

Social security supplements are treated differently from other early retirement subsidies in one important respect: social security supplements are not protected from cutback under section 411(d)(6). Kodak supports the provision in H.R. 2641 (which have been incorporated in the final regulations under section 401(a)(4)) that would permit social security supplements to be taken into account for general nondiscrimination testing only if protected against reduction or elimination under section 411(d)(6).

However, we have reservations about another portion of the provision under H.R. 2641, which provides that social security supplements are disregarded in testing permitted disparity under section 401(l). We believe that, if protected against cutback, supplements should be treated like early retirement subsidies for all purposes. Accordingly, we believe that a social security supplement should be treated as an employer provided benefit in determining the extent to which a plan provides an integrated benefit before social security retirement age.

4. 401(k) testing

S. 1364, H.R. 2730 and H.R. 2641 contain modified rules for testing elective deferrals to a cash or deferred arrangement under section 401(k). Kodak has serious reservations about all the proposed methods. It is Kodak's position that the proposed average deferral percentage (ADP) test governing 401(k) deferrals adequately meets the task of preventing discrimination; there is no reason for adopting new or alternative rules. In particular, Kodak is concerned about the new test proposed in H.R. 2730.

Under present law, contributions to a 401(k) plan are tested by comparing the average deferrals of HCEs with the average deferrals of NHCEs. H.R. 2730 replaces the present law tests with a test under which no HCE can defer an amount in excess of 200 percent of the average deferral percentage of the NHCEs in the previous year. Unlike the test of present law, the proposed test in H.R. 2730 would act as a cap on the deferrals of each HCE.

Our primary concern is that the provision as proposed by H.R. 2730 is not simplification, but the creation of substantive new pension policy. Its primary effect will be significantly to reduce allowable deferrals by certain members of the class of HCEs. To understand this, it is important to remember that the $7000 (indexed) cap on 401(k) deferrals is the most significant constraint on the deferrals of the most highly paid among the HCEs. Even with the $200,000 limitation on includable compensation, the $7000 cap means that the highly paid employees are effectively limited to a deferral of 3.5 percent of compensation. Clearly, this is not the category of employees whose deferrals will be affected by the proposed test provided in H.R. 2730. The category of HCEs whose deferrals will be most significantly reduced by the proposed test are those middle income employees whose wages are just high enough to classify them as highly compensated. For those in this category who have reached middle age, elective deferrals under a 401(k) plan are an important source of retirement savings in the years following savings for other purposes, such as a house and children's college education.

It is also my belief that none of the proposed tests is simpler than the test of present law. A uniform cap based on NHCEs' deferrals of the previous year has the deceptive appearance of being less error prone than the present law ADP test. But because under present law the deferrals of the HCEs are averaged against one another, it is quite possible that in any one year no excess deferrals will occur. With a single cap applied to every HCE, deferrals do not offset one another. It is almost certain that at least some HCEs every year will defer excess amounts. This is more likely than might at first appear for several reasons. Some HCEs will overestimate the amount of income they will earn during the year, and underestimate wage reductions because of disability, job relocations and so forth, and will defer too much as a percent of compensation. Some participants with compensation near the HCE dividing line will not know they are HCEs until the end of the year. In a large plan such as that maintained by Kodak that covers thousands of HCEs, mistaken estimates of this kind are certain to occur.

In sum, I believe the proposed test as stated in H.R. 2730 is a shift in policy, rather than simplification. It will significantly affect the pattern of deferrals, and will not affect the tendency of elective deferrals to yield errors resulting in excess deferrals.

5. Mandatory Plan Transfers

Kodak has significant concerns about the provision in S. 1364 that would require a plan administrator to transfer all preretirement distributions in excess of $500 to an IRA or qualified defined contribution plan that accepts such transfers. This requirement would be imposed whether or not the participant requested such a transfer, and whether or not the participant had designated a transferee plan or IRA. This proposal would create an administrative burden that far exceeds its value in promoting pension portability. In particular, Kodak is concerned about the cost of setting up and administering IRAs for participants who did not establish them. We are concerned that the scope of an employer's responsibilities under this kind of requirement have not been thought through. It is Kodak's strongly held position that maintaining individual financial arrangements for plan participants goes far beyond the proper scope of a plan fiduciary and administrator.

The transfer provision as provided in H.R. 2730, and recommended by the Administration in its "POWER" proposal, is a much more sensible approach to encouraging retention of pension money in retirement arrangements. The proposal would enable employees to request the transfer of funds to a qualified plan or IRA. The plan administrator's responsibility would begin and end with ensuring the proper transfer. The burden of establishing a suitable IRA would be on the plan participant, which is where it belongs.

6. Lump Sum Distributions

Another provision contained in S. 1364 and H.R. 2730 is of significant concern to Kodak. In the Tax Reform Act of 1986, Congress enacted a 15 percent excise tax on excess pension distributions. For 1991, the tax is imposed on annual distributions in excess of $150,000. (This amount is scheduled to increase with inflation in the first year after the year that $112,500 as adjusted for post-1986 inflation equals $150,000). The purpose of the tax is to limit the amount of tax favored savings that any high income individual can accumulate. As part of the provision, Congress also provided a special alternative limit for lump sum distributions, equal to 5 times the limit on annual distributions (*i.e.*, equal to $750,000 in 1991). As a technical provision accompanying the elimination of forward averaging for lump sum distributions, the two bills would eliminate the special alternative limitation on excess pension distributions.

I believe that elimination of the special limitation is not appropriate in the context of pension simplification. While the special alternative limitation is technically linked to the lump sum provisions of the Code, there is no policy connection between the two provisions. Elimination of forward averaging for lump sum distributions is provided by the three bills as part of a package rationalizing pension distribution policy generally. In return for an elimination of forward averaging, affected individuals receive more liberal treatment of rollovers among qualified plans and IRAs. On the whole, the package is designed to make pension distribution policy more more simple and rational.

The $750,000 limitation, on the other hand, was enacted as part of an overall package in which Congress determined the equitable treatment of large pension accruals. Many individuals have acted in reliance on the availability of this special limitation. Elimination of the special limitation merely defeats these justifiable and settled expectations, without any offsetting provision providing more rational pension policy. Unlike individuals affected by the elimination of forward averaging, individuals affected by this provision are given no compensating pension relief.

The elimination of the $750,000 limitation cannot in fairness be labelled pension simplification. It represents a substantive policy change in the treatment of individuals who have accrued large pension benefits. It defeats expectations with regard to a matter that was viewed as settled by the Tax Reform Act, and frustrates the legitimate planning of individuals who acted in justifiable reliance on the provisions of that Act. The provision does not belong in this simplification package.

Conclusion

Several of the comments made above are related to regulations recently issued by the Treasury and the Service. These comments are necessarily general in some cases due to the complexity of the regulations. As we gain a more knowledgeable understanding of the regulations, it is likely that we will have further comments and suggestions relating to pension simplification. We will share those comments with you. Thank you for the opportunity to present these comments.

September 27, 1991.

Hon. DAVID PRYOR, *Chairman,*
Subcommittee on Private Retirement Plans,
Committee on Finance,
U.S. Senate,
Washington, DC.

Re: Pension Simplification

Dear Mr. Chairman: Thank you very much for your letter of September 19, inviting me to comment on your pension simplification proposals. I have assisted in the preparation of comments for other companies, and offer the following thoughts solely as my own views.

TAXATION OF DISTRIBUTIONS

This is probably the litmus test of Congress' appetite for meaningful simplification in the benefits area. Each year the present rules befuddle millions of ordinary retirees and thousands of plan administrators. A great deal of misleading hyperbole has been offered by those who oppose taking away any slight tax advantage in this area. There is no need to retain the awkward 1986 grandfather rules (5-year averaging, etc.); you may wish to consider adopting the rollover rules of H.R. 2730 to attain better revenue estimates.

TRUSTEE-TO-TRUSTEE TRANSFERS

The "forced" transfer proposal of S. 1364 would place a substantial new burden on plan administrators, and its effect on retirement savings is questionable.

INCREASED ACCESS

The SEP provisions are well-intentioned, but past experience suggests that SEPs are unlikely to achieve widespread acceptability. Prototype plans have proved popular, and a provision in H.R. 2730 that would allow the Service to relax the anti-cutback rules where an employer replaces an individually designed plan with a prototype plan is attractive.

401(k)/(m) TESTING

The safe harbor approach of your bill makes perfectly good sense and is quite reasonable. In my view, Treasury's objections are overly technical and do not properly take into account the real world advantages of safe harbors.

DEFINITION OF LEASED EMPLOYEE

This is an area in which I have worked extensively, primarily on behalf of Chevron. It is a prime candidate for simplification because of the current problems faced by many companies, and the fact that a change would be revenue neutral. The basic concept of S. 1364 to replace the "historically performed" standard with a control test is sound. What is also needed is more clarification of exactly what control means. This is necessary to provide guidance to companies, and to ultimately prevent overreaching IRS regulations as have been proposed under the historically performed standard.

The ideal result would be to look at a single type of control. H.R. 2641 does this, by stating that a person would not be a leased employee unless the recipient exercises "primary control over the manner in which the services are performed." In other words, if the recipient of the services is telling the employee how to do his or her job, that person should be treated as a common law employee for benefit testing purposes.

DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

The general provisions of S. 1364 relating to simplifying the definition of highly compensated employee, including eliminating the top 20% rule and the most of the family aggregation rules, are excellent proposals. The proposal to drop the "at least one" concept for purposes of 401(k) and 401(m) testing is more of a policy change than a simplification, and should be discarded if its retention threatens the enactment of needed simplification in this area.

DEFINITION OF NORMAL RETIREMENT AGE

I would suggest including in S. 1364 the proposal to allow plans to us? social security retirement age as a uniform retirement age for all purposes. This would eliminate a serious technical problem under recent final IRS regulations.

OTHER PROPOSALS

I commend you and your staff for including the following additional proposals in S. 1364

—Rounding cost-of-living adjustments
—Simplifying half-year requirements
—Simplifying the penalties for failures to file reports of pension and annuity payments

Again, thank you for this opportunity to comment.

Very truly yours,

DOUGLAS W. ELL.

STATEMENT OF THE EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

The Employers Council on Flexible Compensation is pleased to submit this statement on S. 1364, the "Employee Benefits Simplification and Expansion Act," introduced June 25, 1991 by Senate Finance Committee Chairman Lloyd Bentsen (D-Tex) and Senate Finance Subcommittee on Private Retirement Plans Chairman David Pryor (D-Ark).

ECFC is a non-profit membership association founded in 1981. The over 450 members of ECFC are plan sponsors of Section 125 cafeteria plans and Section 401(k) retirement plans and leading actuarial, insurance and accounting firms that design and administer flexible plans. ECFC member organizations include large and small business corporations, non-profit employers and state and local government employers.

ECFC strongly supports simplification of rules governing the private retirement system. In recent years, Congress has enacted many changes in the laws governing employee benefit plans, generally with the intention of improving the "fairness" of the system by increasing coverage among lower-paid workers. However, the frequency of this legislation and the resulting complexity have deterred many employers, particularly small employers, from establishing pension plans.

ECFC would like to compliment Finance Committee Chairman Bentsen and Subcommittee Chairman Pryor for co-sponsoring S. 1364. This legislation represents a hopeful step towards simplifying and revitalizing the private pension system. In particular, ECFC supports the extension of Section 401(k) plans to non-profit employers and the concept of safe harbor nondiscrimination tests for Section 401(k) plans. The latter change will result in a significant reduction of time and money spent in administering pension plans and an increase in the availability of these plans to America's workers.

Neverthless, we are concerned that the recommendation to repeal five-year income averaging represents a significant tax policy change and is inappropriate in the context of a simplification bill. We believe that meaningful pension simplification is possible that does not sacrifice existing tax treatment on which long-term workers have relied. ECFC is anxious to work with the committee to achieve this goal.

The remainder of our statement will focus on the three specific provisions mentioned above.

1. Expansion of 401(k) plans to tax-exempt employers. ECFC supports the expansion of coverage rules under Section 401(k) to include employees of tax-exempt employers. Allowing Section 401(k) plans for these employers will correct a number of inequities under current law.

The Tax Reform Act of 1986 (TRA '86) precluded tax-exempt employers, along with state and local government employers, from adopting 401(k) plans for their employees. The law grandfathered plans adopted by tax-exempt employers before July 2, 1986. The intent of this change was to impose a limit on the total amount of tax-deferred savings that individuals could set aside annually. At the time, sponsors believed that Section 403(b) tax-deferred annuities provided adequate retirement plan coverage in the absence of Section 401(k) plans.

However, Section 403(b) tax-deferred annuities are not a substitute for 401(k) plans. By law, Section 403(b) plans are available only to certain limited types of tax-exempt organizations, generally hospitals, churches, social welfare agencies and educational institutions. As a result of these limitations, certain categories of non-profit employers do not have access to any salary reduction retirement vehicle. Moreover, Section 403(b) plans do not offer the design and investment flexibility available under a Section 401(k) plan.

2. Simplified non-discrimination rules for Section 401(k) plans. ECFC endorses simplification of the average deferral and average contribution percentage non-discrimination tests for Section 401(k) plans as proposed under S. 1364. The current tests, which require comparison of deferrals and contributions for highly and non-highly compensated employees, can be simplified without undermining the policy objective of assuring broad coverage under these plans.

Section 401(k) was enacted in 1978 and was not the subject of much attention for the next few years. Upon the publication of the regulations implementing Section 401(k), the advantages of funding plans with employee elective salary deferrals and employer matching contributions became apparent and within a short time Section 401(k) plans were adopted by a significant number of employers.

The rapid growth of Section 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 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. The bill also placed a separate dollar limitation on annual elective deferrals of $7,000 as indexed ($8,475 for 1991). 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 on 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 Section 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.

The collecting of data and repeated testing is reminiscent of the infamous Internal Revenue Code Section 89 which was repealed by Congress in 1989. 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 Section 401(k) plans that a fairly generous employer matching contribution and communicating the terms of the plan tends to get nonhighly compensated employees to participate and salary defer.

S. 1364 recognizes the realities and provides alternative safe harbors based upon either a minimum matching contribution, or a 3 percent of compensation non-matching 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. In one instance we are aware of, two employers in the same line of business, with almost identical plans and the same benefits consultant designing the communications, had diverse results in participation. In the case of the employer who had been in business longer and had an older and more stable workforce, the plan had a high degree of participation by 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 Section 401(k) and 401(m) rules as enacted in TRA '86 applied to the 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 Section 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. 1364 of alternative, safe harbor, design based tests under Sections 401(k) and 401(m) is justified and will provide equality of treatment between private sector plans and the federal plan.

The bill (S. 1364) 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, including earlier announcement of the deferral limits, will provide greater certainty and ease of administration that will be most helpful to them.

3. Repeal of five-year forward averaging for lump sum distributions. We oppose this change. Congress endorsed income averaging only five years ago in the Tax Reform Act of 1986. The outright repeal of the five-year averaging rule would cause irreparable financial harm to many plan participants approaching retirement. Participants who would be most affected by this change would not be highly compensated employees, but rank-and-file workers who for many legitimate reasons choose not to roll their benefits into an Individual Retirement Account. While we recognize that this change fulfills both retirement policy objectives and serves as a revenue source for other worthwhile provisions in the bill, we believe it represents a significant tax policy change and does not belong in a simplification bill.

Conclusion

In summary, we commend the members of this Subcommittee for addressing the critical issues of pension simplification and coverage. ECFC members support many of the simplification initiatives proposed under S. 1364. However, we have serious reservations about the repeal of five-year averaging which could cause many of our members to oppose the bill in its entirety. ECFC is anxious to work with the Subcommittee to fashion simplification and access provisions that can be enacted.

STATEMENT OF THE ENTERGY CORP.

Entergy Corporation (Entergy) is pleased to be able to submit written comments to be included in the record of the hearing regarding the Employee Benefits Simplification and Expansion Act of 1991 (S. 1364). Entergy is one of the largest investor-owned public utility holding companies in the United States with over 12,000 employees. It is the leading electric energy supplier to the Middle South, a region comprised of Arkansas, Louisiana, Mississippi and southeastern Missouri. In addition, gas service is provided in the New Orleans area.

Entergy is very supportive of efforts to simplify our nation's tax laws, especially in the employee benefits area. While we are generally in favor of many of the provisions in the Employee Benefits simplification and Expansion Bill of 1991 (Bill), we have a continuing concern regarding the administrative burden associated with leased employees. Entergy strongly supports the replacement of the "historically performed" test with a "control" test, which is included in Section 301 of the Bill.

Although the Bill improves the current law definition of leased employees, Entergy believes that the following suggested changes would significantly reduce the administrative burden presently imposed on many non-abusive employers:

(1) Workers who are members of a collective bargaining unit (union workers) should be excluded from the leased employee definition.

(2) A de minimis exception which would allow large employers (i.e., those with over 500 employees) to be excluded from the leased employee rules if the employer's leased employees comprise less than 10 percent of its common law employees should be adopted.

If these modifications are enacted, employers' costs of complying with the leased employee rules would be significantly reduced because they would be relieved of an overwhelmingly burdensome data collection requirement. A more in-depth discussion of the recommended modifications to the leased employee rules is provided in the attached comments, with which we concur, filed on behalf of commonwealth Edison Company and the Edison Electric Institute.

STATEMENT OF THE INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

IEEE-USA'S INTEREST IN PENSION BENEFITS EXPANSION AND SIMPLIFICATION ISSUES

The Institute of Electrical and Electronics Engineers, Inc. (IEEE) is a transnational professional technical society whose membership currently includes more than 320,000 electrical and electronics engineers and computer scientists in 130 countries throughout the world. IEEE-cited States Activities (IEEE-USA) is responsible for promoting the professional careers and technology policy interests of IEEE's 250,000 U. S. members.

Sixty-six percent of IEEE's U.S. members work for large organizations. Fifteen percent work for medium-sized employers and 12 percent are employed by small organizations. The remaining 7 percent are self-employed or work as consultants to businesses or governments on a full or a part time basis.

Fully 74 percent of our U.S. members are employed by private businesses; 10 percent work for Federal, state or local government agencies; and 10 percent are deans, professors or instructors at educational institutions or work for non-profit research organizations.

Although most of our members work for employers that offer tax qualified pension plans and other retirement savings programs for their employees, long-standing concerns about the extent to which the nation's voluntary private pension system discriminates against an increasingly mobile professional and technical workforce have resulted in IEEE's active participation in legislative efforts to improve that system since the 1970's. To this end, IEEE worked to promote the enactment of the Employee Retirement Income Security Act (ERISA) in 19741 the Individual Retirement Account provisions of the Economic Recovery Tax Act (ERTA) in 1981 and the retirement equity provisions of the Tax Reform Act (TRA) of 1986.

PENSION ISSUES OF SPECIAL CONCERN

In spite of improvements since the enactment of ERISA in 1974, serious weaknesses threaten the effectiveness of the nation's voluntary private pension system as a reliable source of retirement income for an increasingly mobile American workforce. Chief among these weaknesses are limited pension coverage, especially among small businesses; vesting requirements that penalize mobile workers; lack of portabilityl particularly from defined benefit plans; limited incentives for participants to save rather than spend pre-retirement lump sum distributions; the absence of minimum benefit standards needed to ensure that workers will receive adequate benefits when they retire; and complex rules and regulations that make it costly for employers to set up and maintain pension plans.

The issue of greatest concern to IEEE-USA is the continuing lack of portability of earned benefits, particularly from defined benefit plans. are than half of all workers who participate in pension plans are covered by defined benefit plans. Since most plans calculate benefits on the basis of final salary and years of servicel such plans can provide relatively generous incomes in retirement for long tenured workers who spend most or all of their working careers with a single employer. Such plans provide much more meager benefits for mobile (short-tenured) workers who are fast becoming the rule rather than the exception in almost all sectors of the American economy. In the electrical, electronics and computer engineering fields, it used to be that engineers in the defense and space sectors moved around more than most in response to shifts in government contracts. But in recent years, even the traditionally more stable telecommunications and public utilities industries have been buffeted by mergers acquisitions, reorganizations and downsizings that show no signs of subsiding.

Fortunately a proposal has been developed by the Bush Administration and bills have been introduced in both houses of Congress that offer promising solutions to the coverage, vesting, portability, preservation, minimum benefit standards and administrative complexity problems that IEEE members are most concerned about.

These include the Bush Administration's Pension Opportunities for Workers Expanded Retirement (POWER) proposal; Congressman Rod Chandler's Employee Benefit Simplification Act (H. R. 2641); Senator Bob Packwood's PRIME Retirement Account Act (S. 318); Congressman Sam Gibbons's Pension Coverage and Portability Improvement Act (H. R. 2390); Senator avid Pryor's Employee Benefits Simplification and Expansion Act (S. 1364) and Congressman Dan Rostenkowski's Pension Access and Simplification Act (H.R. 2730).

For reasons outlined below, IEEE-USA believes that a combination of key provisions from the Bush Administration's POWER proposal and from the Gibbons and Rostenkowski bills offer the most promise for improving the nation's private pension system.

1. *Increased Access to Pensions.* The POWER proposal and the Chandler, Packwood, Pryor/Bentsen and Rostenkowski bills would all expand pension coverage among small businesses by waiving complex non-discrimination rules for companies with up to 100 employees that agree to contribute from 2 to 3 percent of pay to simplified salary reduction savings plans on behalf of participating employees. The Gibbons bill would expand coverage by requiring all employers that do not currently offer pens ion plans to set up voluntary salary reduction arrangements for their employees

While we applaud N. Rostenkowski's coverage expansion provisions, and similar provisions in the bills introduced by Senator Packwood (S. 318) and by Senators Pryor and Bentsen (S. 1364), we believe that the Gibbons bill will increase pension access for more working Americans. And while we agree that non-discrimination rules need simplification, we also believe that a means must be retained to ensure reasonable equity among all plan participants, whatever their level of compensation.

2. *Vesting Requirements.* In spite of recent reductions in vesting requirements, many workers who are fortunate enough to be covered by employer sponsored plans change jobs before earning a non-forfeitable right to a pension benefit. As a result, they lose some or all of their earned benefits.

The POWER proposal and the Rostenkowski bill would reduce multi-employer vesting standards from 10 years to 5 years to conform to requirements governing single employer plans. While IEEE-USA would prefer to reduce vesting requirements for all plans to one year as proposed in the Gibbons bill, we support reduction of multi-employer vesting requirements to 5 years as an important step in the right direction.

3. *Portability from Defined Benefit Plans.* In the absence of portability of benefits, particularly from plans that determine pension values on the basis of salary and years of service, many workers lose a substantial part of their earned benefits when they change jobs due to lower salary levels when benefits are computed and the years of inflation that occur before they draw benefits.

The POWER proposal and the Pryor/Bentsen and Rostenkowski bills address the portability problem in a limited fashion by making it easier for workers who are currently entitled to receive distributions to roll some or all of those distributions over into Individual Retirement Accounts or other savings arrangements.

The Gibbons's bill, however, is the only one of the current proposals that would improve the portability of earned benefits from defined benefit plans when workers change jobs. It does so by guaranteeing employees freedom of choice in decisions affecting the disposition of earned pension benefits.

Uuder H.R. 2390, terminating employees will be able to leave their earned benefits in a former employer's plan or to transfer them to an IRA or other tax qualified plan. We believe that the Gibbons approach is the best way to improve pension portability.

We have prepared an exhibit that compares the pension benefits earned by a typical long tenured worker with those of a more mobile but similarly salaried worker to demonstrate the magnitude of the portability losses that are incurred by mobile workers under current law, even when the mobile workers are fully vested throughout their careers. This table shows the mobile worker's pension benefits are likely to be about 40 percent less than those of a similarly salaried long tenured worker. The Gibbons bill would reduce that disparity to a little over 10 percent (See Attachment A).

4. *Preservation of Lump Sum Distributions.* Tax favored retirement savings are dissipated when plan participants spend pre-retirement lump sum distributions instead of saving them for retirement purposes.

The Rostenkowski and Pryor/Bentsen bills would reduce consumption of lump sum distributions by providing for direct trustee to trustee transfers of such distributions to IRAs, defined contribution plans that accept rollovers, or to other transferee plans designated by plan participants. The Gibbons bill would discourage consumption of pre-retirement lump sum distributions by increasing the penalty tax on distributions that are not rolled over from the current 10 percent to 25 percent.

While we think that Gibbons's penalty tax would effectively reduce consumption of lump sum distributions, IEEE-USA supports the direct trustee to trustee transfer election provisions in the and Rostenkowski proposals.

5. *Minimum Benefit Standards and Pension Simplification.* IEEE-USA believes that minimum benefit standards are needed to increase the likelihood that all plan participants will receive adequate benefits when they retire. We also believe that rules and regulations governing plan set up and administration can and should be simplified.

The Packwood PRIME Retirement Account Act (S.318), the Administration's POWER proposal and the Rostenkowski bill in effect establish minimum benefit standards by offering to waive non-discrimination testing requirements for small employers that agree to contribute a certain percentage of compensation to Simplified Employee Pension (SEP) plans for participating employees on a salary reduction basis. Title II of the Gibbons's bill would establish minimum benefit standards by requiring that all employers contribute at least six percent of pay but would phase in this requirement over a six year period to ease the initial burden of compliance for affected businesses.

The Packwood, Pryor/Bentsen, Rostenkowski and Gibbons bills also include provisions designed to reduce the complexity and cost of plan set up and administration, particularly for small businesses. The Gibbons bill, for example, promotes administrative simplification by establishing prototype portable pension plans and standardizing rules for determining maximum contribution limits, regardless of the type(s) of plans offered by employers.

While we would prefer the incremental imposition of mandatory minimum benefit standards for all employers as proposed in the Gibbons bill, we recognize that the Administration/Rostenkowski offer to waive complex non-discrimination rules for small employers who agree to contribute 2 or 3 percent of pay to an employer sponsored plan offers a more pragmatic solution to this problem. IEEE-USA supports this approach as an important first step toward a more broadly based minimum benefit pension system. The benefits of the resulting administrative simplification for small businesses should also be considerable.

6. *Revenue Considerations.* IEEE-USA commends the Bush Administration and Congressman Rostenkowski for advancing proposals that promise to expand pension coverage, provide modest improvements in portability, help to preserve pension benefits, establish minimum benefit standards for small employers, and simplify plan administration without increasing the Federal budget deficit. We also view repeal of current five and ten year averaging provisions as an effective way to raise much of the revenue needed to pay for these proposed reforms.

Rather than resorting to increased borrowing or a general tax increase to pay for expanded coverage and benefits enhancement, including substantive improvements in portability from defined benefit plans, policy makers may also wish to consider the imposition of a modest tax on pension earnings to raise needed revenues. Under this approach, as proposed by Alicia Munnell of the Federal Reserve Bank of Boston, benefits enhancements would be paid for by beneficiaries of the system rather than by taxpayers, many of whom do not currently participate in tax-favored private pension plans.

Attachment A—IEEE-USA Pensions Committee, Portability Losses Under Defined Benefit Plans, Fact Sheet

HOW THE TYPICAL DEFINED BENEFIT PENSION PLAN PENALIZES MOBILE EMPLOYEES

Table A.—VALUE OF EARNED PENSION BENEFITS AT INTERVALS OVER A 30 YEAR CAREER FOR SIMILARLY COMPENSATED LONG TENURED AND SHORT TENURED WORKERS

Years of employment	Long tenured worker	Mobile worker: Current law	Mobile worker: Gibbons bill
Period 1: 5 years	$7,000	$2,100	S5,443
Period 2: 5 years	7,000	2,600	5,570
Feriod 3: 5 years	7,000	3,400	6,021
Period 4: 5 years	7,000	4,300	6,294
Period 5: 10 years	14,000	14,000	14,000
Pension at Retirement	42,000	26,400 (62.8%)	37,320 (88.9%)

Actuarial Assumptions:
Age at Hire: 35 .... Annual Inflation: 4%
Income at Hire: $30,000 .... Annual Salary Increases: 5%
Vesting: 100% after 5 Years .... Annual Investment Earnings Rate: 7%
Benefit Formula: 1.25% of final five year average pay X years of service.
Years in Retirement: 20 Years
Gibbons Bill Rule: 3% discount rate applied from pension annuity purchase date to last year of each employment period.

Sources Hewitt Associates, 1990, Woodruff Consultants, 1991.

Statement of the International Association of Fire Fighters

Mr. Chairman, my name is Al Whitehead, and I am the President of the International Association of Fire Fighters. I appear before you today not only on behalf of the more than 180,000 professional fire fighters across the nation, but also on behalf of public pension and deferred compensation plan administrators. This statement has been expressly endorsed by the National Conference on Public Employee Retirement Systems, which represents some 300 state and local government pension plans, 5 million employees and $600 billion in assets, and the National Association of Government Deferred Compensation Administrators, which speaks for the hundreds of public sector deferred compensation plans around the nation.

As you are aware, Mr. Chairman, state and local governments are treated separate and apart from the private sector in many parts of the tax code. Consequently, our pension simplification needs are somewhat different than our private sector counterparts. I would like to focus today on two sections of the Internal Revenue Code which are currently posing problems for public sector workers and officials: Section 415, which caps benefits that may be paid by a qualified pension plan, and Section 457, which governs state and local government deferred compensation arrangements. I will discuss each in turn.

SECTION 415

Section 415 of the Internal Revenue Code was created in 1974 as part of ERISA. The goal was to prevent taxpayer subsidies of exorbitant pension benefits sometimes paid to corporate executives. The law posed a two-pronged test to determine a maximum benefit that may be paid by a qualified, or tax exempt, pension plan: (1) the benefit may not exceed a specific dollar amount set forth in regulation, and (2) the benefit may not exceed 100% of annual compensation, a limit determined by averaging the employees' three highest earnings years.

Although the law generally works well in the private sector, several problems arise when it is applied to public sector pensions. The entire compensation structure of state and municipal government employees, as well as the federal tax treatment of such compensation, differs significantly from the private sector. Unfortunately, Section 415 failed to take into account these differences. The law attempts to apply uniform rules to very different circumstances.

This problem first came to light several years ago, when local governments—much to their surprise—found themselves in non-compliance with a law that was supposed to restrict the compensation packages of corporate executives. Congress responded in 1988 with legislation intended to correct the problem. The new law allowed states to exempt current employees from Section 415 limits if it created a new pension benefit system that would comply with Section 415 for all new hires.

Although well intentioned, the 1988 amendment proved to be inadequate because it failed to acknowledge the inherent differences between public and private sector work. Simply giving states and municipalities additional time to comply with Section 415 did nothing to address the underlying cause of the law's inequity.

Congress now has before it an opportunity to resolve this issue once and for all. It is both imperative and urgent that it does so because, even as we speak, state and local government pension plans are in technical violation of the law. The IRS could tomorrow disqualify an entire state pension system based on a payment to a single participant that exceeds the 415 limit. And let us be clear about who disqualification hurts. First, it hurts fire fighters and other public employees who will be taxed on the accrued benefits of their pension plan during the year they are earned. But it also hurts local governments. Governmental agencies are ultimately responsible for the obligations of their pension system. If the earnings of the pension fund are taxed, government may need to contribute funding in order to cover the money paid to the federal government in taxes. In the end, every American will be affected by this law as states and local governments find themselves forced to either curtail services or raise taxes in order to pay their federal taxes.

I are pleased to note, Mr. Chairman that your Pension Simplification proposal, S. 1364, would correct the inequities currently embodied in the law. On behalf of our nation's fire fighters, I wish to express my deep appreciation for your willingness to include amendments to Section 415 in your omnibus reform initiative. I would now like to take a few moments to discuss how S. 1364 will address the problems associated with Section 415.

- *Definition of Compensation*

The most egregious problem in Section 415 is the use of an inequitable definition of compensation. The definition utilized by the IRS for purposes of applying the 100% of compensation rule discriminates against public sector employees by failing to take into account certain features unique to public sector compensation.

For example, employer pension contributions made through the employer pick-up option (Section 414 (h)) and voluntary contributions made to deferred compensation plans (Section 457) are not counted as income by the IRS for determining the maximum allowable benefit, but they are counted as income by pension plans determining the actual benefit. Consequently, someone whose pension pays only 75% of annual compensation can still exceed the 100% rule simply because they utilized these two benefit options.

S. 1364 resolves this inequity by establishing a uniform definition of compensation which counts employer pick-ups and deferred compensation contributions as income for purposes of determining Section 415 limitations.

- *Survivor and Disability Benefits*

As the nation's most dangerous profession, fire fighters see more than their share of service-connected disability retirements. The application of Section 415 to disability and survivor compensation virtually guarantees that fire fighter pension plans will run afoul of Section 415. Currently, Section 415 requires benefits to be actuarially reduced from age 62 to the present age of the recipient at the time of injury or death. Because many fire fighters are injured at relatively young ages, the 415 limitation will often be lower than the disability benefit. We therefore support S. 1364's exemption for survivor and disability benefits from Section 415 limits.

- *Excess Plans*

The way many private sector pensions avoid disqualification under Section 415 is through the use of excess plans. These plans are non-qualified adjuncts to qualified plans through which pension benefits in excess of the 415 limitations can be paid. We recognize that private sector practices are not always the best model for the public sector, and we therefore are not seeking to replicate private sector excess plans. We do, however, believe that government entities should be given some flexibility when it comes to establishing a supplemental, non-qualified plan.

Under S. 1364, public agencies could establish excess plans, but those plans would be subject to severe limitations. Benefits paid by these plans could only be those benefits which have been earned under the established pension benefit structure. Unlike the private sector, individual employees would not be able to use the excess plan as a way to defer compensation. In this sense, the excess plan proposed in S. 1364 could be more accurately described as an "overflow" plan since it would be used only to pay normal retirement benefits which—through some fluke—happen to exceed the 415 limits. The creation of this excess plan would allow state and local governments to pay legitimate, earned benefits to a few employees without jeopardizing the tax-exempt status of the entire pension plan.

- *100% of Compensation Test*

Section 415's 100% of compensation test was established to curb abuses of the tax-exempt treatment of pensions by prohibiting corporations from creating compensation packages that hide wages in the pension fund. The goal is laudable, but is generally inapplicable to the public sector.

State and local governments, which are watched closely by the press and ultimately accountable to the people, rarely engage in this type of fancy footwork. On the other hand, public sector pensions sometimes violate Section 415's 100% rule simply because of the low pay and long tenure common in public service. For example, a city hall janitor whose pension benefit is 2.6% of salary multiplied by the number of years of service will receive a relatively small pension in terms of the dollar amount, but would exceed the 100% of compensation rule if he or she works for 40 years (2.6% x 40 years = 104%). Surely, Congress never intended Section 415 to restrict the pension paid to a city hall janitor who is guilty of nothing more than spending 40 years in public service.

Simply put, Section 415's 100% of compensation rule is not needed and is a severe detriment to state and local workers. S. 1364 resolves this inequity by exempting the public sector from the 100% of compensation rule.

Before leaving the subject of Section 415, I would like to take a moment to answer a question many people have posed to us. If the basic problem is a conflict between federal law and state pension plans, why not change the pension plans rather than amending the tax code? The question overlooks one important aspect of state and local government pension plans. Many of the pensions—especially those established for disability—are bound by statutory or constitutional strictures against reducing benefits. Thus pension plans are legally prohibited from reducing benefits so as to comply with Section 415. The only viable solution is to change the tax code.

Finally, I wish to address the important and valid question of germaneness. Do the Section 415 provisions of S. 1364 fit the definition of pension simplification? We believe the answer is an emphatic "yes."

From our understanding, the test of what constitutes simplification has three components: is the change non-controversial? will the change have a budgetary impact? and, is the change technical rather than substantive? I shall address each point.

First, the proposed Section 415 reforms are entirely non-controversial, as demonstrated by the broad bipartisan support S. 1364 enjoys. S. 1364 is cosponsored by more than a third of the entire Senate, including both the Chair and the Ranking Minority Members of the Senate Finance Committee. Second, the proposal will have a "negligible" impact on federal budget revenues, according to the Joint Tax Committee. JTC issued that opinion in a June 6 letter. And third, these proposed changes are certainly technical in nature for it was certainly never the intent of Congress to create a pension benefit cap which unfairly disqualifies the pension plan of virtually every state and local government in the country.

SECTION 457

Mr. Chairman, I would now like to turn your attention to a different section of the Internal Revenue Code. Section 457 was enacted in 1978 when Congress opted to provide state and local governments the opportunity to offer deferred compensation arrangements.

As Section 457 plans evolved, we believe there have been some oversights as well as areas which need some technical correction that we now respectfully request this Committee to address. These amendments have been incorporated into legislation introduced in the other chamber: H.R. 2906, authored by Representative Jim Moody.

First is the absence of a provision allowing for inflationary adjustments in the maximum contribution an employee may make annually. All other contributory plans—including 401(k)—are indexed to the rate of inflation. We have been unable to find any legislative history to suggest that this was an intentional distinction. Rather, we believe the absence of the indexing provision extending to 457 plans was an accidental oversight which can be easily corrected. There is simply no tax policy which supports excluding these programs from others as it relates to indexation.

The second technical change we believe should be made to Section 457 is allowing for a one-time change in the date selected by the employee to begin receiving payments from the plan Currently, workers who have participated in a Section 457 plan must make an irrevocable election upon separation from service as to the exact date when payments begin. This may present little problem for many workers, but creates a hardship for those individuals that have changing retirement requirements. It is simply not reasonable to expect someone leaving employment at age 45 to be able to predict whether he or she will want to receive these funds as part of their retirement in 15 years versus 20 years.

The result is that workers choose the earliest reasonable dates only to find they may still be gainfully employed when the deferred distributions commence. The irrevocable election, therefore, can hinder Section 457's intent which is to provide retirement income for public sector workers.

We believe the solution is to allow a one-time change in the date previously selected. Importantly, such a change to IRC Section 457 need not violate the "made available" rule since it is only necessary to allow workers to change to a *later* date. In this way, plan participants would be prohibited from withdrawing funds on command by changing to an earlier date.

The final technical correction we recommend for Section 457 is allowing for the cancellation of a small inactive account. Too often a young person in their first real job will sign up for a deferred compensation plan only to find that he or she cannot afford to continue making payments. Lifestyle changes, such as marriage, buying a first home or having children alter disposable income in such a way that future contributions to the fund become impossible.

These small, inactive accounts are a significant burden to plan administrators. The funds must be maintained and regular statements must be issued to the beneficiary even though the amount of money in question does not justify the expense' and work involved over a period of years.

We suggest this problem be addressed by allowing individuals to withdraw their money or the plan to dissolve the account and distribute the funds to the participant of a 457 plan without penalty if the account contains less than $3,500 and has been inactive (no contributions made) for two years. The recipient of the money would, of course, be taxed on the income.

As with our Section 415 proposal, it is fair to ask, do these provisions meet the definition of simplification? I'm sure you'll agree, Mr. Chairman, that they do.

First, the proposals are relatively non-controversial, and are supported by both the administrators and beneficiaries of 457 plans, as well as state and local governments and the employee unions. Additionally, we have received no indication that the Administration would object to these issues. Indeed, we believe that these provisions are a necessary correction now that the law has had time to mature.

Second, we believe the proposals will have little, if any, budgetary impact. Although the Joint Tax Committee has not yet prepared a revenue estimate, the fact that one of the three proposed changes will be a revenue raiser (and therefore offset any potential revenue losses in the other two) virtually guarantees a negligible net effect on revenue. An indication of the budgetary impact of 'this proposal can be gained from a recent survey from the Ohio Public Employees Deferred Compensation Program. Currently, there are 87,716 participants in the program. Of 65,101 currently deferring, 2,693 are deferring the maximum of $7,500 per year. If each one of them increased to the maximum deferral as provided H.R. 2906 to $8,475 per year, their taxable income would *decrease* by $2,625,675. Of the 15,442 inactive participants, 5,565 have account values less than $3,500 and have not deferred for more than two years. If these individuals were given lump sum distributions under the proposed deminimus provision, approximately $11,000,000 would become immediate taxable income. Assuming other state and municipal government plans are similar (and we have no reason to believe Ohio is in any way exceptional), the data clearly indicates that this three-part proposal would be revenue neutral.

Finally, the proposals are certainly technical in nature; none of the amendments fundamentally alters the program or changes congressional policy or intent.

CONCLUSION

In conclusion, Mr. Chairman, we urge this committee to consider the pension simplification needs of the public sector in putting together this omnibus legislation. The changes we are recommending to Sections 415 and 457 of the Internal Revenue Code (as embodied in S. 1364 and H.R. 2906, respectively) are reasonable and just, and we hope you agree that they belong in any comprehensive pension simplification measure.

As always, Mr. Chairman, the International Association of Fire Fighters appreciates the opportunity to appear before you, and we look forward to working with you on this and other issues affecting the nation's fire service.

MAPCO INC.

Michael J. Wilmering
MANAGER
EMPLOYEE BENEFITS
(918) 592 7294

VIA Federal Express

September 25, 1991

Honorable David H. Pryor
264 Senate Russell Office Building
United States Senate
Washington, D.C. 20510

Dear Senator Pryor:

Thank you very much for your letter of September 19, 1991 wherein you invited MAPCO to submit a written statement on the Employee Benefits Simplification and Expansion Act you have introduced with Senator Bentsen (S 1364/HR 2742). You informed us that a hearing on this bill will be held on September 27 and informed us that any written statement that we wish to provide will be included in the hearing record. This letter and the attachments are in response to your invitation.

We are greatly supportive of your and Senator Bentsen's efforts to achieve pension simplification. We firmly believe that many of the items proposed under the Employee Benefits Simplification and Expansion Act are worthy of inclusion. However, we have some important suggestions for improvement that we believe will be helpful and meaningful (we note that these items are included in Rep. Rod Chandler's "Employee Benefits Simplification Act" (which has drawn considerable bipartisan support from members of the House Committee on Ways and Means)): (1) simplified and improved provisions for permissive aggregation of like union and nonunion plans, (2) simplified and improved provisions facilitating separate testing by lines of business, and (3) an issue MAPCO feels is extremely important, a provision for the use of Social Security retirement ages ("SSRAs") to be treated as a uniform retirement age for vesting and testing. Since MAPCO feels most concerned about this last issue (the use of SSRAs as a plan's normal retirement age) I have attached a separate outline for your review and corsideration.

While we know that you are already familiar with MAPCO, we thought a short review of our Company background and our concerns for pension simplification might be helpful at this point. MAPCO Inc. is a diversified energy company with operations and employees across the United States. The Company consists of four major operating subsidiaries: MAPCO Coal, MAPCO Gas Products, MAPCO Petroleum, and MAPCO Transportation. MAPCO Coal Inc. produces, processes, and markets steam and metallurgical coal from mining complexes in Kentucky, Maryland, Illinois, and Virginia. The Coal operations include seven underground mines and one surface mine. MAPCO Gas Products Inc. operates natural gas processing plants in the panhandle of Texas, and markets propane, propane appliances and fertilizer through Company-owned retail stores in eleven states. Petroleum conducts refining and marketing operations in Alaska and in the mid-south area of the United States. The marketing operation for MAPCO Petroleum includes 295 retail gasoline/convenience stores. MAPCO Transportation includes the Mid-America Pipeline system and various gas storage facilities.

MAPCO regards pension simplification as an important step for Congress to take in order to begin the process of restoring logic and simplicity to the Nation's pension system. Increasingly, employers of all sizes are viewing retirement programs as too complex to sponsor, and workers and retirees are growing confused and frustrated with the ever-increasing complexity of the laws governing their benefit plans. As a result, employers are terminating retirement programs at a rate at which Congress should view as alarming. When more employers terminate their retirement plans, the result will be greater pressure on the Social Security retirement system and ultimately the federal budget. MAPCO views this disturbing trend and the trend of the changing demographics of our Nation (i.e. the anticipated shortage of workers) as reasons enough for pension simplification.

MAPCO is preparing for an anticipated shortage of workers, especially skilled workers, such as accountants, engineers and computer specialists. It is for this very reason that forwardthinking employers such as MAPCO are using, or want to use, SSRAs as their pension plan's normal retirement age. In its recent Workforce 2000 Survey, Coopers & Lybrand identified recruiting and retention of experienced personnel as the greatest concerns facing human resources managers. The greatest pool of experienced personnel will be the group of relatively older workers; however, these workers will likely be less willing to change jobs and relocate, making the recruiting process more difficult. At the same time, employees' retirement decisions appear to be made on the bases of the amount and availability of retirement income. This analysis suggests that early retirement patterns will continue unless current benefit designs are changed. Such early retirement patterns merely exacerbate the recruiting and retention problems MAPCO expects to face with the aging of the workforce. A recent Wall Street Journal article (September 16, 1991) reiterated our concerns (attached). In light of these troubling issues we urge Congress to provide employers such as MAPCO with a level playing field that simplifies pension administration and promotes retirement savings in the United States. Further, we find it illogical for Congress and the Administration to have, on one hand, approved delaying the Social Security retirement age from age 65 to as high as 67 (as they did in 1983) and then, on the other hand, retain impediments against the use of SSRAs in private pension plans.

We commend your efforts in recognizing the overwhelming burdens employers such as MAPCO currently face in administering retirement plans. We believe your Employee Benefits Simplification and Expansion Act, enhanced by the aforementioned provisions, will provide incentives for employees to create, or at the very least, retain retirement plans while at the same time providing no revenue loss for Treasury. We also gratefully acknowledge the concern for addressing these very serious issues shown by your Tax Counsel, Mr. Steve Glaze, in our discussions with him earlier this year. Please let me know if we can provide you with further information.

Sincerely,

Michael J. Willmering
Manager, Employee Benefits

MJW/ao

Attachments

USING SOCIAL SECURITY RETIREMENT AGES TO TEST FOR NONDISCRIMINATION UNDER DEFINED BENEFIT PLANS

Background

In 1983, Congress delayed the earliest age at which currently younger employees may begin to receive their full Social Security benefits. Previously, full Social Security benefits were available only at age 65. After 1983, an employee's full Social Security benefits commence at his or her Social Security Retirement Age (SSRA); employees born before 1938 have a SSRA of 65, employees born between 1938 and 1954 have a SSRA of 66, and employees born in 1955 or later have a SSRA of 67. The adoption of SSRAs was in recognition of the increasing life expectancies of currently younger Americans and the resulting need to maintain a sensible balance between taxpaying workers and older beneficiaries of Federal programs, such as Social Security and Medicare.

In 1991, the IRS issued final regulations on the methodology an employer must use in demonstrating that a defined benefit plan does not discriminate in favor of the highly compensated employees (HCEs). These regulations prohibit an employer from demonstrating nondiscrimination by treating employees' SSRAs as a uniform retirement age. Thus, if (like Social Security) a defined benefit plan provides the same annual retirement benefit to all employees commencing at their SSRAs, the employer cannot be certain, without undertaking more extensive and expensive demographic based testing, that the defined plan is nondiscriminatory.

Proposal

An employer should be allowed to treat employees' SSRAs as a uniform retirement age for purposes of vesting and demonstrating nondiscrimination under its defined benefit plans.

Reasons to Support

GOOD PUBLIC POLICY: The Proposal would encourage currently younger employees to work for additional years before retiring.

Analyses of future workforce patterns indicate future shortages of skilled workers. Also, with longer life expectancies for currently younger employees, the ratio of working employees to retired employees is projected to decrease at significant rates, particularly as the baby boomers age. These demographic patterns have troubling implications both for employers--increased difficulty in retaining skilled workers and financing retiree benefits--and for the financial status of Federal programs--significant shifting of the balance between taxpayers and older beneficiaries of Federal programs (e.g. Social Security and Medicare).

In adopting SSRAs for full Social Security benefits, Congress wanted to address these implications for Social Security. An employer should be able to easily design its own retirement plans on the basis of SSRAs to achieve equivalent objectives for its own workforce. In addition, the failure to facilitate employers in adopting a SSRA-based design undercuts the likelihood that the Federal government will achieve its objectives under Social Security because employer retirement plans will continue to provide powerful and increasing incentives for pre-SSRA terminations.

PENSION SIMPLIFICATION: **The Proposal would greatly simplify the required demonstration of nondiscrimination under defined benefit plans that, like Social Security, use SSRAs as a uniform retirement age. At the same time, using SSRAs would not permit prohibited discrimination in favor of HCEs.**

The IRS has proposed two basic approaches to demonstrating that benefit plans are nondiscriminatory. The **design-based approach** says that if the design of the plan does not raise a significant potential for discrimination in favor of the HCEs, the plan is deemed to be nondiscriminatory regardless of the demographics of the employer's workforce. The **demographic approach** says that if the IRS is not sufficiently certain that a plan's design is nondiscriminatory, the actual distribution of benefits under the design must be analyzed in light of the employer's workforce to determine whether the plan is nondiscriminatory. At present, the use of SSRAs as a uniform retirement age disqualifies a plan from using the simpler, design-based approaches. As a result, plans using SSRAs must unnecessarily demonstrate nondiscrimination under the administratively more complex and expensive demographic test, and in applying this test SSRAs may not be treated as a uniform retirement age.

Using SSRAs in accordance with the Proposal will not permit discrimination in favor of HCEs and thus should not disqualify a plan from the design-based tests. Indeed, using SSRAs would facilitate employers only in offsetting the increase in retirement benefits that is naturally occurring for currently younger employees on account of their increasing life expectancies. In other words, as with Social Security, using SSRAs wou!d facilitate an employer in not providing greater benefits to younger employers.

NO REVENUE LOSS: **The proposal would not have an adverse revenue effect and thus would not require the adoption of a provision increasing revenues.**

The proposal should have no meaningful short-term or long-term revenue effect on Federal receipts or tax expenditures. If anything, the Proposal should enable employers to fund pension benefits somewhat more slowly than they would otherwise do so, and thereby the Proposal should minimally reduce deductible employer contributions and Federal tax expenditures for qualified plans. There is no basis that we have identified for expecting employers to increase their aggregate retirement benefit levels under the Proposal and thus for projecting that the Proposal would reduce Federal revenues.

The Wall Street Journal

The Outlook 9-16-9

Retirees Pose Burden for Economy

WASHINGTON

Last week's report on the benefits of estrogen in reducing heart disease among women adds to the stream of medical science that offers hope for pushing the limits of human life. Rising life expectancy has been a most dependable occurrence of the past century. A hundred years ago, the average American died well before reaching 50. Today, the life expectancy is 75. Most women alive today will survive into their 80s; most boys born today can hope for the same.

The medical community debates whether there's any natural boundary to this exhilarating trend. "George Burns is still getting around at 95," says Edward Schneider, dean of the Leonard Davis School of Gerontology at the University of South Carolina. "Biologically, there is no reason we can't get the majority of population there."

The social benefits that flow from ever-rising life expectancy are plentiful. But the economic ones so far are not, for while people are living longer, they aren't working longer.

The retirement age of 65 has been a fixture in many nations since Bismarck's day. And in the U.S., even earlier retirement has grown increasingly popular.

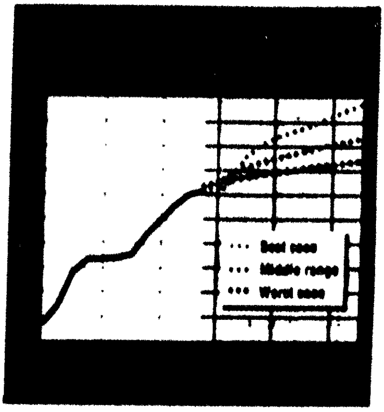
For the economy, the problem of nonworking seniors didn't matter much in the 1970s and 1980s because the labor force was flooded with baby boomers and with women looking to expand their horizons or supplement their families' income. But the 1990s will be another matter. The baby boom has been absorbed into the work force and the percentage of women seeking work has stopped rising.

Slow labor force growth is the main reason unemployment has risen no higher than 7% this year, despite a serious recession. If the recovery proceeds, that slow labor force growth should quickly turn into a labor shortage. More working seniors offer the best solution, especially since few jobs in today's economy involve the sort of hard physical labor that led to adoption of the 65-year retirement age in the first place.

For the federal budget, the problem is dire. Caring for the elderly is becoming the major preoccupation of the federal government. Payments to seniors already account for a third of federal outlays. With the elderly population growing rapidly and health-care costs rising, that fraction will soon soar to over a half. By 2020, an estimated 53 million retirees will get federal benefits, up from 32 million today.

Within the Bush administration, it's clear that an increase in the social Security and Medicare retirement age is high on the agenda for a post-election budget summit. Budget Director Richard Darman apparently hopes such a summit, unlike its predecessors, will address long-term problems, of which supporting the elderly is perhaps the most pressing.

In congressional testimony in April, Mr. Darman said policies are needed "to increase the likely productivity of lives that are extended." The age of eligibility for full Social Security benefits is already slated to rise to 67 in the next century; if it's raised to 69 by the year 2020, Mr. Darman said, "the savings would be greater than $25 billion [in 1992 dollars] per year." Others in the administration agree. "Over the long run," says Michael Boskin, the president's top economist, "we'd be better off for social and economic reasons to allow our senior citizens greater opportunities and incentives to remain in the labor market."



Indeed, the case for raising the retirement age is difficult to dispute. "It's a no-brainer," says Sheila Macdonald, executive vice president of an advocacy group called Americans for Generational Equity. "Obviously we need to do it because of demographic changes in our society."

The problem is that any such change will be fought vigorously by the powerful elderly lobby—for which Ms. Macdonald's fledgling organization is no match. Martin Corry, director of federal affairs for the American Association of Retired Persons, says his group favors incentives to "encourage people to stay in the labor force as long as they wish." But it strongly opposes increases in the eligibility age for either Social Security or Medicare.

Regarding Medicare, the elderly lobby is backed by many business groups that fear if Medicare stops covering workers at 65, they will have to pick up the tab. Heavy business lobbying has already led House Ways and Means Chairman Dan Rostenkowski to propose in his health reform plan lowering eligibility for Medicare to 60.

But eventually government policy will have to be brought into line with the facts of life. People are leading longer and healthier lives. There's no reason they can't lead more productive lives as well.

—ALAN MURRAY

STATEMENT OF MERRILL LYNCH AND COMPANY, INC.

I. Introduction

I am pleased to submit this testimony on behalf of Merrill Lynch and Company, Inc. and similarly situated taxpayers in support of the Subcommittee's objective to simply current pension rules and expand access to pension benefits. Merrill Lynch is committed to providing significant retirement benefits for its more than 37 thousand employees, and believes that a logical and equitable tax code is essential in continuing to meet that goal.

The focus of our comments is an amendment Congress made in 1989 to I.R.C. Section 404(k), limiting the deductibility of dividends paid to employee stock ownership plans (ESOPs). The 1989 amendment was intended redress abusive activity. Unfortunately, as drafted, it inadvertently retroactively penalized companies that followed a course of action encouraged by Congress in 1986 to establish new retirement plans which included ESOPs. For reasons of clarity and equitable public policy, we urge the Congress to enact simplification amendments to eliminate this unintended tax penalty.

II. In 1986 Congress Encouraged the Establishment of Leveraged ESOPs.

In 1986, Congress enacted two provisions -- Section 4980(c)(3) and an amendment to Section 404(k) -- to encourage the transfer of pension plan assets into leveraged employee stock ownership plans (ESOPs).

Section 4980(c)(3) provided a specific exemption from the excise tax, which Congress imposed on pension reversions, for assets transferred from a defined benefit plan upon plan termination to an ESOP. The Senate Finance Committee explained that:

> The Committee believes it is appropriate to provide an exception to this tax in the case of certain transfers of excess assets to an ESOP . . . in order to encourage greater establishment of such plans to promote employee stock ownership.[1]

Also in 1986, Congress amended Section 404(k) to permit a deduction for dividends paid on employer securities to the extent that those dividends are used to make payments on an ESOP loan. As noted by the Joint Committee on Taxation:

> Congress believed that it was appropriate to expand on the incentives that advance the idea of broader capital ownership and employee stock ownership in particular. Congress felt it appropriate to encourage corporations to borrow money in order to make a contribution of stock to employees' accounts...
>
> Further, in order to accelerate the repayment of ESOP loans, Congress found it appropriate to permit a deduction for dividends on employer securities if such dividends are used to make payments on an ESOP loan.[2]

[1] Report of the Committee on Finance accompanying H.R.3838, Report Number 99-313, page 636.

[2] General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, May 4, 1987, p. 844

In permitting deductibility, Congress did not distinguish between dividends paid on employer securities purchased with the acquisition loan (i.e., "leveraged shares"), and dividends paid on other securities ("reversion shares").

III. Merrill Lynch and Similarly Situated Taxpayers Acted in Reliance on Section 4980(c)(3) and Section 404(k).

After 1986, relying upon Sections 4980(c)(3) and 404(k), a number of taxpayers terminated pension plans, applied for favorable IRS determination letters and initiated the process that ultimately would establish the ESOPs Congress had encouraged. For illustration purposes, I will describe the Merrill Lynch transaction.

A. Merrill Lynch terminated the plan in 1988 within the window provided by Congress.

To qualify for the Section 4980(c)(3) exception, an employer was required to terminate its pension plan by December 31, 1988. In compliance with 4980(c)(3), Merrill Lynch terminated its pension plan and transferred the assets necessary to meet the plan's termination liabilities to Metropolitan Life on December 30, 1988. Prior to that date, on October 24, 1988, Merrill Lynch filed a request with the Internal Revenue Service for a determination letter as to the qualified status of the pension plan upon its termination. Merrill Lynch was advised by counsel that it would be prudent to await receipt of a favorable determination letter before the transfer of residual assets to the ESOP and purchase of employer securities thereunder.

B. IRS Delay Effectively Prevented Merrill Lynch from Completing Transaction Before August 4, 1989.

At various times in 1989, Merrill Lynch urged IRS to expedite issuance of its determination letter. The process was unusually slow, even though an IRS moratorium on issuance of determination letters for terminating defined benefit pension plans was not applicable to the Merrill Lynch termination. Even with regular prodding by Merrill Lynch throughout 1989, the determination letter, dated July 31, 1989, did not reach Merrill Lynch until August 4, 1989. We have been advised by IRS officials who participated in the issuance of these determination letters that other taxpayers received favorable determination letters at about the same time, again after a lengthy delay.

C. Merrill Lynch Completed the Transfer to the ESOP Shortly After Receipt of the IRS Determination Letter.

By expediting action after receipt of the IRS determination letter, Merrill Lynch transferred the residual assets to a newly established ESOP pursuant to I.R.C. Section 4980(c)(3) on September 15, 1988. On September 22, 1989, the ESOP used those assets to purchase 9.9 million shares of Merrill Lynch stock (the "Merrill Lynch reversion shares"), and on the same date, relying upon Section 404(k), Merrill Lynch caused the ESOP to borrow $70 million to purchase an additional 2.2 million shares of Merrill Lynch stock (the "Merrill Lynch leveraged shares").

In financing this transaction, Merrill Lynch relied upon the ability, provided by Section 404(k), to repay the acquisition loan using deductible dividends paid on *both* the Merrill Lynch reversion shares and the Merrill Lynch leveraged shares.

IV. Congressional Action in November 1989 Retroactively Penalized Merrill Lynch and Similarly Situated Taxpayers and their ESOPs.

A. Congress Amended Section 404(k) to Address Abusive Activity Wholly Unrelated to Section 4980(c)(3) Transactions.

In the 1989 Omnibus Reconciliation Act (P.L. 101-239, Section 7302), Congress limited the deductibility under I.R.C. Section 404(k) of dividends paid to an ESOP and used by the ESOP to repay a loan incurred to acquire employer securities. Under Section 7302, to be deductible, the dividends must be paid on employer securities purchased with the acquisition loan (i.e., "leveraged shares"). Dividends paid on other securities (i.e., "reversion shares") are no longer deductible, even if the dividends are used to repay the acquisition loan.

Congress amended Section 404(k) to redress an issue wholly unrelated to Section 4980(c)(3) transactions: abusive activity. In amending Section 404(k), Congress intended to eliminate the availability of the Section 404(k) dividend deduction for shares in existing profit sharing and stock bonus plans that were being converted into ESOPs in order to obtain the 404(k) dividend deduction for the employer. The amendment to Section 404(k) was not aimed at eliminating the deduction for dividends paid on shares that were acquired by an ESOP pursuant to a qualified Section 4980(c)(3) transaction, with respect to a termination occurring on or before December 31, 1988.

B. Congress Was Unaware of Retroactive Penalty to Merrill Lynch and Similarly Situated Taxpayers.

The amendment to Section 404(k), which Congress enacted in November 1989 -- two months after Merrill Lynch had completed its leveraged transaction -- imposed a severe retroactive penalty. Because the conferees' decision to choose August 4, 1989, as a retroactive effective date occurred at the close of the 1989 congressional session, we had no opportunity to alert conferees about this unintended penalty.

Because Merrill Lynch had completed its Section 4980(c)(3) plan termination on December 13, 1988, and had filed with IRS on October 24, 1988, for a determination letter that would have allowed Merrill Lynch to prudently transfer assets and acquire employer securities for its ESOP, Merrill Lynch's transaction and those of similarly situated taxpayers should have qualified for grandfathering. Unfortunately, delay by IRS in the issuance of Merrill Lynch's determination letter (coincidentally until August 4, 1989) prevented Merrill Lynch from satisfying either of the grandfathering criteria selected by conferees.

We are confident that, had conferees understood the delays occasioned by the IRS determination process, and that the limited criteria selected for grandfathering inadvertently would penalize leveraged Section 4980(c)(3) transactions (which Congress itself had encouraged), conferees would have provided that Section 4980(c)(3) transactions (particularly those for which timely completion was delayed because of the IRS determination process) should qualify under the August 4, 1989, effective date.

C. Amendment Required to Redress Retroactivity.

We urge adoption of a simplification amendment (Attachment No. 1) which makes clear that the 1989 amendment to Section 404(k) shall not apply to employer securities acquired after August 4, 1989, pursuant to Section 4980(c)(3), with assets transferred from a defined benefit pension plan the termination of which was the subject of a determination letter from the Internal Revenue Service, in effect on August 4, 1989, and at all times thereafter before such securities are acquired.

D. **The Proposed Amendment Will be Revenue Neutral.**

Consistent with the simplification criteria, we are working to couple the attached amendment with an appropriate revenue-raising offset that, as a package, will be revenue neutral.

Attachment No. 1

Text of Proposed Amendment

Version No. 1: In P.L. No. 101-239, Section 7302 (which amended I.R.C. Section 404(k)) add the following new subparagraph (b)(3):

(b) Effective Date.-

(1) ......

(2) ......

(3) Securities Acquired Pursuant to Qualified Section 4980(c)(3) Transfers.-The amendment made by this section shall not apply to employer securities acquired after August 4, 1989, which are acquired [Optional: before October 1, 1989] pursuant to Section 4980(c)(3) with assets transferred from a defined benefit pension plan the termination of which was the subject of a determination letter issued by the Internal Revenue Service in effect on August 4, 1989, and at all times thereafter before such securities are acquired.

Version No. 2. Amend P.L. No. 101-239, Section 7302 (b) (which amended I.R.C. Section 404(k)), by adding the underscored language to subparagraph (b)(1):

(b) Effective Date.-

(1) In General.-The amendment made by this section shall apply to employer securities acquired after August 4, 1989, except for employer securities acquired [Optional: before October 1, 1989,] pursuant to Section 4980(c)(3) with assets transferred from a defined benefit pension plan the termination of which was the subject of a determination letter issued by the Internal Revenue Service, in effect on August 4, 1989, and at all times thereafter before such securities are acquired.

STATEMENT OF MILLIMAN & ROBERTSON, INC.

Mr. Chairman and Members of the Private Retirement Plans Subcommittee:

I appreciate the opportunity to participate in your inquiry into pension access and simplification issues.

As CEO of an actuarial and benefits consulting firm, I have observed for many years the steep decline in employers' interest in providing adequate retirement income coverage to employees. Recent Milliman & Robertson research with corporate chief executive officers indicates that they are concerned with complexities of pension laws, inadequacies of retirement policies, and uncertainty over the future course of pension laws.

Milliman and Robertson queried CEOs of companies of all sizes. Responses from 262 CEOs, including 73 Fortune 500 companies, show that more than 90 percent of CEOs:

o Think our country's retirement savings policies are not effective at encouraging the level of saving that future retirees will need.

o Think the country's overall personal savings trends present problems for current capital needs and future retiree needs.

o Support the idea of a high level panel of public and private sector leaders to search for ways to simplify and enhance the country's retirement policies.

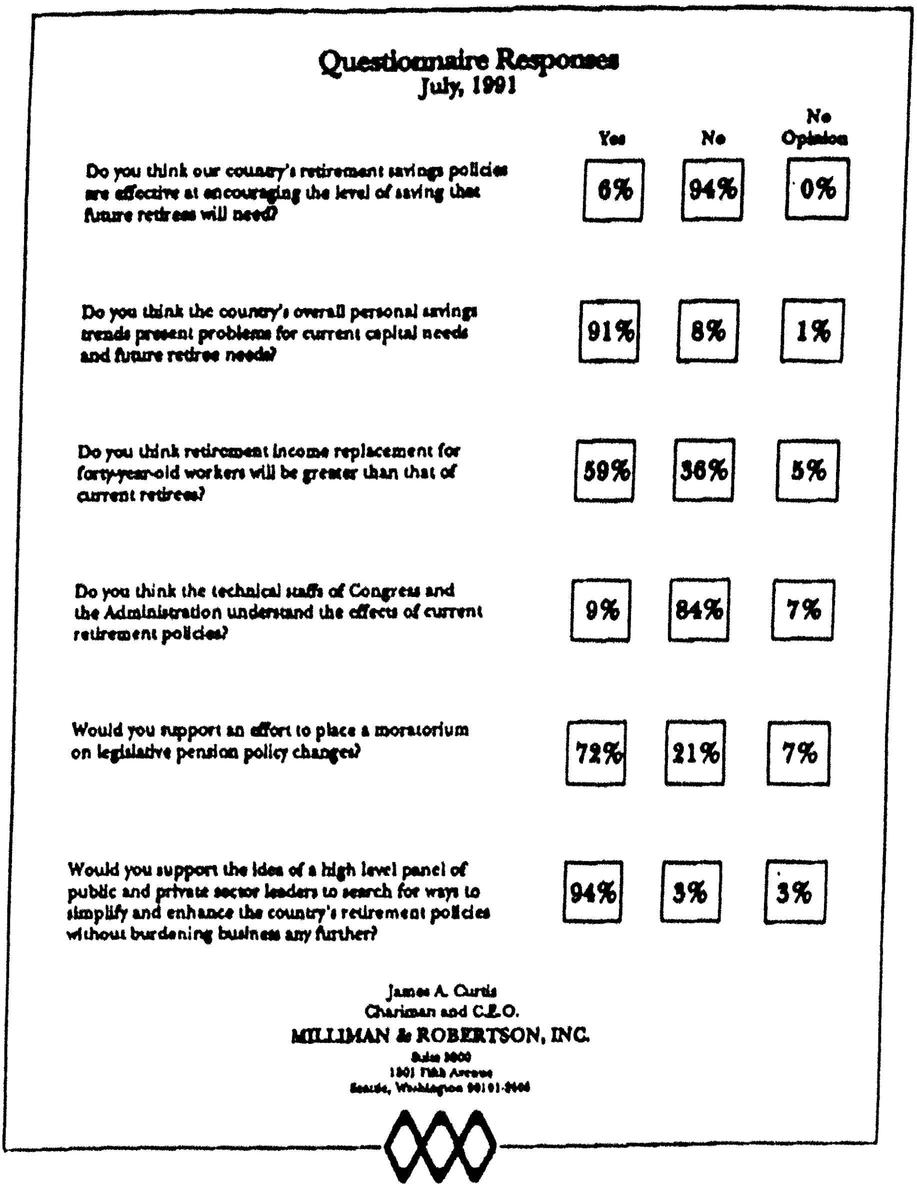
While the responses above are from an informal questionnaire, the results are similar to those produced in a recent survey of small and medium-sized company CEOs sponsored by M&R and conducted by the Wirthlin Group. According to that survey of 100 CEOs:

o They are nearly unanimous in the view that pension laws and regulations are too complex.

o A majority (66 percent) think the current pension laws and regulations discourage employers from sponsoring and maintaining qualified pension plans.

o A majority of small and medium-sized company CEOs support a moratorium on legislative changes.

The findings summarized above suggest that CEOs would like, besides simpler pension laws and regulations, fewer laws and regulations. In addition, they would like a re-thinking of basic pension policies to help foster better coverage and savings. More details of the findings of both surveys are attached.



Questionnaire Responses
July, 1991

	Yes	No	No Opinion
Do you think our country's retirement savings policies are effective at encouraging the level of saving that future retirees will need?	6%	94%	0%
Do you think the country's overall personal savings trends present problems for current capital needs and future retiree needs?	91%	8%	1%
Do you think retirement income replacement for forty-year-old workers will be greater than that of current retirees?	59%	36%	5%
Do you think the technical staffs of Congress and the Administration understand the effects of current retirement policies?	9%	84%	7%
Would you support an effort to place a moratorium on legislative pension policy changes?	72%	21%	7%
Would you support the idea of a high level panel of public and private sector leaders to search for ways to simplify and enhance the country's retirement policies without burdening business any further?	94%	3%	3%

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CHIEF EXECUTIVE OFFICER ATTITUDES TOWARD PENSION PLANS

Prepared for the
Milliman & Robertson, Inc.

April, 1991

The Wirthlin Group

EXECUTIVE SUMMARY

The Wirthlin Group is pleased to present the results of this pension plan survey to Milliman and Robertson, Inc. The study explores executive attitudes toward existing pension plans and assesses attitudes toward a less complex pension plan system. The study is based on the results of one hundred telephone interviews conducted with Chief Executive Officers (CEO). Interviewing was conducted during normal business hours on April 5th thru April 10th, 1991.

Almost unanimously, CEO's view government laws and regulations as extremely or moderately complex. More specifically, two out of every three CEO's of small and medium-sized companies agree that laws and government imposed regulations discourage employers from sponsoring and maintaining qualified pension plans. A majority strongly support simplifying the private pension system.

Eight-four percent of CEO's support standard definitions and rules for all pension plans. A majority also supports a moratorium on legislative changes. CEO's are opposed to dropping pension plans and expanding IRA's.

RESEARCH DESIGN

The respondents interviewed in this study were randomly selected CEO's of small and medium-sized companies. Seventy-six (76%) of the interviews were conducted among CEO's of companies with 100 to 500 employees (small companies) and 24% were among CEO's of companies with 501 to 1000 employees (medium-sized companies). The sample of CEO's was selected from Dun and Bradstreet's data base of all companies nationwide, excluding agricultural operations, utilities, and government agencies.

Since the actual population of companies reflects more small companies (89%) than we surveyed, the data were weighted to reflect the true proportion of small and medium-sized companies. The weighted total is more representative of a random sample of CEO's from all companies with 100 to 1000 employees.

The results of the seventy-six CEO's of small companies are accurate to ± 11.3 percentage points in 95 out of 100 cases. Although normal "margins of error" do not strictly apply to weighted samples, when weighting is not severe – as in this study, normal practice is to consider the margin of error as a guide. In general, random samples of 100 yield results accurate to ± 9 8 percentage points in 95 out of 100 cases.

All interviews were conducted by The Wirthlin Group-trained personnel from our telephone facility in Orem, Utah.

The interview lasted approximately seven minutes and contained 13 questions. An interview schedule (questionnaire) with complete topline results is included in Appendix A. Verbatim responses used to build the codes for the open-ended question are included in Appendix B. Weighted and unweighted crosstabulations of the data are included in Appendix C and Appedix D respectively.

Approximately 15% of all interviews were independently validated for procedure and content by a Wirthlin Group professional. Statistical analysis and cross-tabulations were produced by the firm's own software and computer system.

PERCEIVED COMPLEXITY OF PENSION PLAN SYSTEM

The feeling that current laws and regulations are complex is widespread among the CEO's surveyed. This may provide some insight into what discourages employers from sustaining a pension plan and thus advocating the simplification of the private pension system.

A majority (66%) of the CEO's AGREE "laws and government imposed regulations discourage employers from sponsoring and maintaining qualified pension plans."

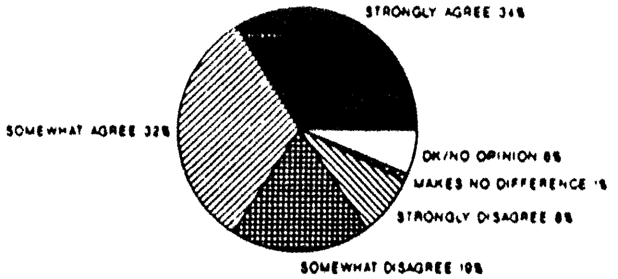
Not surprising, more CEO's whose companies do not offer a pension plan believe government regulations discourage maintaining a pension plan system (76%).

Further, nearly eight in ten (81%) of those who have made their views known to Congress or a special interest group believe government regulations are a disincentive to providing pension plans.

The larger the share of the compensation package represented by their company's pension plan, the more likely a CEO was to agree that regulations present a barrier.

Figure 1

"Laws and government imposed regulations discourage employers from sponsoring and maintaining qualified pension plans?"



Nearly all CEO's (98%) feel government laws and regulations are extremely or moderately complex (Extremely Complex 61%; Moderately Complex 37%). Among these respondents, 79% SUPPORT simplifying the private pension system.

Leading advocators of the simplification of the private pension system include those companies which offer no pension plan (85%), and the Manufacturing Industry (90%).

Figure 2

"Which statement best describes your feelings toward the complexity of government laws and regulations?"

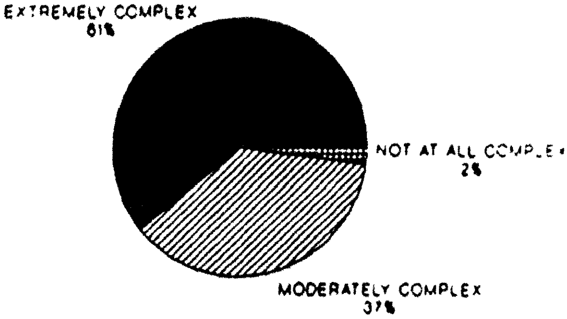
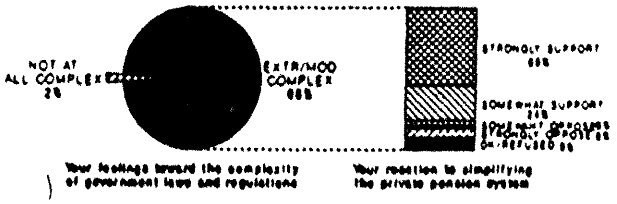


Figure 3

GOVERNMENT LAWS AND REGULATIONS - SIMPLIFYING PRIVATE PENSION SYSTEM

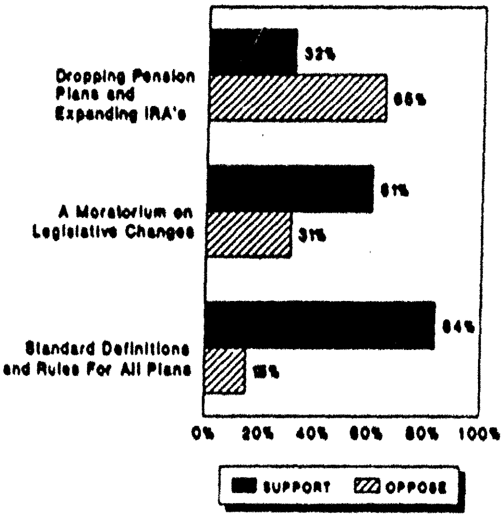


PROPOSED SIMPLIFICATIONS

Respondents were read a list of proposed simplifications to the private pension system and were asked which policy changes they would support. A majority of respondents OPPOSE (64%) dropping pension plans and expanding IRA's. An overwhelming 84% of respondents (52% Strongly and 32% Somewhat, respectively) SUPPORT "Standard definitions and rules for all plans." A majority of employers (61%) also SUPPORT a "Moratorium on legislative changes."

Figure 4

PROPOSED SIMPLIFICATIONS TO THE PRIVATE PENSION SYSTEM



CURRENT RETIREMENT PACKAGES

While not the focus of the survey, CEO's were asked about their company's current retirement program. Seven in ten (67%) of CEO's say, "Yes" their company has a pension plan to offer their employees. Among those companies which offer a pension plan, an average of 15% of the total compensation package is currently being devoted to the company's retirement plan:

Employers with plans were then asked, "What would you say your biggest concern about pension plans is? That is, what concerns you the most about pension plans?" Not surprising, business concerns were foremost on the minds of CEO's. However, it is important to note that although the question was asked of CEO's prior to any discussion of the complexity of the pension system, government control was of measureable, top-of-mind concern.

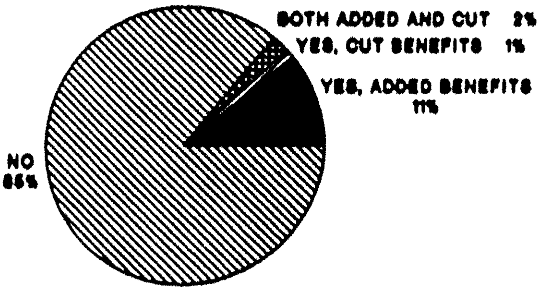
These employers most often cited "Return on Investment/Benefits" (33%), "Company Contribution/Funding" (19%), and "Government Controlled/Stability" (13%) as their biggest concern. Specific comments include:

> *"The prudent investment of the assets. To insure that the assets are invested wisely and prudently so the investments generate reasonable returns. The investment manager is not investing in junk bonds."*
>
> *"The ability of the company to meet obligations and the profitability of the company to meet funding."*
>
> *"I guess the only concern I would have is how good the company is; you never know how long those insurance companies are going to last. With the turnover in the insurance businesses, you just never know."*
>
> *"The federal government is always making laws and not leaving things up to us."*

Pension plans are a valuable and sought after component of one's compensation package, while being perceived as increasingly more complex and difficult to administer. In light of this, it is interesting to note that only 15% of employers with plans have changed the composition of their retirement plan within the past six months; 11% cited adding benefits, 1% cutting benefits, and 2% both adding and cutting benefits.

Figure 6

"Within the past six months have you changed the composition of your retirement package?"



To assess the importance of retirement plans, we asked each respondent to rate how important their company's retirement plan was *to their employees* and *to them personally* on a scale from one to ten. On this scale, "10" means the company's retirement plan is Extremely Important and "1" means the company's retirement plan is Not at All Important.

Not surprising, returement plans are perceived to be moderately important. CEO's consider a pension plan to be more important to them *personally* (8.4), and *to their employees* (7.8). CEO's in the service industry (8.1) and manufacturing industries (8.3) perceive pension plans to be more important *to their employees* than do CEO's in other industries (7.1).

STATEMENT OF THE NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

I. Introduction

The National Association of Computer Consultant Businesses ("NACCB") is pleased to present its testimony on the pension simplification bill now before this Subcommittee, namely, S. 1364. Our testimony will focus exclusively on the provisions in this bill that amends Section 414(n) of the Internal Revenue Code ("IRC") by changing the definition of "leased employees"

NACCB agrees with the large number of organizations which have already expressed their criticism of Section 414(n) in its present form and the IRS interpretation of that provision. NACCB also supports the principle in the pension simplification bill that the definition of "leased employee" in Section 414(n) must be changed, but we believe that the new proposed definition must be further refined We also suggest that other aspects of the "leased employee" issue -- such as the calculation and proof of compensation -- be addressed in any bill that is enacted.

II Summary of Comments on Legislative Proposals

In particular, NACCB's comments may be summarized as follows

- The definition of "leased employee" should be changed so that

  - A worker is a "leased employee" if "such person is not a professional and the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed "

  - Through legislative history, Congress should provide examples of certain types of workers who are "professionals" -- including computer programmers, systems analysts, software and hardware engineers and similarly skilled professional workers in the computer industry -- and it should allow the IRS to define other classes of exempt "professionals"

  - Through legislative history, Congress should also provide examples of what types of workers are not "professionals" -- such as support staff secretaries, receptionists and the like -- and it should explain in what circumstances the service recipient would be deemed to "primarily provide detailed directions and instructions as to the manner in which the services are to be performed "

- The determination of the compensation level at which a "leased employee" is highly compensated should include simplified procedures for demonstrating compensation and consideration of compensation from multiple employers, so that:

  - It should be sufficient for the leasing organization or the leased employee to provide the service recipient with a sworn statement that the employee is or is not "highly compensated", rather than requiring that the actual compensation be revealed to the service recipient.

  - As an alternative to looking at compensation in the preceding year, it should be permissible to determine whether an employee is highly compensated by looking at the rate of compensation in the current year and annualizing it

  - In appropriate circumstances it should be permissible to aggregate compensation that a worker has received from multiple employers in determining if a worker is highly compensated.

- There should be specific legislative report language that independent contractors are not "leased employees"

- The IRS should have the burden of proof to demonstrate that a worker is a "leased employee"

III. NACCB's Interest in the "Leased Employee" Rules

The issue of who is a "leased employee" has been of particular concern to NACCB members Our members are technical services firms which 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 all the parties -- the workers, the technical services firm, and the firm's clients

Unfortunately, however, Section 414(n) is severely disrupting these natural relationships among a technical services firm, its workers, and its clients Because of Section 414(n)'s impact, 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 Section 414(n) can eliminate most of these problems in the technical services industry

IV The Original Intent of Section 414(n)

NACCB believes that any changes to Section 414(n) should be directed towards focusing its application to those situations which initially triggered the adoption of this provision 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 Section 414(n), situations involving technical workers have never been considered as being even remotely akin to the abuses which triggered Section 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 on 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.

V The Definition of "Leased Employee"

We are very concerned that the pending proposal to use the "control" test in S. 1364 to define "leased employee" will be both too difficult to apply and susceptible to overbroad IRS application by the IRS We believe that any test should permit the exclusion of highly-skilled technical service workers from the Section 414(n) rules, while including as "leased employees" only the types of workers that those rules were intended to protect.

A. Use of the "Control" Test to Determine if Services Have Been "Historically Performed by Employees"

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 asked whether "it was not unusual for services of [the] type [at issue] to be performed by employees . " Of course, to determine whether "it was not unusual" for "employees" to perform such services, it is necessary to determine who is an "employee" -- and that requires application of the IRS 20-question common law employment test

The common law employment test is, in reality, a form of "control" test 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

B Long-Standing Criticism of the "Control" Test

Unfortunately, it is precisely this same "control" test which has been long-criticized. The following words have been used by respected government officials and in comprehensive government studies to describe the "control" test "complex", "open to broad and inconsistent interpretation", "extremely difficult to apply", "extremely subjective and often inconsistently applied by the IRS" "lack[ing] precision and predictability", "produc[ing] inappropriate results" and "not yield[ing] clear, consistent or satisfactory answers"

There are several reasons why the "control" test has been thus criticized some of the major reasons being that

* There are too many "control" factors to consider

* Even on an individual basis, many of the factors are too imprecise, subjective and unpredictable

* Attempts to balance several "control" factors to determine, on an overall basis, if there is "control" are too difficult because

  -- it is unclear how many factors must be present or absent to determine whether there is "control", and

  -- it is unclear which factors must be present or absent to determine whether there is "control" since each factor may have a different degree of importance in any particular situation

* In virtually every working relationship of any type, there is always some degree of "control" over a worker by a recipient of services Hence, there is an inherent problem in drawing a line between how much "control" is too much "control"

* In view of the imprecise, subjective and inherently encompassing nature of the "control" test, the IRS has historically applied it in an overly broad manner which results in a conclusion of employment in the overwhelming number of situations. For example, according to the April 1991 issue of The Practical Accountant, in only 8% of the Private Letter Rulings issued by the IRS between January 1, 1987 and March 31, 1988, did the IRS conclude that a worker was not an employee; for the period July 1, 1989 through September 30, 1990, only 75 Private Letter Rulings were issued on the same issue, and in only one of these did the IRS conclude the worker was not an employee.

Governmental leaders have repeatedly made these same points:

* Major problems with the common law "control" test led to Congressional passage of Section 530 of the Revenue Act of 1978, which provided businesses an alternative safe haven test instead of the common law "control" test The tax-writing committees repeatedly referred to the "many complex issues" associated with the application of the "control" test and the numerous "controversies"

created by the IRS application of that test.

* In the well-recognized Report of the Comptroller General, GGD-77-88, entitled "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions", (November 1977) -- which, in part, led to the passage of Section 530 -- the Comptroller General concluded that the application of this "control" test "is open to broad and inconsistent interpretation. . As a result, many employers cannot, with any degree of certainty, determine who will be considered an employee until after the IRS has audited the situation."

* As former Assistant Secretary of the Treasury Donald Lubick testified -- in a remarkable understatement during 1978 Congressional hearings -- 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

* A November 1990 House Government Operations Committee Report concluded that "The 20 common law factors used by employers to make classification decisions, and by the IRS to make reclassification decisions, are extremely subjective and are often inconsistently applied by the IRS."

* A March 1991 study released by the Treasury Department, entitled "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986", reported that the "common law tests, like most facts-and-circumstances tests, lack precision and predictability. Since they were developed in an entirely different context from Federal tax law (primarily the law of employer liability for employee torts), they may also produce inappropriate results for some tax purposes As the Assistant Secretary (Tax Policy) John Chapoton stated in 1982, '[i]n many cases, applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers[,], and reasonable persons may differ as to the correct classification.'"

C. Similarities Between Employment Tax "Control" Test and "Leased Employee" Definition in S 1364

Unfortunately, we do not see a great deal of difference between the "control" test in S. 1364 and the 20-question common law employment test which has been so soundly criticized. We reach this conclusion even though we appreciate the fact that the "control" test in S. 1364 appears to focus on the existence of actual "control", rather than the right to "control" -- which is what the common law employment test addresses. What difference may exist is simply a matter of degree, rather than of kind, and the degree is quite small, as we now explain.

We have already identified the problems with the "control" test in the employment tax area. Addressing these problems one-by-one, it becomes clear that the "control" test for "leased emplo ees" does little to solve them

As to the number of factors that must be considered to determine if there is "control" by the service recipient, we appreciate the fact that the Joint Tax Committee staff has attempted to identify particular factors that are relevant under a similar bill, H.R. 2730; indeed, four such factors were identified (and we assume that they would also apply to S. 1364.[1] However, the staff's explanation explicitly does not restrict a determination of "control" to only the identified relevant factors; rather, according to the explanation, the taxpayer's "facts and circumstances" must be considered, and factors that are relevant are said to "include" the identified factors. It could well be that there are 10 relevant factors, or 15, or even 20 or more -- a possibility that confronts the taxpayer with too many factors to consider, which is a major problem with the employment tax "control" test.

Our concern about the need to consider too many factors is not eliminated by

[1] These factors include whether the worker is required to comply with instructions of the service recipient about when, where and how to work; whether the services must be performed by a particular person; whether the worker is subject to the supervision of the service recipient; and whether the worker must perform services in the order or sequence set by the service recipient.

the Joint Tax Committee staff's identification of certain common law employment "control" factors that are not relevant to the "control" test which would be applied to "leased employees." In fact, the deletion of these factors -- which would otherwise tend to show that the service recipient does not exercise "control" -- only further confuses the issue of how to decide what other factors are relevant or irrelevant [2]

As to the fact that many of the "control" factors are too imprecise, subjective and unpredictable, again we see very little difference between the "control" test for "leased employees" and the common law employment "control" test For example, in IRS employment tax audits, major controversies have arisen over whether it constitutes "instructions about when, where and how to perform services" if a firm instructs a worker that he or she can begin a project by one date and must finish it by a second date Taxpayers take the reasonable position that such instructions hardly amount to "control" over work hours. whereas the IRS often takes the opposite view. Likewise, taxpayers and the IRS typically disagree over what degree of involvement by a service recipient amounts to "supervision" over a worker Disputes even arise over whether a service recipient is "controlling" the order or sequence in which a project must be completed where the services being performed are during only one stage of a multi-stage project -- such as building construction -- and it is obvious that certain stages must be completed before others can begin. Yet, even though substantial disputes exists over these factors -- because they are too imprecise, subjective and unpredictable -- these same factors have been identified as relevant to a determination of "control" by the Joint Tax Committee Staff

As to the issue of the difficulty in balancing several factors to determine, on an overall basis, if there is "control", again we see little difference between the test under S 1364 and the common law employment "control" test It is seldom that all of the relevant factors which point towards "control" will be present. Major problems will exist regarding the weight to be given to each factor, as well as how to balance the existence of some relevant factors against the non-existence of other relevant factors This has clearly been the experience in the common law employment "control" test, and there is no reason why it would be much different under either of these bills

As to the concern that there is always inherently some "control" by a service recipient over a worker, this problem is not solved in the least by S 1364 By implicitly focusing on the existence of actual "control" and identifying certain relevant factors -- such as "supervision" by the service recipient -- this bill has failed to recognize a point made by one of America's great jurists, Judge Learned Hand, several decades ago In discussing an IRS claim that a taxpayer's "control" over certain workers meant that the workers were the taxpayer's employees, Judge Hand stated:

> 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).

Precisely because of the above concerns, as is the case with the common law employment "control" test, the problem remains that the IRS can engage in an overly broad interpretation of the test in S 1364. Indeed, there is no sound basis for any confidence that the IRS will draw reasonably clear lines which would exclude from the new definition of "leased employees" more than a tiny fraction of workers who are likely to be designated as "leased employees" under the currently "historically performed by employees" test in §414(n). In short, if Congress truly believes that the present test is too broad and over-inclusive, so few workers will be affected by the new test in S. 1364 that this bill cannot be called "reform" legislation.

[2] For example, we do not understand why the staff discounted the following "control" factors and explained that there can still be "control" in the service recipient even if the service recipient has no right to hire or fire the worker, even if an entity other than the service recipient provided training to the worker, and even if the worker has an investment in facilities or equipment used to perform the work.

Finally, there is a new problem here which does not exist with the common law employment "control" test. As we will explain, rather than represent pension "simplification", we believe that it is likely that S. 1364 only introduces "complication" to the "leased employee" issue. What we mean is that by virtue of its overbreadth, the "historically performed by employees" test in the current law is actually relatively simple to apply once it is understood that the IRS will almost always conclude that a worker is a "leased employee". In contrast, by introducing a new degree of "control" that is different from the existing degree of "control" which classifies a worker as a common law employee, S 1364 only further complicates matters. More specifically, if this bill is adopted, there will really be three degrees of "control" that are relevant to the analysis of every worker's status:

* If there is some "higher" degree of "control" by a service recipient, then a worker will be considered to be the common law employee of the service recipient.

* If there is some "mid-level" degree of "control" by a service recipient -- but less than the degree of "control" which would classify the service recipient as a common law employer --then the worker will be considered to be the "leased employee" of the service recipient

* If there is no "control" or only a "minimal" degree of "control" in the service recipient, then the worker is neither a "leased employee" nor a common law employee of the service recipient

In addition, in all three situations there will still remain the separate question of whether or not there is enough "control" by the firm which provides the worker to the service recipient so that such firm is the common law employer of the worker However, in answering this separate question of "control" in the employment tax context, taxpayers will have to consider some, but not all, of the very same factors that are relevant to the determination of "control" in the "leased employee" context.

In conclusion, we believe that the "control" definition of "leased employee" in S. 1364 will not solve -- and may further exacerbate -- the problems with the existing "historically performed by employees" language in §414(n). As with the common law employment tax "control" test, taxpayers will have too many relevant factors to consider; they will be uncertain about how to interpret several vague factors, they will not be clear about how to weigh each factor and how to balance the different factors together; they will have to consider factors which inherently include elements of "control" in most any situation; they will be left with a test which is likely to lead the IRS to engage in an overly broad interpretation of who is a "leased employee"; and they will be faced with the confusing task of distinguishing between two different concepts of "control" which have a substantial overlap of relevant factors. This is not simplification.

D. The "Control Over the Manner" Test in H R 2641

If the Senate believes that something like a "control" test is appropriate, it should look at the "control" test in H.R 2641 Rather than focusing on the broad concept of "control" with its numerous component factors, the H R 2641 "control" test classifies a worker as a "leased employee" if "the [service] recipient exercises primary control over the manner in which such services are performed." We believe that this "manner of control" test -- along with an exclusion for "professionals," as discussed below -- is far more preferable to the much broader "control" tests in S. 1364 for a number of reasons

First, the H.R. 2641 test focuses on only one aspect of "control", i.e., control over "the manner in which such services are performed." Although the "manner" of performing services might be described by a further reference to some other factors, it is clear that such other factors would be fewer in number and more narrow in scope than the factors that otherwise determine the existence of "control" as defined in S. 1364. For example, we do not believe that the "manner in which services are performed" would include consideration of directions as to the result that must be obtained by the performance of the services, or even of general instructions by the service recipient as to when and where the services should be performed; nor would a requirement that the services be performed by a particular worker amount to "control over the manner in which the services are performed". In contrast, where a service recipient provides detailed directions and instructions on the steps and methods to be used to achieve a stated result, this might constitute "control over the manner in which the services are performed."

Second, because fewer and more narrow factors would be considered in determining "control over the manner in which the services are performed", there would be less vagueness in this test A line between the existence or non-existence of this type of "control" could be more easily drawn by taxpayers who would be better able to weigh the existence and non-existence of each individual relevant factor, and then arrive at an overall determination of whether such "control" exists

Third, we believe that the H R 2641 test comes closest to covering the type of workers about whom Congress was most concerned when it initially adopted §414(n) typical support staff employees -- like clerical workers, receptionists, and licensed practical nurses in doctors' offices -- who perform routine support services in a "manner" that is directed and controlled by service recipients Other types of workers whose manner of performing services is not controlled by a service recipient -- including high-level computer systems analysts and programmers who exercise a substantial amount of discretion and independent judgment in how to perform their services -- were never intended to be covered by §414(n) and would not be covered under the test in H R 2641

E Proposed Changes to H R 2641

Although we believe that a bill like H R 2641 offers the most predictable and reasoned definition of "leased employee" if Congress is determined to use some type of "control" test, we also believe that some further refinements should be made in the statutory language in this bill so that the potential problems associated with any form of "control" test can be minimized.

In particular, we urge that the phrase "the recipient exercises primary control over the manner in which such services are performed" should be changed to read "the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed " This change would accomplish two major benefits

* It would remove the word "control" and instead focus on "directions and instructions" -- and thus hopefully remove most of the critical "baggage" from the employment tax area that is associated with the word "control".

* It would focus only on "detailed" directions and instructions as to the manner in which the services are to be performed -- and thus preempt any argument that "general" instructions and directions might suggest that the worker is a "leased employee". We appreciate that there may be some dispute over what is "general" versus "detailed", but at least the statutory language will serve to narrow the degree of the dispute

We also urge that H.R. 2641 be amended to specifically exclude "professionals" from the definition of "leased employee" This exclusion would accomplish two major goals

* It would establish for some types of work a "bright line" between covered and non-covered workers In particular, it seems that the emphasis in the current version of H R 2641 is to cover only those workers for whom the service recipient controls the "manner" in which the work is performed This type of worker is on the opposite end of the spectrum from a worker who typically exercises significant discretion and independent judgment in performing his or her work. The latter type of worker is epitomized by the "professional" Rather than requiring a painstaking application of the "manner" test to every type of occupation, it is appropriate to create an explicit exclusion for "professional" workers.

* The inclusion of a "professional" exemption would also allow Congress to specify which types of workers would be considered "professionals" for purposes of this law. The IRS could be given authority to add other classes of "professionals". There is clear precedent for this type of exemption in other laws. For example, the Fair Labor Standards Act includes a "professional" exemption from the overtime laws, and the Department of Labor has defined the term "professional."[3]

[3] Where the Department of Labor has interpreted that term too narrowly, Congress has intervened. See, e.g., P.L. 101-583, where Congress directed the Department to include computer systems analysts, computer programmers, software engineers and similarly skilled workers as "professionals."

With the above changes, H.R. 2641 would read as follows:

> "(C) such person is not a professional and the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed."

F. Examples of the Presence and Absence of "Detailed Directions and Instructions As to Manner"

Even with a shorter, more predictable definition of "leased employee", Congress must provide clear illustrations of who is not a "leased employee" and who is. This will assist the IRS -- and ultimately the courts -- in assuring implementation of Congressional intent as to the breadth of any new definition

We appreciate that the Joint Tax Committee staff has done this in a limited respect. Certainly secretaries and similar support staff would be considered "leased employees" because, typically, 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 These are "detailed directions and instructions as to the manner in which the services are to be performed."[4]

On the other hand, where a service recipient uses "outside" computer programmers, systems analysts, and other similarly skilled workers to provide their services on a particular computer project or to meet requirements that are not being met by a service recipient's own "in-house" employees, these "outside" professionals should generally not be considered "leased employees" regardless of whether they are employees of an "outside" technical services firm firm or are independent contractors who have contracted through an intermediary "broker" In these typical situations the service recipient would not primarily provide detailed directions and instructions as to the manner in which the services are to be performed Rather, the manner in which the work is done is usually established by the worker using his or her own discretion and judgment -- albeit under a timetable and in stages set by the service recipient according to well-accepted quality assurance procedures and techniques in the industry Also the workers would be considered exempt "professionals".

VI. The IRS Should Have the Burden of Demonstrating That a Worker is a "Leased Employee"

No matter how simple and short the definition of "leased employee" may be, a large amount of discretion is built into it 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

VII Simplify and Reduce the Compensation Level in §414(n)

Three additions should be made to any bill ultimately passed by Congress

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, 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" Third, compensation should include a worker's wages from more than one employer if the worker provided services to multiple employers during any year

A. 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 provides the clients the opportunity to determine such proprietary information about the firms 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

[4] The staff also refers to "nurses" as a class of "leased employee." We note that there are very different types of nurses working in very different types of situations and not every nurse would appear to be a "leased employee."

to require manufacturers to reveal to their customers the mark-up for each product, it is likewise inappropriate for the leased employee laws to require the revelation of similar information by vendors of services to their customers

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 vendor 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, any pension simplification bill should permit sworn statements to be used.

B 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 the Appropriate Threshold

As a supplemental alternative to looking at W-2 compensation for the preceding calendar year, it should be 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 the appropriate threshold 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 the appropriate threshold 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 the appropriate threshold 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 Consider Compensation from Multiple Employers

[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 vendor 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

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, $8,000 from B, and $6,000 from C Total compensation is $62,000, but the worker would still be deemed non-highly compensated because no one recipient has paid the worker over the appropriate amount Any pension simplification bill should include a provision which would allow this worker, if deemed a leased employee, to be considered highly compensated

VIII Provide Specific Code Language or Commentary Explaining That Independent Contractors are Not "Leased Employees"

When proposals to amend §414(n) emerged in 1989, there was a major concern that they 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 Cong 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 a vendor firm -- sometimes called an intermediate "broker" firm in the case of independent contractors -- and the independent contractor is not under the control of that 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 under his or her own direction and control and should not designated 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 any bill enacted by Congress [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 any "control" test is likely to leave many ambiguities and problems, if some type of "control" test is desired, unless Congress adopts a test like that in H R 2641 and carefully defines and explains it, 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' or other vendors. If a legitimate independent contractor provides services to a recipient organization, either directly or through a broker or vendor, then it is very likely that he or she -- and not the service recipient -- primarily directs the manner in which the services are performed. 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 ASSOCIATION OF TEMPORARY SERVICES

Introduction

The National Association of Temporary Services represents approximately 1,000 temporary help service companies with over 7,300 offices throughout the United States. The Association's members account for over 85% of the industry's sales. Temporary help companies provide flexible employment opportunities to millions of American workers. Last year, temporary help companies provided temporary jobs to over 6 million people.

Mr. Chairman, we greatly appreciate your efforts in bringing the important issue of pension simplification to public attention. Our statement today relates to a narrow but significant aspect of the pension laws, namely, the treatment of "leased employees" under section 414(n) and (o) of the Internal Revenue Code. Among the proposals being considered for simplifying the leased employee rules is repeal of the so-called "historically performed" test for determining who is a leased employee. We support that proposal. However, our comments today relate to another part of the leased employee definition [i.e., section (414(n)(2)(B)] which requires an individual to perform services for a recipient for a full year before being considered a leased employee. Clarification of this critical threshold test is necessary because the proposed regulations describing that part of the definition do not, in our view, conform to the statute.

Background

The leased employee rules were first enacted in 1982 as part of the Tax Equity and Fiscal Responsibility Act. The rules primarily were aimed at small, professional corporations that were transferring their lower-paid staff employees to the payroll of employee leasing firms to avoid the pension coverage rules. Section 414(n) was intended to stop this practice by requiring businesses to count leased employees when applying the coverage rules.

Although temporary help companies were not involved in such employee leasing arrangements, section 414(n), as interpreted by the proposed regulations issued in 1987, is so far reaching that it covers virtually all contract services, including temporary help. Moreover, the proposed regulations are so complex that few service firms or their clients can understand them, much less find a practical way to implement them. The result has been increased paperwork, confusion and disruption of the service sector of the economy.

Temporary help companies have been especially hard hit by the leased employee rules because customers have prematurely terminated temporary jobs to avoid complex recordkeeping and the possibility of disqualifying their retirement plans. This has disrupted customer operations, especially on longer-term projects. Examples of such projects include records conversions, protracted litigation requiring supplemental clerical support, construction projects, and phase-outs of business operations, and other longer-term but clearly defined projects where it is impractical and unfair to hire full-time workers only to let them go once the project is completed because there is no ongoing need for their services.

Rather than face the burdens and risks of the leased employee rules, our customers are terminating temporary employee assignments before projects are finished and asking for replacements. This increases administrative costs, is inefficient and results in lower productivity and morale. It is especially hard on our temporary employees because once they are taken off an assignment other comparable assignments may not be available.

Congress Should Clarify That An Individual Must Work At Least A Full Year To Be Considered A "Leased Employee."

To ensure that businesses do not terminate temporary jobs prematurely, they must have a clear understanding of how long an individual may perform services for them without having to be treated as a leased employee. Unfortunately, because the length of service requirements set forth in the proposed regulations differ from the plain language of the statute, businesses are confused on this point and Congress should clarify its intent.

Section 414(n) specifically prescribes the service requirements individuals must meet before they must be treated as leased employees. These requirements were intended to distinguish between abusive and non-abusive uses of third-party employees. Congress imposed leased employee treatment on individuals who perform services for a recipient on a "substantially full-time basis for a period of at least 1 year" [IRS Code section 414(n)(2)(B)]. Significantly, Congress passed over and did not use the well known ERISA "year of service" language which simply requires an individual to work a prescribed number of hours (i.e., 1000) during a 12-month period. Clearly, something more was intended.

Unlike ERISA, the section 414(n) service criteria provide a *two* part test requiring both a minimum level of intensity of work ("substantially full-time", i.e., 1500 hours) plus a *minimum period of service* ("for a period of at least 1 year"). However, the proposed regulations under section 414(n) appear to have eroded the one year part of the test by converting a clear statutory requirement that a person actually work *for* a full year to simply having to work a specified number of hours *during* a year.

For example, under the proposed regulations, suppose an individual works 40 hours per week for a particular recipient on a records conversion project and completes 1500 hours of service in a little over 9 months. Let's assume that the project is over at that point and the individual is assigned to another customer of the temporary help company, or assume that the employee leaves the work force for a period of time, as many temporaries do, to pursue other activities. In either case, assume that 6 months later the individual is reassigned by a temporary help company to perform services for the original recipient. That recipient would have to treat the individual as a leased employee immediately upon his return even though the individual had previously worked for the recipient for only 9 months. As we and others have commented, a regulation that would treat an individual with only 9 months of service as having worked *"for a period of at least 1 year"* is inconsistent with the statute.

Congress required a full year of service specifically to avoid including workers on short term assignments and projects within the scope of the term "leased employee." This view was reaffirmed in the conference report accompanying the 1984 Deficit Reduction Act in which the authority of the Secretary of Treasury to deal with abusive leasing arrangements was held not to extend to the typical use by businesses of temporary help company employees on temporary assignments and projects.

Accordingly, we ask that Congress clarify that before leased employee treatment is imposed an individual must not only perform 1,500 hours or more of service for a recipient but must, as the statute provides, perform such service for a full year. To ensure that the one year rule cannot be abused, a provision should be included requiring "tacking" of an individual's periods of service for a particular recipient unless a reasonable break in service has occurred.

The "De Minimis" Percentage Should Be Increased

In 1986, in response to requests for relief from the burdensome recordkeeping requirements under the leased employee rules, Congress amended the tax code to provide an exemption from recordkeeping for recipients that do not have top-heavy plans and whose use of leased employees is "insignificant" [IRS Code section 414(o)]. "Insignificant" was interpreted to mean less than 5% of a recipient's total non-highly compensated work force covered by a plan.

NATS believes that this *"de minimis"* percentage should be increased in order to allow businesses to maintain normal and customary service relationships with outside parties (temporary help companies are only part of that group) without undue recordkeeping. Accordingly, we strongly support the other business organizations that have suggested that the percentage be increased. NATS believes that 15 percent would be a reasonable rule.

Conclusion

When Congress passed the 1984 Deficit Reduction Act, the conference report dealing with the Treasury Secretary's authority to regulate abusive leasing arrangements under section 414(o) stated that the typical use by businesses of temporary help company employees on temporary projects is not abusive. Consistent with this recognition and the express terms of section 414(n)(2)(B), we ask that Congress confirm that "leased employee" status should not be imposed on any individual unless they have performed services for a recipient for a full year. In addition, we ask that the *"de minimis"* threshold be increased to 15 percent.

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 continued effort to simplify some of these complex and burdensome new rules in the Employee Benefits Simplification and Expansion Act of 1991 ("Bill"). I had the opportunity last session to testify before the Subcommittee on Private Retirement Plans on substantially similar legislation, the Employee Benefits Simplification Act (S. 2901). I am hopeful 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.

[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).

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 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.

[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

The Bill contains an off-Code provision that was included in last session's pension simplification legislation. Section 305 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.

Senator Pryor, in his introductory statement of the Employee Benefits Simplification Act (S. 2901), explained the intent of Section 305 in greater detail:

> "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." [4]

As we testified last year at the hearing on S. 2901, 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."

[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).

[4] 136 Cong. Rec. S10,648 (daily ed. July 26, 1990) (statement of Sen. Pryor).

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 employers 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.

STATEMENT OF THE NATIONAL TECHNICAL SERVICES ASSOCIATION

INTRODUCTION

The National Technical Services Association (NTSA) is a trade association comprised of 125 member companies in the technical services industry which collectively employ more than 300,000 technical employees. The purpose of our statement is to describe the impact of Section 414(n) upon technical services companies and to propose that any legislation that would amend Section 414(n) include a safe harbor which would provide that if the leased employees assigned to a company represent a very small percentage of that company's total workforce, then those leased employees could be disregarded by the company when it tests its qualified employee benefit plans. Such an amendment would be a simple, workable solution to the problem that Section 414(n) has created for technical services companies without diminishing the effectiveness of the leased employee rules to prevent the abusive situations which Congress originally sought to address in its enactment of Section 414(n).

BACKGROUND

Technical services companies recruit and employ skilled personnel such as engineers, designers and drafters to satisfy their customers' temporary needs for such skilled services and assign those personnel to work in their customers' facilities, often under their customers' technical direction. A customer's technical services needs generally arise in connection with new product development, special projects or peak work loads. By using temporary technical personnel, a customer can quickly assemble qualified teams of personnel with just the right technical skills to supplement its own technical staff and satisfy these particular, but temporary, needs.

Technical personnel choose to work on a temporary basis because it gives them the opportunity to work on projects which often involve the development or application of new technology, and because they enjoy the variety of working in different job locations and environments and with different coworkers.

Technical services companies have been servicing their customers since World War II when the industry came into existence in response to the temporary shortages of technical personnel caused by the war. The industry continued to exist and grow after the war because companies recognized that, by using temporary technical personnel, they could staff special projects quickly, with minimum disruption to their regular workforce.

The customer base of the industry today is made up of companies of all sizes and includes the country's leaders in the aerospace, automotive, petrochemical, power, marine, electronics, communications and related industries. Typically, NTSA member companies have been engaged to provide temporary technical personnel to work on significant projects, including the following: aircraft and spacecraft design, ship design, refinery and power plant design, automotive systems design, weapons system design (including many of the systems used in the Persian Gulf war), and many other major technical projects.

An example may best describe how the industry works. When an aircraft manufacturer is going to manufacture a new airplane, it will require the services of a substantial number of engineers and designers in addition to its own staff engineers and designers for the design phase of the project. The manufacturer will contract with one or more technical services companies to assign qualified engineers and designers to supplement its staff capability. These personnel will work at the manufacturer's facility under the technical direction of its supervisory personnel for the duration of the project—which may last approximately one to two years. By using temporary technical personnel, the manufacturer is able to "staff-up" quickly, effectively and efficiently to meet this pronounced but temporary need for additional technical talent and, after the need has been met, to "staff-down" in an orderly fashion without disrupting its regular workforce.

ADVERSE IMPACT OF SECTION 414(N) ON TECHNICAL SERVICES INDUSTRY

The proposed Treasury regulations under Section 414(n) require a customer to take into account temporary personnel in testing the qualified status of its retirement plans if the temporary personnel work at least 1,500 hours for the customer in a twelve-month period. As a result of this requirement, many customers are imposing artificial time limits on their contracts with technical services companies so that none of the temporary personnel work the minimum number of hours to be considered the customers' leased employee. Our customers have told us that they set these artificial time limits not because they are concerned that inclusion of our employees in testing their retirement plans would jeopardize the qualified status of their plans, but because they do not want to undertake the sizable task of gathering and analyzing the employment data necessary to perform the tests.

Rather than incur the wasteful costs and expend the substantial effort involved with this process, many customers with assignments expected to last longer than six months or so simply terminate the assignment of a particular worker long before he or she could be classified as the customer8s leased employee. This practice of arbitrarily terminating assignments short of the leased employee "threshold" rather than allowing them to run their course to project completion creates needless inefficiencies and disruptions for the technical services company, the customer and the technical worker.

PROPOSAL

Unfortunately, although the proposals in the simplification bills to replace the "historically performed" test with a "control" test would provide significant improvement over current law for many employers, they will likely not solve the problem of technical services companies because our technical employees generally do work under the technical control of our customers. Therefore, we urge Congress to include a safe harbor which would provide that if the number of a company's leased employees does not exceed 15% of its common law employees, the company may disregard its leased employees for employee benefit plan purposes. (A copy of suggested statutory language is attached as Exhibit A.) Since the compensation levels of technical services personnel are generally the same as the compensation levels of persons with similar skills working in non-temporary positions, this will generally result in a representative cross section of both nonhighly compensated and highly compensated personnel not being included in the plan testing. This safe harbor is easy to apply because a company would simply calculate 15% of the number of W-2 forms it issued for the previous year to determine if the safe harbor is available.

In many cases, such a safe harbor would work the way the *de minimis* recordkeeping exclusion in the proposed regulations should work, i.e., it would allow companies to conclude, with a high degree of confidence and after doing only minimal data gathering, that their numbers of leased employees fall easily within the safe harbor percentage. In other cases, a company would have to gather data only once. Then, having determined its number of leased employees and having determined that the number is within the safe harbor, the company would not be required again to gather data on its leased employees unless the composition of its workforce changed significantly.

This safe harbor would not undercut the policy objective of Congress in adopting Section 414(n). Major companies employing thousands of workers are prevented by the marketplace and the need to maintain employee morale from engaging in the types of practices that led to the enactment of Section 414(n). Small companies would obtain no practical benefit from attempting to shed only 15% of their employees. Schemes that precipitated Section 414(n) involved (and, indeed, to garner any economic benefit, required) very substantial reductions in the numbers of rank and file workers. Assume, for example, a company that has a total of 20 employees, 15 of whom are nonhighly compensated. Does the employer gain any significant increase in its ability to tilt benefits to the highly compensated by being able to exclude 3 nonhighly compensated workers from the calculation? The only realistic response is in the negative. The practice that Section 414(n) was designed to prevent was a company's "leasing" of all or substantially all of its nonhighly compensated workers. Thus, our proposal does not reduce the effectiveness of Section 414(n) to prevent abusive schemes.

Such a safe harbor would provide technical services customers with practical relief from the burdensome data collection and analysis requirement and eliminate the need for them to place arbitrary time limits on the assignments of their temporary technical personnel. More importantly, the safe harbor would enable technical services companies to make normal business plans based upon the needs of the marketplace rather than as a response to their customers' reactions to the tax laws. Our recommendation is fair to those inappropriately entangled in the leased employee rules and is true to the policy that rejects the practice of leasing workers as a means of defeating the antidiscrimination requirements for tax-qualified plans.

EXHIBIT A

Other rules—Paragraph (6) of section 414(n) is amended by adding the following subparagraph (C) immediately after subparagraph (B):

> (C) Safe Harbor Number of Leased Employees—If the number of leased employees performing services for a recipient does not exceed 15% of the number of the recipient's common law employees, then such leased employees shall not be treated as employees of the recipient.

Effective Date—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION,
Washington, DC, September 27, 1991.

Senator LLOYD BENTSEN, *Chairman,*
Senate Finance Committee,
205 Dirksen Senate Office Building,
Washington, DC.

Dear Chairman Bentsen: I would like to commend you for introducing a pension simplification bill and for holding hearings on this very important issue.

The National Telephone Cooperative Association is a trade association which represents almost 500 small, independent, cooperative and commercial telephone companies in 45 states.

NTCA was founded 37 years ago by a handful of telephone cooperatives to enable them to accomplish together what they could not hope to accomplish individually. The commercial giants of the industry found it economically infeasible to provide telephone service to the most high-cost, sparsely populated regions of America. In response, rural Americans banded together and solved their own problems. They brought the magic of the talking wire to the farms and small towns of America.

The National Telephone Cooperative Association provides a multiple employer pension plan for employees of telephone cooperatives who are members of the association. An unintended flaw under IRS Code Section 415 adversely affects these employees' early retirement benefits. An employee's early retirement benefits are substantially reduced if a telephone cooperative does not qualify as a tax-exempt organization for a particular year.

Internal Revenue Code Section 501(c)(12) provides that a telephone cooperative meeting the requirements of this section is tax-exempt. One of the requirements is that at least 85 percent of the cooperative's income comes from the members of the cooperative for the purpose of meeting losses and expenses. If the cooperative fails to satisfy the 85 percent test, then the cooperative is not tax-exempt for that year. However, the cooperative may be tax-exempt for other years when the 85 percent test is met. Whether the test is met in a particular year depends on a variety of factors. For example, the determination of whether certain income is "member related" is an issue open to different interpretations.

A cooperative's tax exempt status has an impact on the maximum retirement benefits which its employees may receive from a qualified pension plan. Since the enactment of the Tax Reform Act of 1986, different reductions for early retirement apply to plans maintained by tax exempt organizations and to those that are not exempt.

Telephone cooperatives are operated for the mutual benefit of their member-patrons. Consistent with this obligation, members of the cooperatives 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.

Applying different pension limitations based on a cooperative's tax exempt status for a particular year is a poor retirement plan rule. It is not administrable from the plan's viewpoint because neither the amount of early retirement benefits 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.

A reasonable way to solve this technical problem would be to amend the IRS code to make the less restrictive qualified plan limitation available, based on whether the organization continues to be a telephone cooperative, rather than if the 85 percent test is met in a particular year. In addition, under this proposal higher paid employees of telephone cooperatives would remain subject to the strict limitations on nonqualified deferred compensation, Section 457, regardless of their organization's income tax status for a particular year.

This change would allow plan trustees to administer the pension rules with reasonable certainty. It would benefit telephone cooperatives who compete for quality employees with commercial telephone companies, that are usually larger and able to offer stock options and other fringe benefits. This change should not involve any revenue loss and makes sense as a pension policy issue.

Our association would be grateful if you and your committee would consider this proposal as part of your examination of pension simplification.

Sincerely,

MICHAEL E. BRUNNER, *Executive Vice President.*

STATEMENT OF THE PENSION RIGHTS CENTER

The Pension Rights Center is concerned that the "centerpiece" provisions of the Employee Benefits Simplification and Expansion Act would neither simplify *pension* laws nor expand *pension* coverage. Instead, these proposals would exacerbate the already disturbing trend away from pension plans and toward do-it-yourself *savings* arrangements. They would make it easier for higher-paid employees to shelter their savings from taxes in 401(k) plans and Salary Reduction SEPs, thus taking the nation's retirement, tax and economic policies in exactly the wrong direction. Our statement summarizes the basis for our concerns and suggests alternative approaches to achieving greater simplification and expansion of private pension plans.

THE PROPOSALS

The 401(k) Provisions. The 401(k) proposals included in the Employee Benefits Simplification and Expansion Act (S. 1364) reflect the frustration felt by business groups at provisions in current law that tie the amounts higher-paid employees can shelter from taxes in 401(k) plans to the amounts put in by the lower-paid. Even though the rules allow employers a great deal of leeway in structuring their plans to leave out potential non-contributors (for example, rank and file union employees are frequently left out of these plans), it remains difficult for companies to induce enough lower-paid employees to put in amounts that are sufficient to allow the higher-paid to take full advantage of the tax shelter provided by the maximum 401(k) contribution limits—$8,478 for employee contributions and a total of the lesser of $30,000 or 25 percent of pay for combined employee and employer-matching contributions.

The bill's provisions would end the tie between contributions made by the lower and higher-paid if the plan met certain conditions: The company would either have to provide a dollar for dollar match for all employees who could afford to contribute— up to 3 percent of pay (or 50 cents on the dollar for contributions up to 5 percent)—or the company would have to put in a contribution of 3 percent of pay for all of the non-highly-paid employees. Once one of these "safe harbor" requirements was met, all employees would be free to make voluntary contributions up to the ceiling for those contributions, now $8475 a year, and the employer would be free to match those contributions up to 6 percent of pay.

The Salary, Reduction SEP Provisions. The bill—proposes changes in Salary Reduction SEPs. These are simpler versions of 401(k)s that were created by the 1986 Tax Reform Act for companies with 25 or fewer eligible employees. They require almost no paperwork or administrative costs, particularly if the employer adopts the IRS Model Salary Reduction SEP.

Current law provides that employers can only set these plans up if half of their eligible employees put money into the plans and it limits the amount that higher-paid employees can contribute to 125 percent of the average put in by the lower-paid. If the employer uses the IRS Model plan, and 60 percent of the contributions are made by higher-paid employees, then a mandatory 3 percent of pay contribution must be made for all employees.

The bill would eliminate both the requirement that half of all eligible employees contribute and the 125 percent nondiscrimination test, and substitute the bill's proposed 401(k) "safe harbor" rules. It would also increase the—of businesses allowed to have Salary Reduction SEPs from 25 to 100 employees.

We are concerned that both the 401(k) and the Salary Reduction SEP proposals would jeopardize, rather than enhance, retirement income security. At worst, they would give employers an easy out from providing company-paid benefits. At best they would offer token benefits to rank and file workers as a tradeoff for tax breaks for higher earners who don't need them.

The proposals would give employers sponsoring 401(k)s and Salary Reduction SEPs the choice of *either* contributing smaller amounts only for those lower-paid employees who can afford to save for themselves *or* contributing larger amounts, as long as they provided contributions for their lower-paid workers.

Most employers would opt for the first choice since it would allow them to continue what companies find to be the most attractive feature of 401(k)s: *They would only have to make contributions for their favored, better-off employees who could afford to take advantage of these plans.* This option would not only preserve 401(k)s as a cheap alternative (or supplement) to company-paid pension plans, but would also allow the higher-paid to reduce their taxable income by the maximum $8,475 in employee contributions.

The alternative 3 percent minimum contribution safe-harbor is likely to be little used. If used, it would provide very inadequate benefits to the lower-paid, as a trade off for much larger employee and employer-matching contributions for the higher-paid.

For example, using extremely optimistic assumptions—a 4 percent real interest rate over a 40 year worklife, real compensation increasing at a rate of 2 percent a year and an age 65 life expectancy of 20 years—the 3 percent contribution would provide middle income employees, those earning $25,000 a year, annuities of only 13 percent of their final earnings when they retired Social security would provide them with roughly 36 percent of their preretirement incomes, giving them a total replacement rate of 49 percent, *less than half of their preretirement incomes.* According to experts, they would need at least 30 percent more to live modestly in retirement—an additional $7,500 a year!

THE PENSION COSTS OF THE PROPOSALS

Enactment of these proposals would not only provide little or nothing through savings plans for most working Americans, it could also result in the loss by many employees of all or part of the protection previously provided to them by company-paid pension plans.

In the decade since the advent of 401(k) plans, this country has experienced a dramatic reduction in the percentage of people participating in company-paid private retirement plans. According to the Social Security Administration, in 1988 only 39 percent of full-time workers participated in company-paid plans, contrasted with nearly 48 percent in 1983. At the same time overall private retirement plan participation has remained roughly constant. (46 percent of the full-time private sector work force participated in private retirement plans in 1988, and 48 percent participated in 1983.)

A recent study by the Pension Benefit Guaranty Corporation suggested that the shift away from company-paid plans among small companies may be traceable almost entirely to a preference for 401(k)s. Certainly, the growth of 401(k)s among small businesses has been phenomenal. They have been enthusiastically embraced by employers eager to shed the burden of paying for their workers' retirement and by middle and upper income employees delighted to find a too-good-to-be-true tax shelter for their savings.

Workers in larger companies have also been adversely affected by 401(k)s. While these companies have generally continued their company-paid plans, they have stopped improving those plans. Instead, they are funneling retirement dollars into the 401(k)s as matching contributions for those employees financially able to contribute to these supplemental plans.

Employers have jettisoned or effectively frozen their company-paid plans because 401(k)s cost less than company-paid plans. Instead of making retirement contributions for all employees, the employer only contributes (if at all) for those employees who can afford to save for themselves.

The overall cutbacks in employer contributions go unnoticed by most employees. Younger workers in particular are happy to have the tax breaks provided by 401(k)s, and access to their money for certain housing, education and medical expenses. Most important, they like the fact that they can cash out their 401(k) money when they change jobs.

While loss of company-paid pension plans would not be a matter of concern if all workers could be assured adequate benefits from 401(k)s, the available evidence suggests that the benefits of these plans are going disproportionately to better-off employees who are merely shifting money they would save anyway to these tax sheltered plans. For example:

- Fewer than one out of ten private sector workers with annual earnings under $25,000 put money into these plans in 1988; whereas nearly a third of those earning $25,000 or more contributed.
- Employee contributions for those earning under $25,000 were only one-fifth of the total $19 billion contributed to 401(k)s. Four-fifths of this amount was contributed by those earing above $25,000.

These statistics reflect the reality that most working Americans are not "yuppies" looking for tax breaks. Instead, they live from paycheck to paycheck wondering how they are going to pay their bills. Half of those workers now going into retirement, a far more frugal generation than their children, have a *total* of $10,000 in individual savings, other than their house and car (or twice that amount if they are married) to add to their social security payments averaging $7,224 a year. These retirees simply did not have the extra money to save voluntarily for retirement.

THE REVENUE COSTS OF THE PROPOSALS

While the proposals to expand 401(k)s would have its most direct impact on retirement income policy, it would also affect tax policy. We find it truly astonishing that at a time of acute concern with the federal budget deficit, that there are no figures on how much 401(k)s are costing the Treasury in lost revenue. This cost, which must be tremendous, would increase significantly if these proposals were enacted and would be born by all taxpayers, either through higher taxes or lower government entitlement or services. From a tax policy perspective this would not be justified unless 401(k)s, as modified by these proposals, would provide a meaningful supplement to social security payments for most rank and file workers, rather than merely providing tax breaks for people who do not need incentives to encourage them to save for themselves.

THE PRODUCTIVITY COSTS OF THE PROPOSALS

We are also concerned that 401(k)s may be producing a net reduction in long-term saving. To the extent that employers are terminating company-paid plans in order to set up these cheaper savings plans, and if 401(k) plan assets are being invested, as the data suggests, much more conservatively than company-paid plans and for shelter periods, they could have a negative impact on productivity. Since the $2 trillion in private retirement plans represents this country's largest single source of private investment capital and accounts for nearly half of the nation's personal savings, the shift to 401(k)s could negatively affect economic policy.

DO-IT-YOURSELF SAVINGS PLANS ARE NOT THE ONLY ALTERNATIVE

The business groups that are seeking enactment of the expanded savings plan proposals argue that "something is better than nothing." They contend that pension rules have become so complex that employers are not setting up company-paid pension plans, and they cite IRS statistics showing that the number of plans being terminated far exceeds the number being created. They assert that the reason for these statistics is the "complexity" of current pension regulations.

The IRS statistics. Pension laws and regulations are unquestionably complex and many companies have terminated plans, but the IRS statistics deserve scrutiny before conclusions are drawn from them. There may also be a number other explanations for these statistics.

On the formation side: The 1990 statistics show that 13,321 plans covering more than 4 million participants were qualified. Is it possible that the relatively small number of plan qualifications is attributable to the fact that companies have delayed seeking approval of their plans until the Tax Reform Act regulations were in final form? Did companies establish plans under master and prototype agreements that do not require individual IRS approval? How many IRS Model SEPs were established that did not have to be qualified?

On the termination side, the statistics show that 30,383 plans were terminated. They do not show the number of affected participants. How many were terminations of "one-man" plans or other small plans that were set up only to benefit company owners and were not meant to survive reforms targeted at tax shelter plans? How many were sham terminations solely for the purpose of taking so-called "surplus" money out of the plan? How many were terminations solely as the result of a merger, or of a company closing, or the retirement of a company owner? *Most important, how many were terminations for the purpose of setting up a less expensive 401(k) savings plan?*

Compliance with complex regulations is not a requirement of setting up or maintaining all pension plans. If employers are willing to have plans that cover all of their employees, provide all employees the same percentage of pay (in benefits or contributions), and pay benefits in the form of annuities, there is no need for the employers even to read the most complicated rules.

It is only if they want to exclude more than 30 percent of their workforce from a plan, provide a much greater percentage of pay to higher paid, older or longer service workers, and pay benefits in the form of lump sums, that the hundreds of pages of coverage, participation, permitted disparity, backloading and distribution rules must be followed. They tell exactly where the lines between permissible and impermissible plan provisions must be drawn. A great many employers find that the "flexibility" and dollar-and-cents gains they can achieve by complying with the rules far outweigh the costs.

ALTERNATIVES TO THE PROPOSALS

There are alternatives that would achieve far greater simplification and coverage than the measures proposed in this legislation

Alternatives That Would Encourage More Small Businesses to Set Up Company-paid Pension Plans. We are convinced that pension coverage can be expanded if employers consider it to be in their self-interest to adopt plans, *if* employees are wiling to forego current pay in exchange for income at retirement and, possibly most important, *if* there are one or more institutions with an economic stake in marketing the need for pension plans to employers and employees.

Up until now it has been widely assumed that small business owners will only set up pension plans if they can use a pension plan to reward themselves at little expense, and as a management tool to attract new employees, to encourage employees to stay with an employer and to induce older employees to retire when they are no longer considered to be productive. The "employee retention power" of pensions is claimed to be particularly important to small basses.

Although this is certainly the basis on which many plans are sold to businesses, few employers would independently think of using a pension plan to reward one employee at the expense of another. Most are shocked to learn that they can legally exclude from a plan a bookkeeper who has worked for them for 20 years, or that they can reduce the already small benefit of a receptionist by subtracting part of her social security benefits from her pension. They are also amazed to discover that the benefit earned by an employee who leaves the plan in her forties only needs to be one-third the amount of the benefit of an employee with the same salary who has worked for the same period of time but leaves in his sixties. These options are presented to employers by plan consultants, who assure them that "everyone does it."

We think that if small business owners were made aware that their workers need pensions—that social security will provide them with considerably less than the minimum wage, and that those workers cannot realistically be expected to have enough income from savings to last them through their retirement years—employers might consider allocating a portion of the wage package to retirement.

Of course, in small businesses the close relationship of workers and employer means that the employer can ordinarily only get away with reducing workers' pay (or more likely, allocating a portion of future pay increases to retirement) if the employees are convinced that they will be better off as a result. This may not be difficult. While some workers expect to win the lottery (or be run over by a truck) before retirement, most do not want to contemplate the future as a bag lady, or her male equivalent. We suggest that the elements to build on are already present in the IRS Model SEP Form 5305. This "paternalistic" SEP is eight years older than the Salary Reduction SEP. It is completely company-paid, with no contributions from employees. It is appealing to employers because they are only required to fill in five blank spaces on a preprinted form which does not have to be filed with the government. There are no complex calculations. The employer simply makes contributions based on the same percentage of pay for all employees who have worked more than three years. There is no requirement that the contribution be the same each year and, more attractive still, no contributions need to be made in years that the employer cannot afford them.

There are minor changes that could be made in existing law that would make the paternalistic SEP more attractive to employers. The most important would change the current requirement that contributions be made for employees who earn more than $363 a year (and have worked more than three years) to a rule requiring contributions only if an employee worked 750 hours within a year. Another would "lock in" contributions until retirement age, death or disability.

There are also new incentives that could be added. An important change would be to recognize that many employers start plans after they have worked for a company for many years and to allow a recognition of this "past service" by allowing an increase in the current $30,000 or 15 percent of pay ceiling on SEP contributions. Employers maintaining IRS Model SEPs might be allowed to contribute—amount in excess of $30,000 a year during a period of years equal to the number of years they had worked for the company before the plan started. Also, a modest five-year phasing out tax credit might encourage profitable companies to set up these plans.

Employees already like SEPs. They like the fact that the money is immediately vested, and that they can direct which financial institution invests it. They would like SEPs even better if these plans offered joint and survivor protection, were federally insured, and offered employees periodic estimates of their likely benefits at retirement age.

While SEPs are not yet widely used—the most recent survey shows that only one percent of employees in businesses with fewer than 100 employees were participating in SEPs—they have also not been widely promoted. As far as we know,the entire promotion of SEPs has consisted of one joint Labor Department-Small Business Administration press conference televised by the Chamber of Commerce, a very few articles and, possibly, an occasional speech. Yet despite this, the demand for a booklet on SEPs was greater than that for any publication in the history of the Small Business Administration, and at one point last year that booklet was No. 14 on the Government Printing Office's "Best Sellers List." Small business owners who discover SEPs almost always set them up.

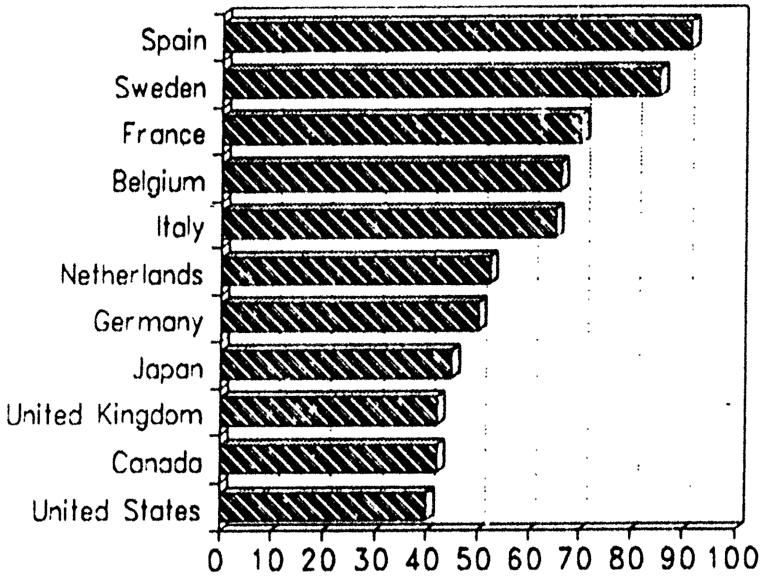
We are convinced that pension coverage can be expanded if there is one or more institution with an economic interest in "selling" pension plans to small businesses.

Savings Bond SEPs. We suggest that the most efficient way to promote pension coverage among small businesses may be for the federal government to issue U.S. Retirement Plan Bonds for IRS Model SEPs. This is because merely by advertising the availability of these bonds (as it does for other types of savings bonds) the government could assure widespread awareness both of the importance of pensions as a necessary supplement to social security and the existence of SEPs. All that would be required would be a small change in the law to reinstate a provision in the Internal Revenue Code (deleted in 1982) authoring the issuance of U.S. Retirement Plan Bonds for Savings Bond SEPs.

Small Business Retirement Funds. A private sector approach would be to encourage the establishment of Small Business Retirement Funds, that is, private, for-profit, regionally-oriented financial institutions. These institutions would be federally chartered, regulated and insured, and would market company-paid, fair pension plans to small businesses. Conceivably, once these funds were well underway, they might be able to make a small percentage of their assets available as loans to contributing small employers seeking capital to expand their businesses.

Other Alternatives. Needless to say, if satisfactory incentives cannot be devised, there will be no alternative but to move to a compulsory scheme, whether through the kind of private mandatory system proposed by Congressman Sam Gibbons' Pension Coverage and Portability Improvement Act (H.R. 2390) or an expanded social security system. It is important to note in this connection that all other for industrialized countries place a greater reliance on compulsory programs (both public and private) than we do. According to a Labor Department study, even Japan, which is often referred to as a country that relies heavily on voluntary savings, has a social security type mandated program that provides the average worker who works a lifetime with at least half of his or her preretirement income. Apparently, "paternalism" is viewed in other countries as "realism" when it comes to providing for the elderly.

Estimated replacement rates from compulsory retirement income programs of major industrialized countries for average full-career factory workers.



Adapted by the Pension Rights Center from: Retirement Income Throughout the World. TPF & C 1990, Towers Perrin Co.

Statement of the Profit Sharing Council of America

Founded in 1947, the Profit Sharing Council of America (PSCA) is a national nonprofit association of approximately 1,200 companies that represents the interests of profit sharing and 401(k) plan sponsors and participants. Member companies engage in every type of business activity and range in size from family-owned fledgling enterprises to Fortune 100 companies. PSCA members sponsor defined contribution plans and a substantial number, including a majority of larger members, sponsor 401(k) plans.

PSCA supports a number of the simplification provisions contained in S. 1364. However, PSCA opposes the elimination of the 5 year averaging for retirement lump sum distributions. Over the long run, 5 year averaging is just as important as 10 year averaging. PSCA also opposes the mandatory transfer of pre-retirement distributions over $500 into IRAs or subsequent employer plans. If these provisions are included in S. 1364, PSCA must oppose the legislation even if this means that other worthy changes cannot be enacted.

We are witnessing an erosion in the use of qualified retirement plans, including defined contribution plans, especially among smaller companies. This erosion results principally from the reduction of economic advantages to companies and participants caused by revenue-raising over-regulation of the qualified retirement plan system. For example, within the last several weeks, the IRS has issued over 600 pages of technical regulations governing participation in qualified retirement plans. Such complicated regulations and reductions in benefits possibly could be defended by some as merely reducing benefits for highly compensated participants. However, S. 1364 contains provisions which would reduce benefits for lower-paid, non-highly compensated workers and impose unnecessary complication on the qualified plan system. Further elimination or reduction of benefits and additional complexity must not be enacted.

THE REPEAL OF 5 YEAR AVERAGING

The repeal of 5 year averaging will eliminate the benefits of income deferral for lower paid participants if they do not choose to retain their retirement lump sums in deferred status. This will diminish voluntary plan participation. Further, the repeal of 5 year averaging is unnecessary as nearly two-thirds of plan participants currently are deferring retirement lump sums—87% of lump sums of $50,—or more—according to a recent Gallup Organization surveys.[1]

The repeal of 5 year averaging would, in effect, treat amounts accumulated over entire working careers as ordinary income in the year they are received. This is unfair. It is inequitable to subject such "bunched" income to the highest marginal tax brackets in the year of retirement. This lump sum represents a major part of an employee's savings for his or her retirement security.

The Joint Committee Staff paper prepared last year argues that averaging is unjustified because tax rates no longer are as graduated as they once were. While the graduation in rates has been reduced, it has not been eliminated. In fact, the 1990 Budget Reconciliation Act actually increased the graduation in rates. Since then there has been further agitation for increasing the graduation even more. Thus, it still is important to maintain tax relief from the effect of "bunching."

It is argued that employees can roll over their lump sums into IRAs and thus protect themselves against immediate high taxes. However, in many cases, this is impractical because of IRA maintenance fees and other costs. These fees can be particularly burdensome in the case of smaller amounts. Further, there is less investment flexibility with a small account, making it less financially attractive to roll over a smaller distribution. Finally, rolling distributions into IRAs does not necessarily protect participants from the bunching effect. Distributions could be taxed at the highest rate whenever participants withdraw more than a modest amount from their IRAs and they would be subject to the 15% excise tax on amounts withdrawn in excess of $150,000 in any one year.

As the table below shows, without averaging, lower-paid workers who defer income are not acting in their best interest unless they are certain that withdrawals of deferred income and earnings will be taken over time or that accumulations will be deferred over a very long period, maximizing the value of compounding. Indeed, without the availability of averaging, older lower-paid workers saving for lump-sum

[1] The Gallup Organization survey, commissioned by the Profit Sharing Research Foundation, was conducted by interviewing 13,022 Americans aged 18 and older across the continental United States by telephone from randomly generated telephone lists. Of this group, 327 people qualified for the questions regarding lump sum distributions.

purchases such as retirement homes would be well advised to invest outside the qualified-plan system. This is especially true if they invest in equities, as normal capital gains are not taxed until the gain is realized and receive preferential treatment (currently at a maximum 28% rate).

Table 1.—ACCUMULATIONS AFTER APPLYING NORMAL TAXATION TO QUALIFIED PLAN LUMP SUM DISTRIBUTIONS COMPARED TO AMOUNTS ACCUMULATED OUTSIDE A QUALIFIED PLAN [1]

Years of participation	Qualified plan accumulation before taxes	Qualified plan accumulation after lump sum taxation—no averaging	Regular investment accumulation
10	$26,502	$19,081	$20,120
20	100,383	72,276	71,617
30	287,036	206,666	191,655

[1] The table assumes: 8% earnings on 6% savings of an initial salary of $25,000, with 5% annual salary increases, continued indexing of the income tax tables; and a 28% tax on the indicated retirement lump sums.

Note: The table does not apply the 15% excise tax to balances over $150,000, which also is proposed.

Proponents arguing for the repeal of 5 year averaging suggest that the qualified plan system is being abused because retirement lump sums are spent frivolously by recipients. This is not true and it is important to understand why lump sum distributions are necessary and desirable.

A primary objective of a profit sharing or 401(k) plan is to provide an accumulation of retirement capital and not necessarily to provide payments in a fixed-income stream. This capital allows retired employees to maintain the flexibility to meet changing conditions during retirement and to protect against inflation. They may want to purchase new homes, pay off mortgages, make investments, or pay for their children's education. In addition, lump sums give retirees a capital sum to invest. Further, since employees are the beneficial owners of their accounts and assume the risks of ownership all through their working careers, including the risk of investment losses, they should have the right to choose lump 'sum distributions.

In addition, a recent Gallup Organization survey has found that a substantial majority of those eligible are deferring their retirement lump sums. The findings of that survey are summarized in Table 2.

Table 2.—PERCENTAGE OF RETIREES DEFERRING ALL OF THEIR LUMP SUM DISTRIBUTIONS BY SIZE OF DISTRIBUTION

Size of Lump Sum	Percentage of Those 55+ Years Old Deferring All Their Lump Sum Distribution
Less than $3,500	56.3
$3,500–$10,000	56.3
$10,000–$50,000	60.6
$50,000+	87.0
All	65.9

The maximum expected error range at the 95% confidence level for a sample size of 327 is +/−5.5%.

It is critical to understand that the proposed elimination of 5 year averaging strikes at the very core of 401(k) plans. Plan sponsors are finding that each narrowing of 401(k) benefits has made it harder for them to maintain lower-paid participation in their plans. For example, in the early days of 401(k), the lower-paid did not have to pay Social Security taxes on deferrals. Today the lower-paid can access 401(k) funds before retirement only for government-prescribed reasons and at the cost of an extraordinary penalty tax.

The availability of special averaging helps make defined contribution plans attractive to younger and lower-paid employees. Employees want the choice of a lump sum distribution. 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 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 when it will be taxed at a higher rate.

APPLICATION OF THE 15% EXCISE TAX TO DISTRIBUTIONS AS SMALL AS $150,000

The only argument in favor of applying the 15% excise tax on distributions to amounts as small as $150,000 is that such a change would ensure that larger retirement lump sums are maintained in deferred status. It is true that such a tax would "force" that result. However, it would do so at a great cost.

Sections 415 and 401(k) limit the contributions paid into profit sharing and 401(k) plans on behalf of participants. Thus, the 15% excess distribution penalty on amounts over $750,000 is a tax primarily on investment gains. Already this tax is unfair in that gains accumulated within a qualified plan are taxed at a much higher rate than those accumulated outside the qualified plan system. Lowering the threshold to $150,000 will subject deferred income to the excise tax as well. This is grossly unfair. It is also unfair that this change will apply the excise distribution tax to plan earnings of the lower-paid.

The ability to avoid the excise tax if lump sums are retained in deferred status is not sufficient to prevent a substantial lowering of participation in defined contribution plans. No worker with a lump sum objective will defer income into a qualified plan if threatened with such a tax. To avoid this tax, workers also will pressure employers to pay cash rather than defer profit sharing distributions.

PRE-RETIREMENT ROLLOVERS INTO IRAS OR SUBSEQUENT EMPLOYER PLANS

S. 1364 includes a provision which would require that all pre-retirement distributions of $500 or more be transferred directly (trustee-to-trustee) into the plans of subsequent employers or into IRAs.

The purpose of this proposal is to protect two groups of terminating employees: those who might inadvertently violate the requirement that distributions must be rolled over within 60 days to preserve their deferred status; and those who do not understand that taking pre-retirement distributions into current income subjects them to a 10% excise tax in addition to regular income tax. Advocates of the proposals also hope to increase pre-retirement rollovers by imposing a barrier of administrative complexity between terminating employees and their distributions.

This proposal is not needed. Nearly all employees eligible for a pre-retirement distribution intend the result of their distribution choice. Those who accidentally do not roll over within the sixty day period or who, misunderstanding the tax laws, take a distribution into current income are only a tiny fraction of those eligible for pre-retirement distributions. Companies already are required by law to inform terminating participants of the laws governing the taxation of their distributions. Further, contrary to current belief, a majority of pre-retirees choose to retain their distributions in deferred status. Those who do not roll over generally are those with very small distributions. Table 3 shows the deferral rate of termination lump sums found by the previously mentioned Gallup Organization survey.

Table 3.—PERCENTAGE OF PRE-RETIREES DEFERRING ALL OF THEIR LUMP SUM DISTRIBUTIONS BY SIZE OF DISTRIBUTION

Size of Lump Sum	Percentage of Those Under 55 Years Old Deferring All Their Lump Sum Distributions
Less Than $3,500	40.8
$3,500–$10,000	60.3
$10,000+	82.9
All	55.0

On the other hand, implementation of the requirement that all pre-retirement distributions must be rolled over into IRAs or subsequent employer plans would not be a simple process. For example, it will often be difficult to obtain from terminating employees the precise information necessary to make plan-to-plan or plan-to-IRA transfers.

It is this type of increasing administrative burden that is discouraging plan formation and encouraging plan termination by smaller employers. Small employers, especially those with less than 100 employees, cannot afford to hire full-time benefits expertise. Many will not be able to administer the complexities required by these proposals without expensive help from the outside.

Consider the case of two employees who have just been terminated for fighting on the plant floor of a small company. It is not reasonable to expect the person doing the termination to know, or know how, to explain to the participants that they must open IRAs and then contact their "former" employer with the information necessary for a transfer of their qualified plan distribution.

Some envision that plan sponsors will be able to establish a rollover IRA at a local bank or other trustee as the "default" option in the event no specific direction is received from the terminating participant. This is not a practical or legally sound solution. For example, no bank or other service provider will accept a mandatory rollover unless the terminating employee actually signs the papers opening the account. Were they to do so, without the employee's authorization, they would assume substantial fiduciary liability. The only practical default solution will be to retain undirected distributions in the current plan. This will impose additional record keeping and communications costs which will discourage plans in smaller companies, where trustee fees and record keeping costs exceed $100 per participant.

Proponents of the mandatory transfer of pre-retirement distributions into IRAs or other qualified plans also suggest that this requirement will in no way affect an employee's ability to withdraw those funds from the IRA after the transfer. That is not true. Banks, insurance companies and other IRA vendors will resist the practice whereby terminating participants roll their pre-retirement distributions through an IRA vendor to get the cash. IRA vendors will refuse to take small rollovers, forcing companies to keep them, or they will provide that rollovers cannot be withdrawn until after an extended period or they will impose their own substantial withdrawal penalties. This change will result in substantially more pre-retirement deferrals. This will substantially decrease government revenue and reduce plan participation as some younger employees will not participate in plans where they do not have access to their money.

Finally, it makes little sense to force recipients to hold small amounts in deferred status where fees are required for investment management and when inflation may exceed the earnings on the money. This conclusion is supported by a study sponsored by the Department of Labor which concluded that "mandatory roll-over of such small funds (under $3,500) into an IRA or another plan would have only marginal effect." It is critical that plans continue to be able to pay pre-retirement accumulations of less than $3,500 directly to participants.

EXPANDED ACCESS TO RETIREMENT BENEFITS

PSCA members are pleased that expanding participation in the voluntary qualified plan retirement system has become a legislative priority. PSCA has long been concerned that there has been too much emphasis on regulation and revenue raising and almost no effort to develop strategies to bring the benefits provided by qualified plans to more Americans.

However, PSCA members, many of which are small employers, do not believe that the proposals in S. 1364 will result in significant new plan formation in small companies.

S. 1364 offers small employers less complex administrative regulation in exchange for what is basically a simplified money purchase plan. This approach does not address the reality in which most small businesses operate. Nearly all small companies are run by owner-managers who personally incur the costs required to fund and administer qualified plans, costs that reduce their profits.

Trading a lower cost commitment to administer a plan for a higher cost commitment in guaranteed benefits does not alter the bottom line for company owner-managers and will not result in new plan formation. In addition, most small employers do not have stable, controllable cash flows. It is dangerous to the survival of their companies for managers to make long term commitments which cannot be adjusted to reflect current income situations.

There is a solution. Deferred profit sharing meets every criterion necessary for successful small company qualified plans. The laws governing deferred profit sharing for small employers should be changed so that the current complexity and expense are reduced to reasonable levels.

Also, the master and prototype plan system should be allowed to operate efficiently. Many more small companies would establish deferred profit sharing and 401(k) plans if the master and prototype plan system was working as originally envisioned. This system allows employers to establish qualified plans in which most of the paperwork is done by plan providers. Unfortunately, it is time consuming and expensive to obtain qualification for master and prototype plans. Also, some who market these plans do not adequately support the small business owner in establishing or operating a plan once the sale is made. PSCA understands that the IRS may be looking at ways to improve the master and prototype plan system. PSCA supports such efforts.

SUMMARY

In summary, there are simplification changes which PSCA supports. Several are included in S. 1364. However, PSCA must oppose proposals which would include further increases in the complexity of plan administration and which would subject plan participants to unfair taxation. Also, while well intentioned, the proposals to encourage small company plan formation will not work. In fact, as presented, S. 1364 in its totality actually will discourage small plan formation and may even result in more small plan terminations.

Statement of the Retail Tax Committee of Common Interest

This statement represents the views of the Retail Tax Committee of Common Interest with respect to certain provisions of S. 1364. The Retail Tax Committee is an organization of large retailers, including Carter Hawley Hale, The Gap, J.C. Penney Company, Inc., The Limited, Inc., Melville Corporation, P.A. Bergner & Co., R.H. Macy & Co., Inc., Sears, Roebuck and Co., and Tandy Corporation. These companies have a total of over 400,000 employees who are participants in profit-sharing plans, Section 401(k) plans, or ESOPs. These employees have a very significant interest in the tax treatment of lump-sum distributions; and on their behalf, we strongly urge that there be no changes in the present tax treatment of lump-sum distributions. We also urge that the current definition of highly compensated employee not be changed in a manner which is detrimental to middle management employees of these companies.

There are three major provisions under present law which are of importance to the Retail Tax Committee companies. These are:

Five-Year Averaging

While the Tax Reform Act of 1986 (the "1986 Act") eliminated the use of 10-year forward averaging, it contained a new provision allowing 5-year forward averaging treatment on lump-sum distributions. This special treatment is available only on distributions made after age 59½ and can be elected only once in a lifetime.

Excise Tax on Lump-Sum Distributions

Under present law, if a distribution in a calendar year exceeds $150,000, an excise tax of 15% is imposed on the portion of the distribution in excess of $150,000. If the distribution is a lump-sum distribution, and special averaging treatment is elected, the excise tax is imposed on the amount which exceeds $750,000 (i.e., five times the $150,000 annual limitation).

Definition of Highly Compensated Employee

Present law contains a multi-part definition of "highly compensated employee." Many employers have designed their qualified plans around the current definition. The proposed changes in the current definition will result in significant costs to large employers while also having a detrimental impact on their middle management employees.

PROPOSED CHANGES IN TAX TREATMENT OF LUMP-SUM DISTRIBUTIONS AND DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

In brief, S. 1364 would change the tax treatment of lump-sum distributions by eliminating both 5-year forward averaging and the higher ($750,000) exemption available to some lump-sum distributions for purposes of calculating the 15% excise tax. As regards the definition of highly compensated employee, S. 1364 would modify significantly that piece of the existing definition relating to compensation levels.

RTC POSITION ON PROPOSED CHANGES

For the reasons outlined below, the existing rules regarding the taxation of lump-sum distributions and the current definition of highly compensated employee should be retained.

Five-Year Forward Averaging

Five-year averaging should be retained. Both fairness, and the need to provide incentives for long-term savings, are sound reasons for allowing averaging of lump-sum distributions. A lump-sum distribution represents "bunched" income accumulated over an employee's working career and in many cases represents the largest single distribution of income to these individuals during their lifetime. It would be inequitable to subject such income to the highest marginal tax brackets in the year of retirement. The Joint Committee Staff paper, dated April 20, 1990, argues against averaging on the grounds that current tax rates are less graduated than they were in the past. It is true that the graduation in personal tax rates has been reduced from the early 1980's, however it has not been altered since the enactment of the 1986 Act which created 5-year averaging. In fact, the 1990 Budget Reconciliation Act actually increased the graduation in rates. In addition, the repeal of 5-year averaging would create disincentives for workers to save. If an employee knows that his or her savings will be taxed away at a high marginal rate in a single future year, he or she is less likely to make significant contributions. Thus, both as an incentive to savings and for reasons of fairness, relief from the "bunching" of income in lump-sum distributions is still necessary.

Finally, because it is a once-in-a-lifetime event, the elimination of 5-year averaging will contribute very little to simplification.

Excise Tax on Excess Distributions

The special $750,000 (i.e., 5 x $150,000 as indexed) exemption applicable to certain lump-sum distributions for purposes of calculating the 15% tax on excess distributions should be retained even if the current law averaging provisions are repealed. As stated above, a lump-sum distribution represents income accumulated over an employee's career. Many long-service employees, even those not considered "highly compensated," may accumulate amounts significantly in excess of $150,000. The 15% tax , added by the 1986 Act, was specifically intended to target highly compensated employees who are able to accumulate very large retirement amounts on a tax-favored basis. The elimination of this special ceiling could, however, dramatically impáct rank-and-file employees who have spent years setting aside funds to provide for their retirement. The proposed change would penalize those employees who, through the good investment experience of their respective retirement plans, have accumulated retirement benefits in excess of $150,000.

Elimination of this special exemption would do nothing to simplify an already overly complex provision of the Code. Should retention of the 5x multiple be deemed excessive, a higher exemption amount should be established for employees who desire a lump-sum settlement.

Definition of Highly Compensated Employee

Employers should have the option of using either the proposed definition or the current definition of "highly compensated employee," including that portion which contains the "top-paid" group rule. Congress generally concluded in the 1986 Act that individuals earning less than $50,000 indexed should be considered highly compensated only if they were in the top 20% by pay of all employees. While it might now be considered "simplest" to eliminate the need to determine a top-paid group, it is inappropriate to penalize those employers who have designed qualified retirement plans around such a definition. Many large employers have designed their Section 401(k) and Section 401(m) discrimination testing around this definition. If this definition is changed, such a change would result in middle management employees who barely fit into the proposed definition of highly compensated employee having their ability to save for retirement further restricted. Encouraging savings for retirement through 401(k) and 401(m) plans should be a Congressional priority. This goal should not be set aside in the name of pension simplification. Although a change in this definition would result in simplification for certain taxpayers, we believe that its use should be made optional so as not to penalize those plans designed to qualify under the existing definition.

ROLLOVER INTO AN IRA IS NOT THE ANSWER IN ALL CASES

It is sometimes argued that employees could avoid the proposed high tax on lump-sum distributions by rolling them into an IRA. While this argument may have validity in some cases, there are many situations in which it is not a good answer. For example, where employer stock is distributed in kind, or in the case of relatively small distributions, the fees charged by institutions to handle IRA's may be a factor in deciding not to roll over. Further, if employer stock is rolled over into an IRA, its full market value will be taxed as ordinary income when it is later distributed. In other cases, employees who had planned to use their lump-sum distributions for major post-retirement activities, such as paying off an existing mortgage, buying a retirement home and/or opening a small business could be deterred by the significant penalties on IRA's. It is argued that IRA rollovers must be encouraged to prevent employees from "squandering" their savings. But this argument, especially in the case of defined contribution plans such as profit-sharing plans, Section 401(k) plans, and ESOPs (as contrasted with a defined benefit plan), where each employee has his own account, is not rational. The investments made for and by the employee are carried in that account, as are earnings on those investments. Further, the employee gets the benefit of any appreciation and takes the risk of any depreciation in those investments over his working career. It is not logical to assume that an employee, who has been trusted for years to manage the size and manner of his savings investments, cannot be trusted to manage those same funds upon retirement other than through an IRA. There is simply no legitimate policy reason to require the employee, who has been the true owner of his account over the years, to roll the account into an IRA.

Additionally, unless an employee does not withdraw a major portion of the assets rolled into an IRA for a number of years, his overall tax burden is likely to be greater under a rollover than the tax incurred under the averaging provisions of current law.

It is clear that if the proposals discussed herein are enacted into law they will force employees, even those with small distributions, to roll over their distributions whether they want to or not, so as to avoid confiscation of a significant portion of their accounts. It has been argued that these changes would not result in a revenue loss; however, the delay in taxation on significant numbers of distributions would definitely result in a revenue loss in the near term. While amounts distributed out of an IRA are fully taxable, these distributions would be made at far later times than would be the case with taxable lump-sum distributions under present law.

CONCLUSION

In summary, we commend the Senate Finance Committee for addressing the issues of pension simplification. The proposals provide some benefit in some areas of pension law. However, the expansion of the 15% excise tax, the elimination of 5-year averaging, and the failure to offer as optional the use of the present definition of "Highly Compensated Employee" more than offset the inclusion of other provisions which we believe do benefit the pension area. Because of this result, the Retail Tax Committee of Common Interest cannot support the legislation as currently proposed.

STATEMENT OF SEARS, ROEBUCK AND CO.

Sears, Roebuck and Co. is filing this statement to provide comments on various pension access and simplification proposals. We request that this written statement be included as part of the printed record of the hearing before the Subcommittee on Private Retirement Plans of the Senate Finance Committee.

Our views are primarily directed to certain provisions contained in the "Employee Benefits Simplification and Expansion Bill of 1991" (S. 1364 introduced by Senate Finance Committee Chairmen Bentsen on June 25, 1991). However, because certain provisions in the Administration's "Pension Opportunities for Workers' Expanded Retirement" (POWER) proposal and in other bills which have been introduced in the House of Representatives (particularly H.R. 2730 introduced by Congressman Dan Rostenkowski) contain even more onerous provisions adversely affecting the tax treatment of lump sum distributions from qualified plans, we are presenting herein our views with respect to each of the various provisions which we strongly believe will have an impact on the retirement security of Sears employees.

We are very appreciative of the fact that S. 1364 has preserved 5-year averaging, 10-year averaging and capital gain treatment (for pre-1974 accumulations) with respect to individuals who had attained age 50 before January 1, 1986. We also note that S. 1364 recognizes the fairness of continuing the deferral of tax on unrealized appreciation in employer securities distributed from a qualified plan.

However, S. 1364, as currently drafted, does repeal 5-year averaging for all individuals (other than those who had attained age 50 before January 1, 1986), and also repeals the special "5 times" rule for purposes of the 15% excise tax on large lump sum distributions. We strongly urge that these two provisions in S. 1364 not be enacted. In addition, we strongly urge the Senate Finance Subcommittee on Taxation to reject the provisions of the Administration's POWER proposal which advocates the repeal of (i) the grandfather clause allowing people now nearing retirement to use either 5-year or 10-year forward averaging and (ii) the present law rule allowing individuals to exclude net unrealized appreciation in employer securities distributed from a qualified plan.

Description of Sears Profit Sharing Fund

The Sears Profit Sharing Fund was created on July 1, 1916, 20 years before the adoption of Social Security. The main purpose of the Fund from its very beginning was to provide for the financial security of the employees upon their retirement from the Company and to meet other financial needs as they arise. This was accomplished by providing the employees the opportunity to share in the profits, the opportunity to acquire a proprietary interest in the Company, and the opportunity to invest their savings.

Sears employees are eligible to participate in the Profit Sharing Fund after one year and 1,000 hours of service. The Fund provides for full and immediate vesting of all participants, and at the present time, there are 225,000 participants in the defined contribution plans of Sears and its affiliated subsidiaries.

As in all defined contribution plans, each participant has his or her own account in the Fund. The employee's own deposits and share of the Company contributions are credited to the employee's account each year. The account is invested in Sears stock and other investments, in accordance with the options elected by each employee. The employee's account is credited each year with the number of Sears shares purchased for the employee and with the market value of other investments made on the employee's behalf. Any appreciation or depreciation on these other investments and any investment income received is also credited or charged to the employee's account each year.

The Fund presently has a Section 401(k) cash or deferred option, and employees may deposit between 1% and 17% of their salary each year as pre-tax deposits. Pre-tax deposits are, of course, subject to the overall annual limit provided by the Code, $8,475 for 1991. Employees may make after-tax deposits of between 1% and 10% of eligible pay, but to the extent after-tax deposits are made, the 17% limit on pre-tax deposits is reduced. It should be noted, of course, that the higher paid employees are limited to lower percentage contributions because of discrimination tests which must be met.

Each year the Company contributes a maximum of 6% of pre-tax profits, less certain Fund administrative expenses, to the Fund. This Company contribution is allocated to the various participants based on their pre-tax deposits up to 5% of salary, but subject to the overall pre-tax limit on employee deposits.

In complying with one of the original purposes of the Fund -- to allow the employees to acquire a proprietary interest in the Company -- the Fund has invested a substantial portion of its assets in Sears stock. At the end of 1990, over 51,000,000 shares of Sears stock, or more than 15% of the total outstanding shares were credited to the accounts of members. Another 21,000,000 shares were held by the Fund under a leveraged ESOP feature, adopted in 1989, which will be allocated to Fund members' accounts over the next 14 years. The members are able to instruct the trustees on how to vote their stock at shareholders' meetings.

Upon termination of employment or retirement, the employee's entire account balance is distributed in a lump sum. Sears stock credited to the employee's account is distributable in kind.

The Need for Lump Sum Distributions from Profit Sharing Funds

Before discussing the various pension simplification proposals, we would like to first outline why lump sum distributions are necessary and desirable. A primary objective of a profit sharing plan is to provide an accumulation of retirement capital and not necessarily to provide payments in a fixed income stream. (As a matter of information, Sears employees are also covered by a Company-paid pension plan that does provide a fixed income stream.) The capital provided by a profit sharing plan allows the retired employee to maintain the flexibility needed to meet changing conditions during retirement and protect against inflation. The employee may wish to purchase a new home, pay off his mortgage, make investments, pay for his children's education, etc. In addition, lump sums give retirees a capital sum to invest. Since the employee is the beneficial owner of his profit sharing account and assumes the risks of ownership all through his working career, including the risk of gain or loss, he should have the right to choose a lump sum distribution if he desires.

Some have argued that employees can protect themselves against immediate high taxes by rolling over a lump sum to an IRA. Indeed, rollovers to IRAs are utilized by many Sears employees to defer the tax on their distributions. IRA rollovers are sometimes more attractive to the higher-paid employees who may have other assets and income to provide for their retirement income replacement. However, many thousands of Sears employees do not rollover. Many Sears employees believe a rollover eliminates much of the flexibility presently available under lump sum distributions. Sears employees often retain their distributed Sears stock and use the dividends to supplement their other retirement income. With a rollover, this can be impractical because of IRA maintenance fees and other costs, depending on who the employee selects as his IRA trustee. This could be especially true for smaller and medium size accounts.

In spite of these factors, a significant increase in tax on lump sum distributions would force retirees, even those with small distributions, to roll their lump sums over into an IRA so as to avoid confiscation of a significant portion of their accounts. (Sears randomly selected ten recent distributions to employees, and in comparing tax owed under present law and the proposed rules, determined that the employees tax liability in most cases more than doubled under the proposals being made.) This would be detrimental to retirees and would result in a near term revenue loss to the Treasury. There would be no revenue gain until many years later when the amounts are ultimately withdrawn from the IRA.

Present Tax Treatment of Lump Sum Distributions

Prior to the 1986 Tax Reform Act, lump sum distributions were taxed under a special 10-year forward averaging method, and pre-1974 accumulations were eligible for capital gains treatment. At the time the 1986 Act was passed, Congress felt that it was inequitable to change the tax rules for those 50 and older. Therefore, while this favorable tax treatment was eliminated by the 1986 Act, persons over 50 years of age were grandfathered so as to protect those nearing retirement from having their tax liability abruptly increased.

In lieu of 10-year averaging, the 1986 Act made future lump sum distributions eligible for a special 5-year forward averaging treatment. This method can only be elected on distributions made after age 59½, and only once in a lifetime.

Current law provides that distributions in any year in excess of $150,000 (indexed) are subject to a 15% excise tax. Under the "5 times" rule, the $150,000 threshold for the tax is multiplied by five for lump sum distributions.

Under present law, appreciation in employer securities which are distributed in kind is not taxed at the time of distribution. Thus, employees who receive Sears stock include as taxable income an amount not greater than the Profit Sharing Fund's cost for such stock. Tax on such appreciation is deferred until it is realized by a later sale of the stock.

In addition to the averaging provisions, present law allows employees who receive lump sum distributions to roll their distributions into an IRA, thus deferring the tax until amounts are withdrawn from the IRA.

Reasons Why Averaging Rules Should Be Retained

As previously noted, S. 1364 repeals 5-year averaging for distributions after December 31, 1991 (except for those individuals grandfathered under the 1986 Tax Reform Act). The Administration's POWER proposal goes even further and advocates repeal of the averaging provisions for those grandfathered under the 1986 Tax Reform Act. This would, in effect, treat a lump sum distribution of an employee's account, accumulated over his entire working career, as ordinary income in the year he receives it.

There are many valid reasons for allowing income averaging for lump sum distributions. A lump sum distribution represents "bunched" income accumulated over the employee's working career and it would be inequitable to subject such income to the highest marginal tax brackets in the year of retirement. The lump sum represents a major part of the employee's savings for his retirement security.

Some have argued that averaging is unjustified because tax rates are no longer as graduated as they once were. While the graduation in rates has been reduced from the early 1980s, there has been no reduction in rates since the enactment of the 1986 Act which created 5-year averaging. In fact, the 1990 Budget Reconciliation Act actually increased the graduation in rates. Since enactment of that Act, there have been further suggestions for increasing the graduation even more. Thus, it is still important to give tax relief from the effect of bunching income accumulated over an entire career into one year.

It is particularly inequitable to eliminate the grandfathering of the 10-year averaging (with capital gains treatment at a 20% tax rate for pre-1974 accumulations). When the 1986 Tax Reform Act was passed and 10-year averaging was repealed, Congress determined that individuals 50 years of age or over should be grandfathered, so that they would not be subject to substantial tax increases as they neared retirement. All of these people are now over 55 years of age and are five years closer to retirement. It would be even more inequitable to eliminate 10-year averaging now than it would have been then. We cannot recall of any other instances where Congress repealed a "grandfather" rule which was specifically enacted to provide transitional relief under prior legislation.

Some have argued that simplification of the distribution rules for participants is one of the driving forces behind repeal of the averaging provisions. There is very little simplification in repealing 10-year averaging. This provision can be used only once in a lifetime, and only by persons who are now over 55 years old. Thus, the grandfather rule will soon be phased out by retirement of persons in the protected group.

In his recommendations made to Congressman Rostenkowski, Mr. Ronald Pearlman, in his letter of April 20, 1990, stated (at page 9) that 10-year averaging benefits an extremely small class of taxpayers since 5-year averaging is more beneficial for individuals who receive lump-sum distributions that are less than $474,000. This is an erroneous statement; the reverse is actually true. Ten-year averaging generally is more beneficial for distributions under $474,000. 'Over 40,000 members of the Sears Profit Sharing Fund qualify for 10-year averaging, and nearly all of these distributions would be under $474,000.

Five-year averaging should also be retained. As previously noted, averaging is necessary to alleviate the problem of "bunching" of income. Further, it would contribute very little to simplification of the Internal Revenue Code to eliminate 5-year forward averaging, since it can be used only where the distributee is over 59½ years old and can be used only once in a lifetime.

Arguments have been made that the 5-year and 10-year averaging provisions are being unfairly used by individuals changing employers to pay a lower effective tax rate on qualified plan distributions, thus enabling them to dissipate funds intended for their retirement. Thus, proponents of repeal say that it would be good retirement because participants would be encouraged to keep their money in the retirement system. These are not valid arguments Since passage of the 1986 Tax Reform Act, the averaging provisions can be used only by individuals at or near retirement. As noted, 5-year averaging can be used only where the distributee is over 59½ years old and only once in a lifetime. Surely, such an individual would be using 5-year averaging on plan distributions which will be used for his retirement needs. Similarly, 10-year averaging can be used only by individuals who are at least 55 years old and can also be used only once. Thus, the averaging provisions merely provide needed flexibility for retiring individuals to plan for their retirement security.

Excise Tax on Large Distributions

S. 1364, as well as several of the other bills introduced, advocate repeal of the special "5 times" rule for purposes of the 15% tax on large distributions, thus subjecting any distribution over $150,000 to this tax. The 15% tax and the "5 times" rule were enacted only recently as part of the 1986 Tax Reform Act. The "5 times" rule should be retained.

As previously noted, a lump-sum distribution represents income accumulated over an employee's working career. Many long-service employees, even those not considered highly compensated, may accumulate amounts significantly in excess of $150,000. This provision was intended to target the highly compensated who are able to accumulate large amounts (over $750,000) on a tax-favored basis. Very few Sears employees are aware that the 15% excise tax even exists, and most will assume that it does not apply to them. Thus, elimination of this special ceiling would adversely affect many rank-and-file employees who receive lump-sum distributions. For example, a retiree receiving a $200,000 distribution could face a marginal tax rate of 46% on the amount over $150,000.

Deferral of Unrealized Appreciation

Under current law, when a qualified plan distributes employer stock that has appreciated in value in a lump-sum distribution, the net unrealized appreciation in such stock is not included in the employee's income. Instead, taxation of the appreciation is postponed until the stock is sold or exchanged. In addition, in the case of employer stock attributable to employee contributions, taxation of the unrealized appreciation is deferred even if the stock is not distributed in a lump-sum distribution.

Both H.R. 2730 and the Administration's POWER proposal would repeal the exclusion of unrealized appreciation. We strongly oppose repeal.

The provisions excluding unrealized appreciation have been in the Internal Revenue Code for many years as an incentive for employees to invest in employer stock. Repeal of these provisions will upset the many thousands of Sears employees who, in reliance on the existing rules, have invested in employer stock through the Sears Profit Sharing Fund. Sears employees will resent this abrupt change in the rules, especially if it turns out that they must sell the Sears stock in order to pay the tax on the distribution.

Congress has historically supported employee investment in employer stock. This support is reflected in the many special tax provisions pertaining to employer stock, such as excluding unrealized appreciation in employer securities (a provision predating passage of ERISA) and the special tax benefits accorded to Employee Stock Ownership Plans (ESOPs). Employee ownership of employer stock acts as a very important incentive to employees and gives them a real stake in their employer's business. In view of Congressional policy toward encouraging employee investment in employer stock, repealing the exclusion of unrealized appreciation would seem to be a reversal of this policy, since repeal will encourage employees to sell the stock as soon as it is distributed to them.

Deferral of tax on unrealized appreciation is sound for three reasons. First, the employee should not be taxed until the appreciation is realized, and there is no realization simply because stock has been withdrawn from a profit sharing trust. Second, it would impose an unwarranted hardship on the employee to tax him before he has converted the stock into cash. Finally, it would produce erratic results. Each of these points is discussed below.

Income is Not Realized

When the employee withdraws from a profit sharing plan and takes his securities, the appreciation in value of the securities is not realized at that time, and will not be realized until he sells the securities and obtains cash or other property for it. At the time of such sale, the employee will be taxed. Likewise, individual purchasers of securities are not taxed until the appreciation in value on such personally held securities is realized through a sale or other taxable transaction. Thus, under current law, employees purchasing the securities of their employer by participating in a qualified profit sharing plan are placed in the same position as those individuals acquiring securities directly.

For example, employees who are members of the Sears Profit Sharing Fund can elect to invest their after-tax deposits in Sears stock. It is highly inequitable to tax the unrealized appreciation on this stock where the employee continues to hold it after its distribution from the Fund, when the employee would not be taxed on the unrealized appreciation if he had used his after-tax deposits to buy Sears stock directly from his broker.

Income or gain is normally taxed when realized. However, the Internal Revenue Code provides in a number of cases that income shall not be recognized and taxed even though such income is theoretically realized. For example, an exchange of income producing properties of like kind, or a sale of a personal residence and purchase of a new residence with the sales proceeds, are realizations of income not subject to tax under special non-recognition provisions. One of the basic reasons for the non-recognition of gain in these cases is founded on the principle that a mere change in the form or identity of an asset is not a taxable event and the gain should not be subjected to tax.

The case is even stronger for not taxing unrealized appreciation in employer stock at the time of distribution than it is for non-taxation in the above examples. At the time of distribution of the stock, there is no exchange, no sale and reinvestment, and no conversion of assets. There is no realization of income upon distribution because the employee is merely receiving property which has been his all along and has been held for his account in a custodial arrangement.

Serious Hardship if Appreciation is Taxed

Serious hardship would be imposed on the employee if the tax were based on the appreciated value of distributed employer's securities. Many Sears employees prefer to keep the Sears stock when they retire. Frequently, the employee would not have the cash to pay the tax and would be forced either to borrow money, or else to liquidate a portion of his investment in order to pay the tax. Repeal of this exclusion, combined with the repeal of 5-year and 10-year averaging, will be a significant deterrent to investing in employer stock.

Moreover, the ability to roll over the distribution to an IRA frequently is not a satisfactory answer. Not all institutions that offer IRAs will accept rollovers of employer stock and others may impose maintenance fees that retirees do not now incur.

Erratic Results

Repealing the special tax treatment for unrealized appreciation in employer securities can complicate, rather than simplify retirement decisions. If the employee had to pay a tax on the market value of the employer's stock distributed to him, the tax would vary greatly depending on the value of the stock at the time of withdrawal. Thus, if the price is at a high point when the employee retires, he would pay more tax. For example, two employees might retire within a few weeks of each other and yet incur widely different tax liabilities even though they each received the same number of shares and have the same average cost price for such stock. The recent fluctuations of the stock market highlight the importance of this consideration.

The fluctuation in market values can be illustrated by the fact that in the last year, Sears stock has traded from a low of $22.00 per share to a high of about $43.00. This situation would cause an employee to speculate on the time of his retirement, and his selection of a retirement date would depend to a great extent on fluctuations in the value of the stock.

Moreover, repealing the exclusion for unrealized appreciation would not simplify the employee's tax calculations. Under current law, the Fund's trustee is required to report to the employee at the time of distribution the amount that is currently taxable and the cost of the stock distributed. The employee includes the taxable amount in income and retains the cost information in order to report the gain on disposition of the employer stock in the same manner that he reports gains on any other stock transactions. Thus, no significant simplification would be achieved by requiring the employee to pay tax on the fair market value of the employer securities distributed to him.

Present law recognizes the importance of providing an incentive for investment by profit sharing plans in the stock of the employer corporation. Taxing unrealized appreciation would discourage such investments by profit sharing plans. This, in turn, would substantially reduce a very important employee incentive which makes the employee a true partner in the success of the employer's business. Furthermore, it would decrease the desirable trend toward wider ownership of American industry.

STATEMENT OF THE SECTION 457 TASK FORCE

Mr. Chairman, my name is Ken Kies. I am a partner with the law firm of Baker & Hostetler. I appear in my capacity as the Designated Representative of The Section 457 Task Force, a coalition of tax-exempt employers and organizations which represents tax-exempt employers. Members of the Task Force include the American Society of Association Executives representing thousands of trade associations throughout the country; the National Assembly, an association of voluntary nonprofit organizations concerned with providing a variety of human support services,* Colonial Williamsburg, the Cleveland Clinic, Goodwill, the Association for Advanced Life Underwriters, Mutual of America, and others. This coalition believes the amendment to section 457 included as part of the Tax Reform Act of 1986 and its subsequent interpretation by the IRS is resulting in treatment of employees of tax-exempt employers which is both discriminatory and inconsistent with basic principles of income tax policy. The Ways and Means Committee addressed a portion of this problem through legislation adopted as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). The Task Force urges the Committee on Finance to complete this process through the enactment of language like that contained in either H.R. 2499, the "Section 457 Reform and Simplification Act of 1991," legislation introduced on May 30, 1991, by Congressman Matsui and Congressman Vander Jagt, or Section 319 of H.R. 2641, the "Employee Benefit Simplification Act of 1991," introduced by Congressman Chandler on June 13, 1991. The Committee on Ways and Means adopted language similar to that included in H.R. 2499 and Section 319 of H.R. 2641 in both 1987 and 1988.

I. Background.

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") broadened the coverage of section 457 of the Internal Revenue Code (the "Code") to apply to employees of private tax-exempt employers. Previously, section 457 had applied only to state and local government employees.

Although the 1986 Act expanded the group of employers subject to section 457, there was no indication by Congress that the substantive scope of section 457 had been changed. Nevertheless, the Internal Revenue Service ("IRS") took a public position in 1987 in Notice 87-13 that the types and nature of deferred compensation plans governed by section 457 included nonelective deferred compensation (e.g., vacation pay plans, severance pay plans and nonelective deferred compensation plans) which generally had been thought to be outside the scope of the section 457 rules (as they previously applied to state and local governments). The direct effect of this interpretation is to tax individuals currently on amounts which they have not yet received, never have had the right to elect to receive, and may not actually receive in the future. This interpretation is wholly inconsistent with basic concepts of Federal income tax policy dating back to the origins of the income tax in 1913 under which individual taxpayers have historically been taxed generally only upon receipt of income.

In response to the IRS position, H.R. 3312 was introduced in 1987 by Mr. Matsui and Mr. Vander Jagt along with 22 other Members of the Ways and Means Committee as co-sponsors. H.R. 3312 specifically reversed the effect of the IRS interpretation by providing that section 457 did not apply to any nonelective deferred compensation. The Committee on Ways and Means included H.R. 3312 in its 1987 tax bill but the language was dropped, along with all other non-revenue raising provisions, as part of the November 1987 Budget Summit Agreement. The Committee on Ways and

* Among the members of The National Assembly are organizations such as the American Red Cross, the USO, the United Way, the Boy Scouts of America, the Girl Scouts of the USA. A complete list of The National Assembly members who provide volunteer services to Americans appears as Attachment A.

Means again adopted this language as part of its version of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). As part of the compromise in conference on TAMRA, however, only certain classes of individuals performing services for tax-exempts received a clarification that section 457 did not apply to their nonelective deferred compensation, specifically, independent contractors, church employees, and employees under certain collective bargaining agreements.[**] Earlier amendments to section 457 exempt other classes of employees from current taxation of nonelective deferred compensation as follows: state judges; employees covered by a deferred compensation plan of an Alabama nonprofit corporation which received an IRS ruling on March 17, 1976; employees covered by a deferred compensation plan with respect to which a letter dated November 6, 1975, submitted the original plan to IRS; and employees receiving nonelective deferred compensation under a plan dated August 16, 1986, if they were covered by that plan prior to that date. In addition, employees of taxable employers may receive both elective and nonelective deferred compensation without being taxed until the time of actual receipt.

H.R. 3080, the "Section 457 Reform and Simplification Act of 1989," was introduced by Mr. Vander Jagt and Mr. Matsui on August 4, 1989, and was co-sponsored by over 36 Members of Congress. Similar legislation was introduced in this Congress by Mr. Matsui and Mr. Vander Jagt as H.R. 2499. Finally, Section 319 of H.R. 2641 is similar to H.R. 3080 and H.R. 2499. Enactment of any of these pieces of legislation would complete the reform and simplification of section 457 begun with the TAMRA provisions by providing that section 457 uniformly does not apply to any nonelective deferred compensation for any employee of a tax-exempt employer. The effect of this change would be to tax individuals only when they are paid such compensation. As a result, no employees of tax-exempt employers would be taxed currently on income which (1) they have not yet received, (2) never had the right to elect to receive, and (3) may never receive as is the case under current law for those employees not qualifying for the various exceptions now applicable to the "general rule" of section 457.

II. Detailed Discussion of Status of Current Law and Need for the Reform Section 457.

Either H.R. 2499 or Section 319 of H.R. 2641 would uniformly provide that nonelective deferred compensation is not taxable until paid. Under current law, employees of many tax-exempt organizations and State and local governments are taxed on nonelective deferred compensation before they are entitled to receive it. Taxing such amounts prior to the time when received is inappropriate because it results in current taxation of amounts which --

First -- The taxpayer has not received.

Second -- The taxpayer never had the right to elect to receive; and

Third -- Which the taxpayer may not actually receive.

[**] In addition, TAMRA statutorily provided that section 457 does not apply to vacation pay, sick pay, compensatory time, severance pay, disability pay, or death benefits.

An example of the unfair impact of this current law treatment is as follows:

> In 1990 trade association X hires Mr. Smith to manage its office. Mr. Smith is provided an employment agreement under which he will be paid $50,000 per year for five years, i.e., 1990-95. Assuming Mr. Smith works for the entire five years for the trade association, the agreement provides that Mr. Smith will be entitled to an additional $10,000 payment in each year from 1996 through 2000. The trade association has structured the compensation package in this manner to provide an incentive to Mr. Smith to make a long-term commitment and because its current budget does not have sufficient resources to pay these amounts any earlier than the schedule provided. Under the current law interpretation of section 457, if Mr. Smith works for the entire five-year period of 1990 through 1995, he would be taxed in the 1996 tax year on the full present value of the five years of $10,000 payments which he would be paid in each year from 1996 through 2000 even though he would be entitled to, and receive, only $10,000 in 1996. If you assume that the discounted present value of the five years of $10,000 payments is $40,000, the taxpayer would be subject to tax in 1996 of $11,200[***] even though he received only $10,000 of payments for the year, for an effective tax rate of 112%. The above result would occur even if the trade association becomes insolvent in 1997 and is unable to pay the four remaining $10,000 payments. This analysis assumes Mr. Smith does not apply for one of the eight exceptions to the "general rule" of section 457.

Congress has already recognized the unfairness of the general rule of current law which provides for taxation of nonelective deferred compensation before it is received. Specifically, Congress has exempted from this harsh and unfair treatment many classes of taxpayers as follows:

> First, employees and independent contractors performing services for taxable employers are not taxed on either elective or nonelective deferred compensation until paid.
>
> Second, independent contractors performing services for tax-exempt employers are not taxed on nonelective deferred compensation until paid.
>
> Third, employees of tax-exempt employers performing services pursuant to a collective

[***] Calculated assuming the 28% rate applied to all the income. If the taxpayer was subject to the so-called "bubble" when the rate is 33%, the tax would be $13,200 for an effective rate of 132%.

bargaining agreement in existence on December 31, 1987, are not taxed on nonelective deferred compensation until paid. This rule applies even if the employee is hired after December 31, 1987. In some cases, this represents a permanent exception because certain collective bargaining agreements are permanently considered to be in effect even though subject to subsequent amendment.

Fourth, employees covered by a plan maintained by a church for church employees are not taxed on nonelective deferred compensation until paid.

Fifth, state judges are not taxed on elective deferred compensation until paid.

Sixth, employees covered by a deferred compensation plan of a nonprofit corporation organized under the laws of the State of Alabama with respect to which the Internal Revenue Service issued a ruling dated March 17, 1976, are not taxed on nonelective deferred compensation until paid even if they are employed in the future.

Seventh, employees covered by a deferred compensation plan with respect to which a letter dated November 6, 1975, submitted the original plan to the Internal Revenue Service responded with a letter dated December 24, 1975, are not taxed on nonelective deferred compensation until paid even if they are employed in the future.

Eighth, employees receiving nonelective deferred compensation under a plan in effect on August 16, 1986, are not taxed on nonelective deferred compensation until paid provided that they were covered by such plan prior to August 16, 1986.

Employees of tax-exempt employers not within the various classes of exception set forth above generally are currently taxed on nonelective deferred compensation even though they have not actually received payment, never had the right to elect to receive payment, and may not actually receive payment in the future. Such treatment obviously is discriminatory and unfair. Moreover, it undermines the credibility of the income tax system because comparably situated taxpayers are not subject to comparable tax rules. This absence of comparable treatment for similarly situated taxpayers is illustrated by many situations. First, many tax-exempt employers have both employees covered by the August 16, 1986, grandfather provision and employees not covered, notwithstanding the fact that they are performing identical services. Second, some employees within the tax-exempt sector are covered by the various exceptions, e.g., independent contractor, church employees, etc., while others are not. Finally, employees of taxable employers may receive both elective and nonelective deferred compensation without being subject to current taxation. This latter situation presents significant difficulties for tax-exempt employers in recruiting talented individuals from the taxable sector because they are unable to offer compensation arrangements comparable to those available in the taxable sector. The Task Force believes that employees of taxable and tax-exempt employers should be treated the same. While H.R. 3080 will not fully accomplish this result, it will provide comparable treatment for all employees of tax-exempt employers and reverse tax treatment of certain tax-exempt employees which is both unfair and inconsistent with long-standing, basic principles of Federal income tax policy.

The balance of this testimony discusses section 457 in the context of its legislative history, and explains why the general scope of section 457, which was not changed by the 1986 Act, should be limited to non-qualified, elective deferred benefit arrangements. Nonqualified, nonelective retirement pay plans (as well as other nonelective deferred benefit plans) of both tax-exempt and state and local government employers should be unaffected by section 457 in accordance with the clear Congressional intent which accompanied the original enactment of section 457 and its subsequent extension to private tax-exempt employers as part of the Tax Reform Act of 1986.

III. The History of Section 457 Indicates It Was Never Intended to Apply to Nonelective, Non-Qualified Deferred Compensation Plans.

A. Deferred Compensation Rules Before 1978; Constructive Receipt Rule.

Prior to 1978, nonqualified deferred compensation arrangements were subject to broad statutory guidelines and regulations. A cash-basis employee included deferred amounts in income when those amounts were "actually or constructively received." Treas. Reg. 1.466-1(c)(1)(i); see also, I.R.C. 451; Treas. Reg. 1.451-2 (constructive receipt of income). IRS administrative rulings further defined the income recognition rules for various nonqualified deferred compensation arrangements. See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174 (guidelines for applying rule of constructive receipt to deferred compensation arrangements), modified, Rev. Rul. 70-435, 1970-2 C.B. 100 (replacing one factual example). Under traditional constructive receipt principles, deferred amounts are not taxed currently unless they are "made available" to the taxpayer so that the taxpayer can elect to receive such amounts currently. See, e.g., Metcalfe v. Commissioner, 43 T.C.M. (CCH) 1393, 1396 (1982).

B. Proposed Regulation Section 1.61-16.

In 1978, the IRS published Proposed Regulation section 1.61-16 (the "Proposed Regulation"), which would have eliminated the ability of employees to defer compensation at their individual option. See 43 Fed. Reg. 4638 (Feb. 3, 1978). Specifically, the Proposed Regulation would have required all cash-basis taxpayers covered by elective, nonqualified deferred compensation arrangements, to recognize deferred amounts as income in the taxable year such amounts otherwise would have been payable, rather than in the later taxable year when the deferred amounts actually were paid.

By its terms, however, the Proposed Regulation only affected those amounts deferred "at the taxpayer's individual option." Id. Thus, nonelective, nonqualified retirement plans that basically consisted of deferred commitments to pay benefits pursuant to a formula or schedule were not the target of the

Proposed Regulation. Since the benefits under such plans were not attributable to amounts deferred "at the taxpayer's individual option," they would not have been covered by the Proposed Regulation.

C. Congressional Response to the Proposed Regulation.

Congressional response was swift. Section 131 and 132 of the Revenue Act of 1978 (the "1978 Act") specifically addressed most elective deferred compensation arrangements jeopardized by the Proposed Regulation. See Public Law 95-600, 92 Stat. 2779-83 (Nov. 6, 1978), reprinted in 1978-3 C.B. 13-17; see, also, H.R. Rep. No. 1445, 95th Cong., 2d Sess. 52-53, reprinted in 1978-2 C.B. 226-27 (reasons for change); S. Rep. No. 1263, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 363 (reasons for change); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 538 (reasons for change).

Section 131 of the 1978 Act created section 457, which applied to State and local government deferred compensation plans. Section 132 of the 1978 Act rejected application of the Proposed Regulation to deferred compensation plans of private, taxable employers. In section 132(a) of the Act, Congress pronounced that the legal principles governing private deferred compensation plans would be those in effect on February 1, 1978 (two days before publication of the Proposed Regulation). Id. at 92 Stat. 2782-83, reprinted in 1978-3 C.B. 16-17.

D. The 1986 Act.

The 1986 Act originated from The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) ("President's Proposal"). The President's Proposals included the proposed extension of section 457 to all tax-exempt employers. As described in the President's Proposals, the change in section 457 would affect elective deferrals by employees:

> The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or tax-exempt employer under an ineligible deferred compensation plan would be includible in the employee's gross income when there is no longer a substantial risk of forfeiture.
>
> (President's Proposal, Chapter 14.10 at 381 (emphasis added).)

There is no indication that section 457, as then in effect, was understood to apply to anything but elective deferral arrangements. In fact, the tenor of Treasury's description of the changes suggests that the employees of the tax-exempt community would be receiving a benefit from the extension of section 457, a suggestion clearly inconsistent with an extension of section 457 to nonelective deferred compensation.

Generally adopting the President's Proposals, the 1986 Act extended section 457 rules to tax-exempt employers. 1986 Act section 1107, H.R. Rep. No. 841, 99th Cong., 2d Sess. at I-361 to 366. The operative language of section 457 remained substantially the same, except for the deferral coordination rules of section 457(c) and the new distribution rules of section 457(d).

The Conference Report accompanying the 1986 Act gave no indication of any Congressional intent to expand the scope or nature of plans encompassed by section 457. See id. at II-397 to 400. And the Joint Committee's General Explanation of the Tax Reform Act of 1986 (the "1986 Blue Book"; published May 4, 1987) confirms that section 457 "continues to apply to the same types of deferred compensation to which it applied under prior law." Id. at 654. Thus, although the 1986 Act expanded the group of employers affected by section 457, it was not intended to change the type or nature of deferred compensation plans subject to the section 457 rules.

IV. Notice 87-13 and Examples of Plans to Which Section 457 Should Not Apply.

On January 5, 1987, the IRS released Notice 87-13 (published January 26, 1987 in Internal Revenue Bulletin No. 1987-4), which contained the preliminary IRS views regarding the scope and application of section 457. At Q&A-26, the IRS adopted the following position:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or a defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select group of executives or other highly compensated employees (e.g., a "top hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).
>
> Section 457 applies to amounts deferred under a deferred compensation plan, whether or not such deferral is pursuant to the election of the individual taxpayers. Thus, section 457 applies to both elective and nonelective deferred compensation amounts.
> [1987-4 I.R.B. at 26.]

The position adopted by the IRS disregarded the historical distinction between the tax treatment of employee elective deferrals and employer-provided, nonelective deferred benefits.

The IRS position threatened many unfunded retirement programs and other benefit programs (*e.g.*, vacation pay and sick pay plans) maintained by tax-exempt organizations and State and local governments. The unfairness of the IRS position was acknowledged when the IRS announced it would not enforce the interpretation of section 457 as applied to vacation pay, sick pay, and severance pay even before TAMRA was enacted. The Congress subsequently provided for this by statute in TAMRA by providing specifically that section 457 does not apply to vacation pay, sick pay, compensatory time, severance pay, disability pay, or death benefit plans. TAMRA also provided that independent contractors, church employees, and employees under certain collective bargaining agreements would not be taxed on nonelective deferred compensation until such amounts are paid. H.R. 3080 would complete this much needed effort to reform section 457 by providing that all employees of tax-exempt employers are subject to the same fair rules under which they would be taxed on nonelective deferred compensation only when paid, thus ending the current law treatment applicable to only certain classes of employees of tax-exempt employers whereby they generally are taxed currently on amounts that (1) they have not yet received, (2) never had the right to elect to receive, and (3) may not actually receive.

The Task Force congratulates the Committee on Ways and Means for its past actions in 1987 and 1988 in attempting to address the problem associated with section 457 and encourages this Subcommittee and the full Committee to complete this process by achieving enactment of either H.R. 2499 or Section 319 of H.R. 2641.

Thank you, Mr. Chairman. I would be happy to answer any questions.

ATTACHMENT A

Members of the National Assembly

AFL-CIO
American Association of Homes for the Aging
American Camping Association
American Red Cross
Association for Volunteer Administration
Association of Jewish Family and Children's Agencies
Association of Junior Leagues, International
Big Brothers, Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire, Inc.
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
The Evangelical Lutheran Church in America
4-H, Extension Service
Family Service America
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
Joint Action in Community Service
National Association of Homes for Children
The National Council on the Aging
National Crime Prevention Council
National Mental Health Association
National Network of Runaway and Youth Services
The Salvation Army
70,001 Training and Employment Institute
Travelers and Aid International
United Neighborhood Centers of America
United Seamen's Service
United Way of America
Volunteer - The National Center
Volunteers of America
Women in Community Service
YMCA of the USA
YWCA of the USA, National Board

STATEMENT OF THE SHELL OIL CO.

Shell Oil Company would like to take this opportunity to thank Chairman Pryor and the Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service for the opportunity to comment on the Employee Benefits Simplification and Expansion Act. We believe pension simplification is a noble objective and support your efforts.

While the provisions in this legislation are numer0u5, we would like to address two issues of direct concern to Shell. The first provision concerns the definition of a leased employee. Under present law, "leased employees" must be counted for purposes of the nondiscrimination rules that apply to almost all types of major employee benefits. In order to comply with current law, companies must first determine how many leased employees they utilize and what benefits they are provided. This has proven to be an impossible task, not only because of the vagueness of the definition, but also due to the enormous administrative task of determining when it applies.

This definition of "leased employee" includes a host of persons that one would not ordinarily envision. For example, the rules characterize an individual as a leased employee if it is not unusual for the services to be performed in the recipient's "business field" by regular employees of any employer in that "business field." In the absence of clear guidance, it is nearly impossible to determine whether an individual is performing services in a business field in which a company historically operates or whether the services are performed by employees in a particular business field.

Simplification would be greatly improved by adopting the leased employee definition in your legislation. We believe your proposed definition would provide greater administrative simplicity for taxpayers and would still safeguard equitable benefits for employees. We have attached a position paper on this proposal.

The second provision involves the treatment of rollovers from qualified plans. Current law places limitations on an individual's transfers into individual retirement accounts ("IRAs") of partial distributions from qualified plans. In general, a "total" distribution can be transferred into an IRA without income tax recognition in the year of the distribution. Certain partial distributions also qualify for this favorable treatment. However, partial distributions which do not qualify for this special tax treatment are generally subject to immediate income taxation and may also generate additional penalty taxes. These taxes and penalties can amount to nearly 50 percent of the distribution, *plus interest.*

The rules determining which partial distributions qualify for favorable tax treatment are confusing, hamper effective administration of qualified plans, and often result in an erosion of the retirement assets of those plan participants who fail to appreciate their peculiar nuances. As such, we believe the law should be amended to provide less restrictive rules governing partial distributions transferred by an employee to an IRA or other qualified plan.

The benefits of such a proposal are substantial. Initially, simplification of the rules would allow more flexibility in plan design and decrease the costs associated with plan administration. Amending these rules to allow greater flexibility encourages employees to keep retirement savings in tax-favored retirement vehicles by more readily allowing a worker to maintain a retirement account during a working career for all of the retirement savings accumulated, regardless of movement from one job or employer to another. The reduced complexity of determining which distributions qualify for rollover permits more efficient management of retirement savings.

An additional benefit would be the increased ability of a participant to manage his or her retirement assets. Under current law, a qualified plan participant who disagrees with the management of his retirement assets may be penalized severely in the form of immediate income tax and tax penalties if he removes the retirement assets from the qualified plan trust. Participants in qualified plans should be allowed at least some of the same management flexibility provided for IRAs without current tax or penalty. The nature of the original investment as a contribution to a qualified plan rather than' an IRA should not affect management rights.

The rollover rules in your legislation would provide all of these benefits to employers and employees. We support these provisions and provide you with additional thoughts on the matter in a separate attachment.

We are pleased to have this opportunity to comment on your legislation and would be happy to respond to questions.

Attachments.

LEASED EMPLOYEES: DESCRIPTION OF THE PROBLEM AND SUGGESTIONS FOR REFORM

SUMMARY

The leased employee rules were originally designed to preclude employers from firing their employees (who had traditionally performed a particular service) to avoid having to provide them with benefits and then leasing them through a contractor. The rules, as interpreted by the Internal Revenue Service in proposed regulations, go far beyond stopping that abusive practice.

CURRENT PROVISIONS

Under present law, "leased employees" must be counted for purposes of nondiscrimination rules that apply to almost all types of major employee benefits:. While there is no limit to the number of leased employees a company can utilize, if a company has a sufficiently large number of leased employees that are provided relatively small benefits (by the contractor) in relation to benefits provided to the recipient's own regular employees, the recipient's pension, profit-sharing, health, and life insurance plans may all be deemed "discriminatory" for tax purposes. This can subject both the recipient and certain employees participating in these plans to severe tax penalties.

In order to avoid incurring penalties, companies trying to comply with the leased employee rules must first determine how many leased employees they utilize and what benefits they are provided. This has proven to be an impossible task, not only because of the vagueness of the definition, but also due to the enormous administrative task of determining when they apply. A leased employee is defined in the law as any person who is not a regular employee and. who provides services to a company (the "recipient") (1) pursuant to an agreement between the recipient and another organization (the "contractor"), (2) the services are performed on a substantially full-time basis for at least one year (6 months for purposes of testing core health benefits), and (3) the services are of a type that have historically been performed, in the recipient's business field, by regular employees.

REASON FOR CHANGE

This definition of "leased employee" in the statute and the one in the proposed regulations, includes a host of persons that one would not ordinarily envision. For instance, IRS regulations have determined that a service has been historically performed if *any* regular employee of the recipient has performed that job in the last *five* years. Further, without regard to a company's own practice, the rules characterize an individual as a leased employee if it is not unusual for the services to be performed in the recipient's "business field" by regular employees of *any* employer in that "business field." The regulations neither explain, define, or limit the meaning of the term "business field." In the absence of clear guidance, it is nearly impossible to determine whether an individual is performing services in a business field in which a company historically operates or whether the services are performed by employees in a particular business field.

Most companies have never maintained very detailed employment records necessary to run all the tests on leased workers, and it has been extremely difficult (if not impossible) to even gather those records from contractors to make the required determinations. While this information may be available from contractors, most are extremely reluctant to furnish companies the necessary information both for financial reasons and because they view some of the information as confidential or proprietary. Those companies which have tried to obtain the necessary information from the contractors have received a very limited response, notwithstanding repeated requests for information and occasional threats to withdraw business.

THE PROPOSAL

An individual who performs personal services directly for the recipient where the recipient controls the provision of such services, so as to satisfy the common law test used to distinguish an employee from an independent contractor, is an employee of the recipient and not the contractor. Leased employees, on the other hand, typically are common law employees of the contractor. An employee of the contractor should not be treated as a leased employee of the recipient unless the contractor is providing individuals (leased employees) rather than services to the recipient.

These principles are reflected in the following proposed language as a substitute for the current language in I.R.C. §414(n)(2)(C):

(C) SUCH SERVICES ARE PERFORMED BY SUCH PERSON UNDER THE CONTROL OF THE RECIPIENT.

A contract for a specialized service—such as, for the repair or maintenance of machinery for which the contractor provides a crew of workers with a supervisor to perform the contracted service—generally would not give rise to leased employees. However, a contract for one or more secretaries would tend to create a leased employment relationship. Typically, contract secretaries perform services under a contract which requires the contractor to furnish the recipient with a designated number of individuals who will be supervised by the recipient rather than to perform a specific service supervised by the contractor.

CONCLUSION

The leased employee rules are virtually impossible to administer in their present form and would classify as leased employees a larger field than is necessary to alleviate the perceived abuse in this area. New statutory rules should be adopted to prevent the abuse, but which are based on reasonable and administrable principles as outlined above.

TREATMENT OF ROLLOVERS FROM QUALIFIED PLANS: SUGGESTIONS FOR CHANGE

I. SUMMARY

Current law places limitations on an individual's transfers into individual retirement accounts ("IRAs") of partial distributions from qualified plans.[1] In general, a "total" distribution can be transferred into an IRA without income tax recognition in the year of the distribution. Certain partial distributions also qualify for this favorable treatment. However, partial distributions which do not qualify for this special tax treatment are generally subject to immediate income taxation and may also generate a penalty for premature distribution and an excise tax on excess distributions. These taxes and penalties can amount to nearly 60 percent of the distribution, *plus interest.*

The rules determining which partial distributions qualify for favorable tax treatment are confusing, hamper effective administration of qualified plans, and often result in an erosion of the retirement assets of those plan participants who 'fail to appreciate their peculiar nuances.

To simplify the rules governing distributions from qualified plans, to increase plan portability, and to grant plan participants greater flexibility in the management of retirement assets, I.R.C. §402(a)(5) of the Internal Revenue Code of 1986, as amended ("I.R.C."), should be amended to provide less restrictive rules governing the favorable tax treatment of partial distributions which are transferred by the employee into an IRA.

II. CURRENT LAW

A. Definitions

1. Total Distributions

I.R.C. §402(a)(5)(E)(i) defines a total distribution as

(1) one or more distributions

(2) which

(a) occurs within one taxable year of the participant on account of termination of the plan of which the trust is a part or

(b) is a "lump sum" or

(c) is a distribution of "accumulated deductible employee contributions."

I.R.C. §402(e)(4)(A) defines a lump sum as a distribution or payment within one taxable year of the balance to the credit of the employee which occurs after one of four "triggering events":

(1) the employee's death,

(2) the employee's attaining age 591,

(3) the employee's separation from service, or

(4) the employee's disability.

[1] A "qualified" plan is one which qualifies for deferral of income recognition for amounts contributed for the benefit of an employee. In general, recognition of income earned by the plan trust on contribution, is also deferred.

In the case of the employee's death or separation from service, the employee or his estate must establish that the distribution was actually made on account of death or separation from service. I.R.C. §72(o)(5) defines accumulated deductible employee contributions to include income, gains, expenses, and losses attributable to employee contributions.

2. Partial Distribution

I.R.C. §402(a)(5)(E)(v) defines partial distributions as any distribution which is not a total distribution.

B. IRA Rollovers

I.R.C. §402(a)(5)(A) states the general rule that qualified plan distributions transferred by the employee to an eligible retirement plan ("rollovers") are not includable in gross income in the year of distribution ("rollover treatment").

To qualify for this rollover treatment, the rollover must occur within sixty days of the distribution. I.R.C. §402(a)(5)(C). Rollover treatment is available for total distributions and for certain partial distributions.

Partial distributions must meet the following requirements to receive rollover treatment.

(1) The distribution must be at least 50% of the balance to the credit of the employee in the qualified trust.[2]

(2) It must be payable on account of the employee's death, separation from service, or after the employee's disability.

(3) It cannot be one of a series of periodic payments.

(4) The employee must affirmatively elect the rollover treatment.

C. Special Lump Sum Averaging Treatment

For those distributions which qualify as lump sums, the employee is entitled to determine the amount of the income tax payable in the year of the distribution as though the distribution had been made in equal parts over five years ("lump sum treatment"). I.R.C. §402(e). However, where the employee has previously elected rollover treatment for a partial distribution, lump sum treatment is unavailable for a subsequent distribution from the same or similar plans, even if the subsequent distribution otherwise meets all of the tests for lump sum treatment. I.R.C. §402(a)(S)(D)(iii).

D. Strict Interpretation

The rules governing the definition and tax treatment of total and partial distributions are strictly interpreted. Identical distributions to two apparently similarly situated employees may receive drastically different tax treatment solely because of seemingly insignificant details. Thus, an employee who receives three distributions, the *last* of which occurs one day after he attains age 59½ will be eligible to elect rollover treatment for the final distribution if it otherwise qualifies as a total distribution. Attaining age 59½, is the triggering event for this purpose. In contrast, none of a similar series of payments to a fellow employee may qualify for rollover treatment if the *last two* distributions occur one day and three days after he attains age 59½, but not within the same tax year. In the latter case, the final distribution may not qualify as a total distribution eligible for rollover treatment unless a triggering event occurred between the second and third distributions. The intervention of the second distribution between the attainment of age 59½ and the third distribution prevents consideration of attaining age 59½ as a triggering event for the third distribution. Thus, unless the second and third distribution together qualify as one total distribution, there is no total distribution eligible for rollover treatment. It is also most likely that none of the payments in either case qualify as partial distributions since they may be characterized as part of a "series of periodic payments."

E. Series of Periodic Payments

The status of a payment as one of a "series of periodic payments" will prevent what would otherwise be a qualified partial distribution from receiving favorable rollover treatment. Neither the statute nor the governing regulations provide guidance on what constitutes a series of periodic payments. The Joint Committee expressed its view that

> [i]t is intended that, for purposes of the rule denying rollover treatment in the case of a distribution that is part of a series of periodic payments, the

[2] The balance to the credit of the employee is determined immediately before the distribution and without regard to the aggregation rules of I.R.C. §402(e)(4)(C).

> mere fact that payments to an employee are made in more than one taxable year does not automatically mean that they constitute a series of periodic payments.

Rep. of the Joint Comm. on Int. Rev. Tax, Description of the Technical Corrections Act of 1988, 100th Cong., 2d Sess. (1988), p. 165.

The Joint Committee included an example of distributions in more than one year which resulted from a calculation error, concluding that such a series of distributions should result in the first distribution being' treated as a lump sum distribution and the second distribution being treated as a partial distribution eligible for rollover treatment under the provisions of I.R.C. §402(a)(5)(D). Id. To date, it appears that the Internal Revenue Service has restricted this explanation to only the example case.

III. REASONS FOR CHANGE

A. Simplification

The rules governing the treatment of qualified plans are complex and difficult to understand, particularly for ordinary plan participants who are not tax experts. Furthermore, in the view of most participants application of these provisions does not achieve any logical goal or relate to any obvious purpose which could provide a frame of reference to guide the interpretation. A set of rules which allows rollover treatment of a distribution after an employee attains age 59½ for a total but not partial distribution furthers no apparent legislative goal. Similarly, rollover treatment for an amount received in one payment but not two defies logic. Certainly if large withdrawals can be tax favored, smaller amounts should be also.

The rules governing qualified plan distributions ought to foster the purpose for which qualified plans were established—providing secure retirement for plan participants through conservation of the assets. Instead, current rules may in fact act to deplete those assets solely because the unsophisticated may be unable to apply them properly.

The complex rules governing partial distributions also affect employers designing the plan to suit the needs of a diverse work force. There is also a tremendous burden placed on plan administrators who must advise participants on the tax treatment of various kinds of distributions. Simplification of the rules would allow more flexibility in plan design and decrease the costs associated with plan administration.

B. Plan Portability

Recent proposals with respect to qualified plans have focused on the desirability of increasing "portability." Current law limits portability by limiting the kinds of distributions which qualify for rollover treatment. Amending these rules to allow greater flexibility encourages employees to keep retirement savings in tax favored retirement vehicles by more readily allowing a worker to maintain a retirement account during a working career for all of the retirement savings accumulated,' regardless of movement from one job or employer to another. The reduced complexity of determining which distributions qualify for rollover permits more efficient management of retirement savings.

C. Management by Participant

Under current law, a qualified plan participant who disagrees with the management of his retirement assets may be penalized severely in the form of immediate income tax, excise tax, and tax penalties if he removes the retirement assets from the qualified plan trust, even if he transfers the assets to a limited access IRA to preserve their character as retirement assets. In contrast, employees whose retirement assets were originally placed in IRAs have far greater management flexibility and can roll over IRA balances every twelve months. I.R.C. §408(d). In most instances, a portion of an IRA may be rolled over. Furthermore, an employee typically has several IRA accounts established in different tax years, allowing tremendous flexibility in the management of his retirement assets in IRA accounts.

Participants in qualified plans should be allowed at least some of the same management flexibility provided for IRAs without current tax or penalty. The nature of the original investment as a contribution to a qualified plan rather than an IRA should not affect management rights.

IV. PROPOSED CHANGE

A. Description

I.R.C. §402(a) should be amended to provide a single set of triggering events which would qualify a distribution for rollover treatment or lump sum treatment. This could be accomplished by the following changes:

(1) add the attainment of age 591 as a triggering event qualifying a partial distribution for rollover treatment;

(2) delete the restrictions which apply to a series of periodic payments; and

(3) delete the requirement that at least 50 percent of the employee's balance be distributed to qualify the partial distribution for lump sum treatment.

The proposals would simplify the rules governing rollover and lump sum treatment by applying one set of rules. In effect, any distribution after a triggering event would qualify for rollover treatment.

B. Statutory Language

I.R.C. §402(a)(5)(D)(i) should be amended to read as follows:

> "(i) Requirements.—Subparagraph (A) shall apply to a partial distribution only if—
>
> (I) such distribution is payable as provided in clause (i), (ii), (iii), or (iv) of subsection (e)(4)(A) (without regard to the second sentence thereof), and
>
> (II) the employee elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have subparagraph (A) apply to such partial distribution.
>
> Any distribution described in section 401(a)(28)(B)(ii) shall be treated as meeting the requirements of subclause (I)."

V. CONCLUSION

The rules governing distributions from qualified plans should encourage preservation of retirement assets for retirement. At the same time, however, the rules should allow a certain level of flexibility to the plan participants to manage those assets. The proposed changes accomplish both of those goals by giving favorable tax treatment for retirement assets preserved in that form and by removing restrictions on asset management and portability.

Current rules are inconsistent with those goals. Where the plan participant finds it necessary to elect, even on the basis of hardship, to receive a partial distribution, favorable tax treatment. of future distributions may be jeopardized. Where distributions are to be taxed unfavorably without regard to the preservation of their character as retirement assets, the participant has no incentive to preserve that character. Current rules also may force a taxpayer to leave assets in a plan in spite of a better investment opportunity elsewhere. Furthermore, even when a plan offers a very good investment opportunity, the participant might be forced, where he wishes diversification beyond the plan's offering, to remove all assets in order to receive favorable rollover treatment.

Although arguably the statutory provisions could be amended to provide specific exceptions such as hardship distributions to the rules limiting rollover treatment, this would increase the complexity of the rules. Moreover, the number of situations in which exceptions ought to be provided are so numerous that exceptions would become the general rule and vice versa. The proposed amendments present a more acceptable statutory solution; comport with reasonable tax policy; and add a measure of logic, order, and consistency which will result in more efficient application and administration of the rules.

EXAMPLES

1. A 57 year old employee separates from service and immediately begins receiving quarterly distributions. In no one year are these distributions ever as much as 50 percent of the balance to the credit of the employee on the date of the initial distribution. Immediately after attaining the age of 59½, the employee receives a final distribution of his account balance.

Under current law—

a. The quarterly distributions are currently taxable and are not eligible for rollover treatment since the distributions in any one year are not at least 50 percent of the balance to the credit of the employee. If the quarterly distributions in any one year were at least 50 percent of the balance to the credit of the employee, rollover treatment would probably not be permitted since the payments are likely to be treated as part of a series of periodic payments.

b. The final distribution is eligible for lump sum treatment or rollover treatment since the payment appears to satisfy the requirements of I.R.C. §402(e).

Under the proposed amendment—

a. The quarterly distributions would be eligible for rollover treatment since there would be no 50 percent requirement or prohibition from rolling over one of a series of periodic payments. If not rolled over; the distributions would be taxed in the year of distribution.

b. The final distribution would qualify as a lump sum distribution under I.R.C. §402(e), and would qualify for lump sum treatment or rollover treatment if rollover treatment was not elected for any of the preceding years' quarterly distributions. If rollover treatment of any of the quarterly distributions was elected, qualification for lump sum treatment would not be available pursuant of I.R.C. §402(aX5XDXiii). However, the final distribution would qualify for rollover to an IRA as a partial distribution under revised I.R.C. §402(aX5XDXi).

2. Same facts as example 1, except that the employee continues to receive quarterly distributions for two years after attaining the age of 59h and then receives a final distribution of his account balance at age 62.

Under current law—

a. As in example 1, the quarterly distributions are taxable in the year of receipt and are not eligible for rollover treatment.

b. The account balance distributed at age 62 is not eligible for lump sum treatment because the requirements of I.R.C. §402(e) are not satisfied. If the account balance distribution is not equal to at least 50 percent of the balance to the credit of the employee, the distribution does not qualify for rollover as a partial distribution. Even if the distributed account balance is equal to at least 50 percent of the balance to the credit of the employee, the IRS would probably determine the payment to be one of a series of periodic payments, removing eligibility for rollover. Accordingly, the distributed account balance would be taxable in the year of distribution.

Under the proposed amendment—

a. As in example 1, the quarterly distributions would be eligible for rollover as a partial distribution under revised I.R.C. §402(aX5XDXi).

b. As under current law, the final account balance distribution would not qualify for lump sum treatment since the requirements of I.R.C. §402(e) are not satisfied. However, the distributed account balance would qualify for rollover to an IRA as a partial distribution since the distribution would no longer have to be at least 50 percent of the balance to the credit of the employee and is no longer required not to be one of a series of periodic payments.

3. An employee begins receiving quarterly in-service distributions at age 59½. In no one year are these distributions ever as much as 50 percent of the balance to the credit of the employee on the date of the initial distribution. The employee separates from service at age 62 and immediately receives a final distribution of his account balance. No other distributions were received by the employee after separation from service.

Under current law—

a. The quarterly distributions are currently taxable and are not eligible for rollover treatment since attaining age 59½ is not a triggering event.

b. The account balance distributed upon separation from service is eligible for lump sum treatment or rollover treatment since the payment appears to satisfy the requirements of I.R.C. §402(e).

Under the proposed amendment—

a. The quarterly distributions would be eligible for rollover treatment since attaining age 59½ would be a triggering event. There would be no 50 percent requirement and no prohibition from rolling over one of a series of periodic payments. If not rolled over, the distributions would be taxed in the year of distribution.

b. The account balance distributed upon separation from service would qualify as a lump sum distribution under I.R.C. §402(e), and qualify for lump sum treatment or rollover treatment if rollover treatment was not elected for any of the preceding years' quarterly distributions. If rollover treatment was elected for any of the prior quarterly distributions, I.R.C. §402(aX5XDXiii) prohibits the use of lump sum treatment for the distributed account balance. However, the distributed account balance would be eligible for rollover to an IRA as a partial distribution under revised I.R.C. §402(aX5XDXi).

4. Same facts as example 3, except that the employee continues to receive quarterly distributions for two years and then receives a final distribution of his account balance at age 64.

Under current law—

a. As in example 3, the quarterly distributions are taxable in the year of receipt and are not eligible for rollover treatment.

b. The account balance distributed at age 64 is not eligible for lump sum treatment. The payment does not satisfy the requirements of I.R.C. §402(e) since the payments due to separation from service did not take place in one year. The distribution of the account balance also is not eligible for rollover treatment. Even if the amount of the account balance distributed at age 64 is at least 50 percent of the balance to the credit of the employee on the date of the first payment after the employee's separation from service, the IRS would probably determine the payment to be one of a series of periodic payments. Accordingly, the distributed account balance would be taxable in the year of distribution.

Under the proposed amendment—

a. The quarterly distributions would be eligible for rollover treatment since there would be no 50 percent requirement or prohibition from rolling over one of a series of periodic payments. If not rolled over, the distributions would be taxed in the year of distribution.

b. The account balance distributed at age 64 would not be eligible for lump sum treatment, just as under current law. However, the account balance distribution could be rolled over to an IRA as a partial distribution since there would be no 50 percent requirement or prohibition from rolling over one of a series of periodic payments. If the distributed account balance is not rolled over, it would be taxable in the year of receipt.

STATEMENT OF THE SMALL BUSINESS COUNCIL OF AMERICA, INC.

Mr. Chairman, my name is Paula Calimafde, President of the Small Business Council of America, Inc. The Small Business Council of America (SBCA), the Small Business Legislative Council, known as SBLA, and the National Small Business United, known as NSBU are pleased to present this written statement for the September 27, 1991 hearing of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service regarding pension simplification issues.

As representatives of millions of small businesses, we strongly support the effort to promote the voluntary retirement system by simplification. We are not, however, willing to see existing benefits and options eliminated in exchange for insignificant gains in simplification.

I also represent the delegates to the 1986 White House Conference on Small Business at which I served as the commissioner of the Payroll Cost Section. This section covered employee benefits and the private retirement system. The 1,813 delegates to the White House Conference on Small Business from across the country formulated, for the President and the Congress, 60 detailed policy recommendations. The 20th recommendation reads as follows: To promote the retirement security of our nation's employees, Congress must support and promote the continued viability of the private retirement system in the small business community. In support of this goal, there must be a five-year moratorium on further changes in our private retirement plan laws except for the following changes which we recommend: (a) promote-parity between large and small plans and between private and public sector plans; (b) simplify filing requirements and paperwork; (c) increase contribution benefit limits, including 401(k) plans and IRAs, to be at least as great as the pre-1986 tax reform act limits.....

Over the last decaJe, Congress has amended and revised the tax laws governing retirement plans at an alarming rate. In the quest to find short term revenue to offset the budget deficit, the long term impact of a given change on the retirement system has not been given enough consideration. This constant tinkering is taking its toll on the retirement system in America.

Only individuals who work with retirement plans understand how destructive the constant change imposed on the system has been to both employers and employees. Only the individuals communicating plan changes to employees hear the distrust generated - and not only just to Congress or the Internal Revenue Service, but also to the employer. Only the advisors who send the bills for services rendered, which go up every year in response to the intricate and unreasonably complicated laws, hear the complaints from their clients and often hear that the plan must be terminated.

To paraphrase some of the excellent words of Robert S. Stone who testified on behalf of ERIC at the September 16, 1991 Hearing of the House Ways and Means Committee Select Revenue Measures Subcommittee on pension access and simplification issues: "Constant change is costly for major employers and even prohibitive for medium and small employers. Each revision required in computer systems, administrative procedures, employee communications and plan design costs money that would be better spent on benefits. Constant change is upsetting to employees who look to retirement security programs as a safe, non-volatile program that they understand. Faced with the confusion of shifting ground rules, employers and employers alike lose their incentive to get into or to stay in the system."

Our discussion of the major pension simplification proposals, including to some extent the Administration's "POWER" proposal, must be placed in the context of the current environment where no change is often preferable to any change, even if the change is slightly better than existing law. Only when a change is one that will clearly foster the growth of the system, eliminate unnecessary complexity, and simplify the system in a meaningful manner - will the SBCA, SBLC and NSBU strongly support the change.

Here is a brief overview of the problems faced in the retirement world by privately held companies:

Imagine a high tech company that is a decade old with stable profits. The company is run by two young computer geniuses, each of whom own 50% of the company. There are 5 management employees and 10 staff members. This company sponsors a 401(k) retirement plan which provides for a 5% fully vested profit sharing (employer contribution) and allows non-highly compensated employees to make a full 401(k) contribution in the amount of $8,475.00. The highly compensated employees are then allowed to put in whatever amount is allowed under the 401(k) anti-discrimination tests.

First, who are the highly compensated employees? Under the laws in existence today, a highly compensated employee is a person who falls within one of these categories for both the present year or the preceding year:

o a 5% owner;

o an officer whose is compensation is greater than 50% of the Section 415 (b)(1)(A) limitation for the year (lesser of $108,963 for 1991 or 100% of the participant's average compensation for high three years);

o an employee whose compensation is in excess of $75,000 as indexed ($90,803 for 1991); or

o employees whose compensation is in excess of $50,000 as indexed ($60,535 for 1991) if they were in the employer's top-paid group of employees for the year. The "top-paid group" is defined in Section 414(q)(4) as an employee in the top 20% of the employees on the basis of compensation.

IRS has prepared approximately 14 pages of temporary regulations to help individuals determine what is meant by a highly compensated employee. Now it is our guess that a normal person would respond to this gibberish by saying a highly compensated person is someone who makes over X dollars, (though we imagine honest men and women would differ over the value of X). We contend such a definition would be fully consistent with the intent of the statute.

We commend the attempt in the bills to simplify this overly complex definition, but they do not go far enough. Why should a 5% owner be deemed to be a highly compensated employee simply because he or she owns an interest in the company? Treasury tells us this is because owners of privately held companies have the ability to reduce their compensation so that they won't be highly compensated. We don't know how this can be done, but assuming it can be - it is hard to imagine that an owner of a privately held company would reduce her or his income below $90,000 in any given year because of the ramifications of doing so in the company's 401(k) plan. This is the kind of thinking that breeds the many discriminatory provisions incorporated against privately held business in the retirement system.

The SBCA, SBLC and NSBU also believe the dollar threshold should be based upon the current $75,000 (as indexed for inflation), rather than being reduced as presently provided in the three major bills before the Congress. The changes in the proposed bill (while simpler than existing law) once again make the law more restrictive by expanding the definition of who is highly compensated. Again, simplification is something we applaud - taking away benefits and options of employees in the name of simplification is something we deplore and which has caused many of the problems the system is now facing.

Further, we suggest that for ease of application, the highly compensated employees be determined on the basis of the preceding plan or fiscal year of the employer, rather than the current and preceding years as is the case under current law.

Now let's go back to our imaginary high tech company. It has now been determined that the two owners are highly compensated employees as is a manager who makes more than $61,000. Also, one of the owners is married to the company's in-house marketing person whose salary is less than $25,000. This person is also deemed to be a highly compensated employee because of the family attribution rules. The company also finds out that the salary of the owner and the marketing expert must be limited for purposes of plan contributions because of the family aggregation rules.

The family aggregation rules work against family members who choose to work together -these rules are an anachronism and contrary to accepted public policy. Only the Chandler bill and the POWER proposal have provisions repealing this odious provision. We strongly urge the repeal of this provision be included in any simplification bill that emerges from Congress.

Once our hypothetical company has determined its highly compensated employees, because it is a small company, it must also determine its key employees. This is required to determine whether the plan is considered to be a "top-heavy plan" and if so, which employees are entitled to minimum benefits. Unfortunately, virtually all small plans are considered to be top-heavy because of the mathematical formulas utilized to determine this status. In this case, the plan is satisfying the top-heavy benefit requirements because the 5% fully vested employer contribution exceeds the required three percent (3%) minimum contribution under the top-heavy rules. However, the company is informed of one minor technicality under the top-heavy rules. The hypothetical company has an employee who use to work full-time and was a participant in the plan. This employee is now on flex-time and works less than 5 hours a week (and obviously less than the 1000 hours per year required for an employer contribution). Even though the plan does not cover the other part-time workers (as allowed under ERISA), the top-heavy rules will require that the plan make a 3% contribution for this single employee. This is a point that will be missed by many advisors.

To determine who the key employees are the company must look to all employees who at any time during the plan year, or any of the 4 preceding plan years, are or were:

o a 5% owner;

o an officer whose compensation is greater than 50% of the Section 415 (b)(1)(A) limitation for the year (lesser of $108,963 for 1991 or 100% of the participant's average compensation for high three years);

o the top ten employees having annual compensation greater than the Section 415(c)(1)(A) limitation (lesser of $30,000 or 25% of compensation) who also own the largest interests of the employer; or

o a 1% stockholder who has compensation in excess of $150,000.

This provision has all sorts of technical qualifications and explanations and has approximately 20 pages of Temporary regulations.

We strongly suggest the repeal of the key employee definition contained in Section 416. It is largely duplicative of the highly compensated definition, described above, but different enough to require additional calculations to be made. Further, it is an unnecessary burden on privately held businesses to review employee records for the current year and the four preceding years.

Additionally, it is our recommendation that the Top-Heavy rules of Section 416, including the definition of key employee, be repealed in their entirety as being one of the most complex and unnecessary provisions in the pension area. At an absolute minimum a voluntary safe harbor should be included in any simplification bill which would provide that if a plan contains a top-heavy vesting schedule and provides the applicable defined contribution or defined benefit minimum benefits that the plan will automatically satisfy Section 416 and no language or testing for key employees or account balances are required.

As an aside, allegedly the top-heavy rules were needed to be imposed on small business because it was determined that small business plans did not provide sufficient contributions to non-key employees. This determination appears to be based upon people looking at the contributions going to the participants of a plan sponsored by a small business from a vertical perspective rather than a horizontal perspective. By this we mean that if you look at the overall contribution to a plan vertically and see that out of a total contribution, a significant amount is allocated to the key employees' account balances, one might conclude that the plan is not generous to its non-key employees. However, if you look at the very same plan and contribution from a horizontal viewpoint and see that each and every participant, key and non-key, received a contribution equal to 10% of compensation, the same plan now appears to be extremely generous to its employees. In an informal survey of the SBCA membership which covered some 250,000 retirement plans, approximately 30% of the plans provided contributions in excess of 15% of participants' compensation. More than 35% of the plans provided contributions in excess of 35% and more than 40% provided contributions in excess of 7%. We suggest the correct approach in viewing contributions to privately held plans is horizontal, since the vertical approach is misleading when applied to small businesses which have a significantly higher proportion of key employees to non-key employees than larger businesses.

Our hypothetical company now has to figure out the 401(k) anti-discrimination tests since the highly compensated employees are not automatically allowed to contribute $8,475 of their own salary to the plan - the amount they can contribute is based on the amount the non-highly compensated employees choose to contribute plus the employer's fully vested 5% contribution. Unfortunately, the in-house person who does this test has not read the 39 pages of final regulations and explanations just issued, so the chances are that this test will not be determined fully in compliance with the regulations!

This is an area where we cannot applaud the Employee Benefits Simplification and Expansion Act as well as the bill introduced by Congressman Chandler enough. Both of these bills provide what we consider to be the first major 401(k) simplification provisions ever introduced. These bills utilize the concept of voluntary safe harbor provisions. They require either an employer contribution or an employer match of a certain amount - in exchange the company does not have to do any of the 401(k) testing. Now whether the provisions require too high a contribution or match is debateable, but it is crystal clear that this is the type of provision which will simplify the system in a meaningful way without requiring companies to change who desire to stay with the status quo. Many companies are now comfortable with the existing 401(k) tests - they have set up the necessary computer programs, issued the proper employee communications and all involved in the process basically know what they are doing. These companies may very well prefer to stay where they are - it will actually be simpler for them not to fall within a safe harbor. On the other hand, the company who chooses to streamline administrative burdens and costs will be allowed to do so by falling within one of the voluntary safe harbors.

The SBCA, SBLC and NSBU strongly suggest that if a company falls within any voluntary safe harbor that they automatically satisfy the top-heavy provisions, otherwise the safe harbor providing for matches at required levels will be meaningless for small business.

We oppose the new 401(k) test proposed in H.R. 2730 for two reasons. First, this new test would force all 401(k) plans to change their method of anti-discrimination testing once again. This means new employee communications, changes in programming and teaching the people administering the plan about the new test. All of this costs money. Second, this test takes away benefits from the middle income taxpayers who are deemed to be highly compensated under the highly compensated definition. We believe that the retirement system cannot afford to have any further benefits reduced. It is imperative to remember that retirement plans provide additional savings. Conceivably, this provision could be retained as a third voluntary safe harbor.

We must also commend Senators Pryor and Bentsen and Congressmen Chandler and Cardin for recognizing that with the laws as they are at this time, the single plan which is most likely to succeed in increased coverage of employees is the 401(k) plan. The SEP changes contemplated in the POWER proposal, the PRIME proposal and in Mr. Rostenkowski's proposal are doomed for failure. SEP plans are basically bonus plans and employers are certainly not going to begin sponsoring a plan that they have ignored for ten years because it now has a required contribution. Most stable, profitable privately held businesses want a plan that is designed with their needs in mind - they want the flexibility inherent in the current system even at the expense of necessary complexity. Turning money over to separate IRAs for employees is not what most privately held companies would deem to be a successful retirement plan. In particular, we do not believe that any existing benefit or benefit option should be cut back in any way to raise revenue for plans theoretically desired by small business which will not be utilized. Small business does not stand firmly behind the SEP vehicle - it is not clear to us who does.

The distribution rules presently contained in the Code are confusing and overlapping. Attempts to simplify in this area are welcome. It must be noted however, that to require 5% owners to receive distributions before they retire, when all other employees, including the top management of major companies, are not required to take distributions until they retire, smacks of discriminatory treatment towards privately held businesses.

With respect to the distribution rules, it is our position that the repeal of the five year averaging provision is unacceptable at the very least as it applies to present participants. Our position with respect to 5 year averaging is founded on the basic concept of fairness. All present participants in the retirement system have had the opportunity to use the 5 year averaging provision in their retirement planning. To remove the provision for current participants is in effect a promise broken. The ten year averaging rule also should not be repealed for the same reason. Moreover, the fiscal impact of the continuance of the provision will be eliminated fairly rapidly with the passage of time.

It is not clear how these provisions can be deemed to be simplification provisions - these are provisions which are totally optional on the part of participants. Further these provisions are most useful to mid-level employees. The Congress must insure that the employees' confidence in the system is not eroded by unfair provisions.

We strongly urge the Congress to either repeal the combined plan limitations of 415(e) or Code Section 4980A which imposes an excise tax on supposedly "excess" distributions. Employees who are benefitted by a defined benefit and defined contribution plan should be subject to either Section 415(e) or Section 4980A, but not both. If Section 415(e) is to be retained, then Section 4980A should be repealed. If Section 415(e) is retained, it should be revised to be based on a plan design approach rather than an actual accrued benefit approach. This recommendation is particularly true in light of the recommendation that the averaging provisions be repealed. The term "excess" distribution is particularly odious when it is analyzed in terms of fairness. The accumulations in retirement plans were permitted under rules in place at the time the accumulations were made. To impose a tax on "excess" distributions after the fact is one of the many reasons that confidence in the federal government's ability to appropriately impose tax laws is being eroded. In the event 5 year income averaging is repealed and Section 4980A remains in the Code, then the "5 times" rule with respect to the excess distribution excise tax should apply to a single distribution once in a participant's lifetime. Otherwise, this change will result in an additional retroactive tax on a law which is already tantamount to a retroactive tax.

The rollover rules modifications should permit rollovers from one qualified plan to another qualified plan or to an Individual Retirement Account. In addition, it should be permissible for a transfer from a trusteed plan to another trusteed plan, or from a trusteed plan to an IRA and subsequently to a trusteed plan in order to obtain the desired result of portability. All rules dealing with the rollover provisions should be voluntary.

We are concerned with the effective dates of many of the provisions in the bills. Any major pension bill of this sort requires lead time for employers to make changes in plan documents, computer programs, employee communications and plan administration.
We also suggest the following:

o Repeal or modify Code Section 401(a)(26). The reach of the proposed regulations is so broad that almost all plans, except the most elemental, will be subjected to this Code Section.

o Modify the full funding limitation. Code Section 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current "termination liability." This is misleading because termination liability is often less that the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. In effect, current law inappropriately mortgages benefit promises by prohibiting the level funding that is the reasonable way for plans to fulfill benefit obligations and, instead, requires plans to be funded with payments which escalate in later years. Instead, the full funding limitation should be based on ongoing (projected) liabilities, and not on termination liability.

o Make uniform the definition of compensation under the Code. Code Sections 414(s), 414(q), 415, and 401(a)(17) all provide different definitions of compensation which are relevant for different purposes under the pension laws. Having to comply with so many different definitions is confusing and invites error.

o Simplify the rules on affiliated service groups under Code Section 414. Inexact language in the statute and overboard regulations issued in proposed form have combined to creates artificial affiliations which do nothing to promote the integrity of the retirement plan system. Solution: have Congress give greater direction to the IRS on the types of abuses to be covered.

o Eliminate Code Section 414(o). This section provides a broad grant of regulatory authority to the IRS to deal with business arrangements which would allow circumvention of the qualified plan requirements. We believe that this section should be eliminated because it has made it virtually impossible for a sole proprietor and other small businesses to determine eligibility for plan contributions when it is involved in any way with another entity.

o Simplify coverage under Code Section 410(b) by eliminating the second part of the average benefit test. Solution: return to the "old" fair cross-section test as the alternative test for determining adequate coverage under a qualified plans.

Finally, Congress must halt the overt discrimination which is occurring in the IRS audit program aimed at small business defined benefit plans. The President in his budget directed IRS to collect 660 million in 2 years from small business defined benefit plans. This is, plain and simple, reprehensible. To go after a class of taxpayers because it is known they do not have the deep pocket necessary to litigate against the IRS cannot be tolerated. This program is unseemly - secret memos requiring agents to ignore long standing published and widely disseminated actuarial guidelines for small business, key officials at IRS and Treasury publicly stating they know nothing of the program and forcing the public to get the memos and other data through Freedom of Information. It will not be enough to simplify the system if companies know that by sponsoring a retirement plan, they are basically "buying" an audit. Audits are expensive. Congress must direct the White House and the IRS that overt discrimination against any sector of our economy will not be tolerated and that the application of retroactive rules will be brought to a halt.

CONCLUSION

As representatives of millions of small businesses, the SBCA, SBLC and the NSBU strongly support the effort to promote the voluntary retirement system by simplification. We support, however, only those changes which clearly foster the growth of the system, eliminate unnecessary complexity, and simplify the system in a meaningful manner. We are not willing to see existing benefits and options eliminated in exchange for insignificant gains in simplification. In particular, we support the concept of voluntary safe harbor provisions in the 401(k) plan area, support the repeal of the anachronistic family aggregation rules, and strongly oppose the proposed elimination of 5 and 10 year income averaging. We do not believe that the private sector should be asked to give up retirement benefits and options in order to fund the 401(k) plan for local and state governments. We do not believe that the SEP proposals will be nearly as successful as attracting employers to the voluntary retirement plan system as will the voluntary safe harbor provisions under the 401(k) plan. We are hopeful that any simplification bill emerging from Congress will repeal the top-heavy provisions, the full funding limit, and the duplicative Code section 4980A.

The following chart reflects which provisions of the three major bills we believe are positive or negative to small business.

COMPARISON OF PENSION SIMPLIFICATION BILLS
AS OF JULY 8, 1991
PREPARED BY
SMALL BUSINESS COUNCIL OF AMERICA

Provision[1][2][3]	Employee Benefits Simplification & Expansion Act (S.1364) PRYOR BILL	Employee Benefits Simplification Act of 1991 (H.R. 2641) CHANDLER BILL	Pension Access & Simplification Act (H.R. 2730) ROSTENKOWSKI BILL
1 Modification of Highly Compensated Employee Definition			
a Taxable entities - 5% Owners and employees earning greater than $50,000 (SBCA prefers only $75,000, indexed)	Included(-)	Included, also applies to tax-exempts and governments(-)	Included, but dollar amount is $65,000. Look back rule included for dollar limit (-)
b Use of prior year compensation for dollar threshold	Not Incl (-)	Included (+)	Not Included (-)
c Index of Dollar Limit	From 1986	From 1986	From 1990
2 Repeal of Family Aggregation Rules	Not Incl (--)	Included (++)	Not Included (--)
3 Modification of Additional Participation Requirements(SBCA prefers repeal)	Included	Included, with simplified testing method	Not Included
4. 401(k) and 401(m) Nondiscrimination Requirements			
a Voluntary 401(k) Safe Harbor (+)(+)	Included (++)	Included (++)	Not Included (--)
(i) 100% match up to 3% (+)(+)			
(ii) 50% match from 3% to 5% (+)(+)		Matching on 3 6% (++)	
(iii) Alternative to match - 3% nonelective contribution(+)(+)			
(iv) Nonincreasing matching rate			
(v) Alternative plan designs (+)(+)		Not Incl (--)	
(vi) Notice requirement (-, redundant with current law)			
b Each HCE limited to 200% of prior year ADP or ACP of Non-HCE[2]	Not Incl (++)	Not Incl (++)	Included, for both 401(k) and 401(m) (--)
c 401(m) Safe Harbor	Included (++)	Included, with 10% aggregate contribution limit (SBCA prefers elimination of 10% aggregate limit)(+)	Not Included (--)
(i) Based on 401(k) Safe Harbor (+)			
(ii) Nonincreasing matching rate		Not Included	
(iii) Notice requirement (-, redundant with current law)			
(iv) Matching on compensation up to 6%			
d Use of Prior Year ADP[2]	Not Inc. (+)	Included (+)	Included (+)
e. Modification of Excess Distribution and Excess Contribution Rules	Included (+)	Included (+)	Included, slightly modified (+)
5. Distributions			
a. Simplification of Rollover Distributions (++)			
(i) Rollover of all distributions other than those required by Code §401(a)(9)	Included (++)	Included (++)	Included, except that distributions of amounts received as a life annuity or an annuity of 5 years or more may not be rolled over (++)
(ii) Rollover of employee contributions	Not Incl (-)	Included (+).	Included (+)

[1] Provision based on Pryor Bill, unless otherwise indicated
[2] Indicates provision in Chandler Bill.
[3] Indicates provision in Rostenkowski Bill

Provision	Employee Benefits Simplification & Expansion Act (S.1364) PRYOR BILL	Employee Benefits Simplification Act of 1991 (H.R. 2641) CHANDLER BILL	Pension Access & Simplification Act (H.R. 2730) ROSTENKOWSKI BILL
b Repeal of forward averaging treatment (--, particularly since it affects 15% excess distribution tax)	Included, effective for distributions after 1991. (-) Transition rule for individuals eligible for 10 year averaging	Included, effective for distributions after 1996 ( ) Transition rule for individuals eligible for 10 year averaging	Included, effective for distributions after 1991 ( ) 1992 transition rule for individuals eligible for 10 year averaging.(-)
(i) Repeal "5 times" rule for 15% excise tax (SB-CA prefers 5-times rule to apply to lump sums)	Included (--)	Included (--)	Included (--)
c Repeal of Special Treatment for Net Unrealized Appreciation	Not Included	Not Included	Included (-)
d Repeal of $5,000 death benefit exclusion	Not Included	Not Included	Included
6 Trustee-to-Trustee Transfers	Included, transfers required (-)(-)	Not Included (+)	Included, transfers are an available option. (+)
7 Required Distributions			
a Distribution after later of age 70 or retirement	Included	Included, but using age 70 1/2	Not Included
b Distribution after age 70 for 5% owner	Included (-)	Included, also for individuals whose account balance exceeds $750,000 (-)	Not Included (+)
c Actuarial Adjustment	Included (-)	Included (-)	Not Included (+)
8 Simplified Method of Taxing Annuity Distributions	Not Incl (-)	Not Incl (-)	Included (+)
9 Treatment of Leased Employee (based on control)	Included (+)	Included (+)	Included (+)
10. Elimination of Half-Year Rules (59 1/2 becomes 59 and 70 1/2 becomes 70)	Included (+)	Not Incl.(-)	Included (+)
11 Parity for Self-Employed Individuals (doesn t include plan loans)	Included (-)	Included (-)	Included (-)
12 Alternative to 150% Full Funding Limitation	Not Included	Not Included	Included
13 Modification of SEPs			
a. Expansion of eligible employees to 100; repeal of 50% participation requirement	Included	Included	Included
b One-year participation requirement	Included	Included	Not Included
c Safe harbor discrimination requirement for elective deferrals	Included	Included, but modified to require nonelective contribution	Not Included, instead $5,000 deferral limit, with 3% nonelective contribution requirements, single plan requirements, matching contribution limitations, notice requirements
14 401(k) Plans for Tax Exempt Organizations	Included (+)	Not Incl (-)	Included,(+) 401(k) plans available for government in 1995 (-?)
15 Inclusion of Social Security Supplements Under Code §401(a)(5)	Not Inc. ded	Included	Not Included
16 Uniform Retirement Age for Code §401(a)(14) Purposes and Vesting Purposes	Not Included	Included	Included
17 401(a)(4) Nondiscrimination Based on Average Accrual Rates of Non-HCEs	Not Incl.(-)	Included (+)	Not Included (-)
18 Clarification that Code §457 Does Not Apply to Non-elective Deferred Compensation	Not Incl.(-)	Included (+)	Not Included (-)
19 Modification and Rounding of Cost of Living Adjustments	Included (+)	Included (+)	Included (+)
20 Election to use Base Pay as Compensation	Included (+)	Not Incl (-)	Not Included (-)

STATEMENT OF TEKTRONIC, INC.

Chairman Pryor, Tektronix, Inc., a Fortune 500 company headquartered in Beaverton, Oregon and founded in 1946, appreciates the opportunity to provide testimony on pension simplification legislation now under consideration in your subcommittee and elsewhere in Congress.

Pension plan legislation is important to us. The Tektronix Retirement Program consists of a Defined Benefit Pension Plan, a 401(k) Plan, and a Non-Elective Deferred Profit Sharing Plan. These plans cover 22,000 participants, including active participants and those who have terminated with deferred benefits or who have retired. Overall, Tektronix has $660 million under pension management. In the most recent fiscal year, the company paid out $40 million in benefits to retirees.

In preparing this information for your subcommittee, both of us have drawn on approximately 10 years of experience in pension management and experience in national organizations whose purpose is to advise Congress and the Administration on how to improve private pension plans.

As our executive summary indicates, two issues -- the definition of compensation and nondiscrimination testing -- are of primary importance to Tektronix in any pension simplification legislation. Other issues, including rollovers from qualified plans, plan-to-plan transfers, minimum distributions at age 70, cost-of-living adjustments, and half-year age requirements, also are important.

We are making comments on each of these issues from the standpoints of Tek's pension plan administration, as well as the effect of legislative initiatives on our plan participants. We are indebted to Senator Bob Packwood for his assistance and his willingness to submit our comments for the record as the Subcommittee on Private Pension Plans considers legislation this session.

We will begin by dealing with the two priority issues from Tektronix' viewpoint.

1. Definition of Compensation

   Tek's position is that "annual rate of pay" should be accepted as a nondiscriminatory definition of covered pay for qualified plans. Several proposals in Congress accept this definition, but some do not. As is true of many other pension plans, we currently use "annual base pay rate" as covered pay for pension purposes. We apply annual pay rate uniformly to all pension plan participants and it is a term well-understood by all employees. Our pension plan is a "final-average-pay" plan. Using annual pay rate as covered compensation actually increases the plan benefit of all employees who receive a pay increase within the 12 months preceding termination.

   This increase in benefit would not be as significant if we used actual pay received instead of the annual pay rate.

   We support a definition that would make it appropriate for pension plan managers to continue using annual rate of pay.

2. Nondiscrimination Testing -- ADP Test

   Current law requires qualified 401(k) plans to perform an annual test on contributions to assure that the average percentage of total compensation deferred by "highly compensated" employees be within a specific range of the average percentage of deferred amounts of the "non-highly compensated" employees. Since 1987, Tektronix has been performing -- and passing -- this test.

One bill under consideration in Congress limits the contribution percentage of those employees in the low to mid-level of the "highly compensated" group to 200 percent of the average deferral percentage of the non-highly compensated group for the prior year. If this proposal would have been law this year (1991), employees at Tektronix in the $60,000 to $87,000 pay range would not have been able to save for their retirement to the same extent as current law permits ($8,475). Yet, those whose pay is less than $60,000 or more than $87,000 could have saved the maximum ($8,475).

This, to us, constitutes inequitable treatment of employees in the $60,000 to $87,000 salary range.

Two proposals in Congress include design-based "safe harbors" which would eliminate the need for plans that conform to stated design features to run the ADP test at all. Since the plans we operate are broad-based and apply to all regular employees uniformly, almost any type of design-based approach to nondiscrimination is preferable to a mathematical formula approach.

In summary, then, our position is either that the current nondiscrimination testing procedure should remain in effect or that design-based approaches should be favored over those that involve mathematical formulas.

We now will turn to a summary of our positions on other pension simplification issues embodied in various Congressional proposals.

- Rollovers from Qualified Plans

Rollover rules currently are very complex, with specific conditions to be met depending on the type of distribution from a qualified plan into either an IRA or to another employer's qualified plan. Reducing complexity would constitute true pension plan simplification.

- Plan-to-Plan Transfers

We believe the best approach is to allow employees to elect plan-to-plan transfer of their accounts rather than making such transfers mandatory and to allow plan managers to make any requested transfers in the easiest way possible. From an administrative standpoint, plan-to-plan transfers require more handling due to the required filing of form 5310 with the IRS by both the receiving and the distributing plan. Corresponding disclosure in the annual report to the IRS also is required.

Currently, Tektronix accomplishes the same result, with much less administrative complexity, by distributing the funds and depositing them directly via rollover into the other qualified plan.

We hope that this flexibility can be built into any Congressional proposal.

- Minimum Distribution at Age 70 1/2

Current law requires qualified plans to start benefits at age 70 1/2 to any individual, even if he or she is still an active employee. We support a change, advocated by several members of Congress, that would restate the minimum distribution rules to start payments, in general, at age 70 1/2 or when the individual retires, whichever is later. This requires less administration.

- Nondiscrimination in Coverage and Participation

Tektronix does not have a problem in passing the current nondiscrimination rules in coverage and participation. We understand them and we are comfortable administering our plan under them. No doubt the same is true of many other plan managers. Therefore, we oppose any initiative that would apply a new or different mathematical model, including one that would impose a coverage rule based on an average accrual rate for highly compensated employees compared to an average accrual rate for non-highly compensated employees.

Since the current system is working well, we favor retaining it.

- Cost-of-Living Adjustments

Currently, the various dollar amounts in qualified plans indexed to the CPI are based on changes as of the last calendar quarter of the preceding year. This means that the IRS does not publish these new amounts until sometime in late January, a timing issue that presents a disadvantage for some employees.

One proposal suggests basing increases as of the calendar quarter ending September 30, thus allowing the IRS to publish the new amounts before the end of each calendar year. In turn, plan managers could notify employees by the end of December of the new limits and they would be able to change their 401(k) elections, if needed, effective with the first paycheck in the next calendar year.

- Half-Year Requirements

Current law requires certain distributions by age 70 1/2 and allows certain other distributions after age 59 1/2. We support initiatives that would change the ages simply to 70 and 59.

Conclusion

We appreciate this opportunity, afforded by Senator Packwood, to provide our views for the record. We support moves toward pension simplification and are prepared to work through Senator Packwood's staff to provide more information or react to any specific questions.

Summary Table

Proposal	Impact On: Employees	Administration	Support/Oppose
Rollovers	Positive	Positive	Support
Mandatory Plan-to-Plan Transfers	Neutral	Negative	Oppose
Age 70 1/2 minimum distributions delayed to termination date	Positive	Positive	Support
Design-Based ADP Test	Positive	Positive	Support*
Coverage Testing	Neutral	Negative	Oppose
Compensation Definition	Positive	Positive	Support*
COLA Changes	Positive	Positive	Support
Eliminate Half-Year Ages	Positive	Positive	Support

* Denotes top-priority issues

UNITED STATES CATHOLIC CONFERENCE

Office of the General Counsel

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September 25, 1991

The Honorable David Pryor
Chairman, Subcommittee for Private
Retirement Plans & Oversight
of the Internal Revenue Service
205 Senate Dirksen Office Bldg.
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

The United States Catholic Conference is a nonprofit, tax-exempt organization whose members are all active Catholic bishops in the United States, representing almost 200 dioceses and over 55 million people nationwide. 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 supports passage of S.747, "Church Retirement Simplification Act of 1991," because it would help simplify the administration of church retirement plans.

Congress recognized the uniqueness of churches and their related ministries by carving out church plan exceptions from the application of many pension rules applicable to secular, for profit employers. However, Congress seems to have overlooked the unique status of church plans when enacting subsequent pension legislation and inadvertently applied to church plans pension rules meant for secular employers.

S.747, while providing much needed simplification, would also insure that consistent rules are applied to church retirement plans and that these rules are not changed inadvertently when Congress revises the rules that apply to secular, for profit employers. This last point is really the cornerstone of S.747. The bill identifies, simplifies and brings together, in a separate place in the Code, all the rules applicable to church retirement plans. This "wall off" feature of the bill insures that church retirement plans will not be affected adversely when, in the future, Congress considers changes in the pension rules applicable to secular employers.

Over the years, churches have had to come to the Congress on a regular basis to explain why their unique circumstances present problems in implementing pension laws passed with secular, for profit employers in mind. These efforts have required a great expenditure of time and money. Generally, when these problems have been identified and explained, Congress has been quick to respond appropriately to the special situations of church pension plans. It is our hope that by locating the rules that apply to church retirement plans in their own separate place in the Code, inadvertent changes will cease and the consequent need to petition Congress will be eliminated.

I appreciate the opportunity to submit our views in support of S.747. I respectfully request that this letter be incorporated in the record of your September 27th hearing on this matter.

Sincerely,

Deirdre Halloran

Deirdre D. Halloran
Associate General Counsel

Statement of the U.S. Chamber of Commerce

The U.S. Chamber of Commerce appreciates this opportunity to express its views on S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, which was introduced by Senators Pryor and Bentsen. Employee benefits simplification is critically important to the Chamber and its member companies. Over the past decade, Congress ha.; adopted major revisions to the pension laws almost annually. The vast majority of these changes have imposed new requirements, limitations, or restrictions on pension plans and the companies that maintain them. These legislative changes have been followed, often after a delay of several years, by huge packages of regulations, which have imposed many additional requirements and tests.

The result has been that, year after year, an employer that wishes to provide retirement benefits to its employees faces greater difficulties in understanding the pension laws, higher costs in complying with those laws, and diminished flexibility in designing and administering its plans. As a result, far fewer employers are establishing new pension plans while many employers who had been maintaining plans have been forced to terminate them.

The damage caused by the excessive complexity and cost of pension regulation is starkly illustrated by Internal Revenue Service (IRS) statistics on the number of determination letters requested for new plans compared to the number of determination letter applications for plan terminations. In 1980, over 69,000 applications for determination letters for new plans were filed, compared to 13,000 for plan terminations. By the end of the decade, however, the ratio of plans established to plans terminated had been drastically altered. In 1989, for the first time, the IRS received fewer determination letter applications for new plans than for terminations of existing plans. In 1990, applications for terminations exceeded applications for new plans by a margin of 2.5 to 1. While other factors may have contributed to this trend, it is clear that the increased complexity of pension laws was a major factor.

The main victims of over-regulation have been the millions of workers who have been denied access to pension coverage. In particular, small businesses often lack or can't afford the expertise and resources needed to comply with pension laws, and therefore have refrained from maintaining plans for their employees.

It has become critically important that Congress act promptly and decisively to reduce the burden of compliance with the pension laws and to expand access to pension plans for all employees, particularly employees of small businesses. S. 1364 is intended to help achieve these goals, as are two other simplification bills introduced this year by Rep. Chandler and Rep. Rostenkowski, which contain many provisions similar to S. 1364. Each of the bills also contains provisions similar to those of the labor Department's Pension Opportunities for Workers' Expanded Retirement (POWER) proposal.

S. 1364 contains many elements that truly would help to simplify the pension laws and encourage employers to establish and maintain plans. Certain other provisions, however, seem designed to raise revenue at the expense of plan participants or to further other ends, rather than to advance the goal of simplification. We urge that these provisions be deleted.

The Chamber's specific comments on some of the major provisions of S. 1364 are provided below.

I. SIMPLIFICATION OF THE DEFINITION OF HIGHLY COMPENSATED EMPLOYEE (SECTION 101 OF S. 1364)

Under current law, an employee is 'considered a "highly compensated employee" if he or she falls into one of four categories. One category consists of those in the top 20% of employees by compensation whose income exceeds $50,000 (indexed). The determination of who is in the top 20% by compensation is made on a controlled-group basis; this is often quite difficult for employers with multiple subsidiaries.

S. 1364 would redefine "highly compensated employee" as one who earned more than $60,535 (indexed) in compensation in the preceding plan year or was a 5% owner. This would simplify the law by enabling the employer to determine its highly compensated employees at the beginning of the plan year, and by eliminating the need to determine the top-paid 20% of the controlled group as well as some of the other unnecessary complications contained in the current definition The Chamber supports this proposal with one qualification: the lower limit for compensation should be at least $65,000 (indexed) rather than $60,535. If no employee satisfies the definition of highly compensated employee, the employer should be deemed to have no highly compensated employees.

The current law rules requiring aggregation of the family members of certain highly compensated employees are both unnecessary and administratively burdensome and should be completely eliminated.

II. MODIFICATION OF SECTION 401(A) (26) MINIMUM PARTICIPATION RULES (SECTION 104 OF S. 1364)

Section 401(a)(26) is one of the most egregious examples of excessive and redundant regulation of pension plans. Although the Internal Revenue Code contains coverage and nondiscrimination rules that are more than sufficient to prevent abuses, section 401(a)(26) provides an additional and unnecessary lower limit on the number of employees that can be covered by the plan.

The Chamber believes that section 401(a)(26) should be eliminated. At a minimum, this section should be limited to defined benefit plans, as under S. 1364.

III. SAFE HARBORS FOR ADP AND ACP TESTS (SECTION 105 OF S. 1364)

The actual deferral percentage (ADP) test for elective deferrals under 401(k) plans and the average contribution percentage (ACP) test for employee and matching contributions have caused widespread dissatisfaction among both employers and employees. The tests require collection and processing of vast amounts of data and are thus quite costly for the employer. Moreover, the employer has no way of knowing at the begetting of the year whether the plan w1ll pass and therefore must either monitor deferrals on a continuing basis throughout the year or refund excess amounts to highly compensated employees at the end of the year. Employees, for their part, are often quite unhappy to receive a corrective distribution

S. 1364 contains two design-based safe harbors that would be available as alternatives to the ADP test. One safe harbor would be satisfied if the employer provided, for non-highly compensated employees, a 100% match of elective deferrals up to 3% of compensation and a 50% match of elective deferrals between 3% and 5% of compensation The second safe harbor would be satisfied if the employer provided a nonelective contribution to all non-highly compensated employees of at least 3% of compensation The safe harbors also could be used as an alternative to the ACP test for matching contributions if certain additional requirements were satisfied. The Chandler bill contains similar safe harbors.

The Rostenkowski bill would replace the current ADP test with a new test that would be applied at the beginning of a plan year. Under the new test, the deferral percentage for each highly compensated employee in a plan year would be limited to no more than 200% of the average deferral percentage of non-highly compensated employees in the preceding plan year. Similarly, the ACP test would be replaced with one under which the contribution percentage for each highly compensated employee for a plan year could not exceed 200% of the average contribution percentage for non-highly compensated employees for the preceding plan year.

The Chamber supports the design-based safe harbors in S. 1364 (and the similar safe harbors in the Chandler bill). These safe harbors would permit employers to avoid most of the recordkeeping and other administrative burdens associated with the ADP and ACP tests, as well as the employee dissatisfaction that results from distributions of excess deferrals, while still ensuring that substantial benefits are provided to non-highly compensated employees.

The 200% test in the Rostenkowski bill also could be useful to many employers. Instead of replacing the current ADP and ACP tests, however, the 200% test should be available as an alternative to satisfying the current law tests. Many employers, after drafting their plans and setting up the administrative structure to work with the current ADP and ACP tests, would prefer not to have to learn and apply a new test. We see no persuasive reason why these employers should not be given the flexibility to continue to apply the current tests. Also, the limitation in the 200% test is applied to deferrals by each highly compensated employee, rather than to the average deferrals by all highly compensated employees, which means that permissible deferrals by many moderate-income highly compensated employees will be lower than under current law.

We therefore recommend that the committee retain the current ADP and ACP tests, but permit employers to use the design-based safe harbors in S. 1364 and the 200% test in the Rostenkowski bill as alternatives to those tests. This will provide employers maximum flexibility to adapt to their individual circumstances while still protecting non-highly compensated employees. Moreover, Congress should overrule the provisions of the final 401(k) regulations that prohibit aggregation of an employee stock ownership plan (ESOP) with a non-ESOP, thus making it easier for employers to pass the ADP test.

S. 1364 would also provide that excess deferrals, matching contributions and employee contributions with respect to highly compensated employees would be corrected by adjusting the deferrals and contributions of those employees with the greatest amount of excess deferrals or contributions rather than those whose deferrals or contributions represented the highest percentage of their compensation. The Chamber believes that both methods of reducing excess deferrals and contributions (percentage of compensation and absolute level of deferrals or contributions) are reasonable and that employers should be permitted to choose between them.

IV. ROLLOVERS, AVERAGING OF LUMP SUM DISTRIBUTIONS AND REQUIRED DISTRIBUTIONS (SECTIONS 201, 202, AND 203 OF S. 1364)

Current law imposes many limitations on the types of distributions that can be rolled over into another retirement plan. These limitations are both complex and devoid of any rational policy basis. The Chamber believes that all distributions, other than those required by section 401(a)(9) of the Internal Revenue Code, should be eligible for rollover treatment. Moreover, section 401(a)(9) should be amended to impose minimum distribution requirements only on 5% owners and those with account balances exceeding $750,000.

The Chamber opposes, however, the provision of S. 1364 that would require plan administrators to make most distributions to an IRA or another qualified plan, rather than to the participant. This provision would impose additional administrative burdens on plans and would also expose plan administrators to liability in cases in which the administrator is forced to designate the entity to receive the distribution because the participant has failed to do so. The Chamber would not object, however, to a provision that would allow a participant to direct that his or her distribution be deposited in an IRA.

Under current law, five-and-ten year averaging is permitted for certain lump sum distributions. S. 1364 would eliminate five-year averaging. This would cause great hardship to the many employees who have based their retirement planning on the assumption that averaging would be available. Although the enhanced availability of rollovers would mitigate this hardship to some extent, it would not eliminate it. For example, an employee who wanted to use a lump sum distribution to buy a retirement home would be forced to pay substantially higher taxes than under current law.

Current law also defers the taxation of net unrealized appreciation of employer securities distributed as part of a lump sum distribution S. 1364 wisely retains this deferral. Elimination of the deferral would be inconsistent with the other rules governing distributions from qualified plans, unwise as a matter of policy, and unfair to employees who are eligible to receive distributions of employer securities.

V. REPLACEMENT OF HISTORICALLY PERFORMED TEST FOR LEASED EMPLOYEES (SECTION 301 OF S. 1364)

The leased employee rules of the Internal Revenue Code were intended to prevent employers from evading the coverage and nondiscrimination rules applicable to qualified plans by moving non-highly compensated employees to an outside service organization. Under section 414(n) of the Code, an individual who performs services may be deemed to be an employee of the recipient of those services for purposes of various provisions of employee benefit law if, among other requirements, the "services are of a type historically performed, in the business field of the recipient, by employees."

This "historically performed" test has proven to be both vague and overbroad in application It creates numerous uncertainties as to who is considered a leased employee and requires many individuals to be treated as employees of the recipient even where no abuses are involved and where it is clear that, under any rational policy, they would not be so treated.

The Chamber supports the proposals to replace the historically performed test with one based on the degree of control exerted by the recipient. A control test will be considerably easier to administer than the historically performed test and will permit many employers to use outside service providers in non-abusive situations without risking having them classified as leased employees.

The various simplification proposals contain somewhat different formulations of the control test. The Chandler bill, which provides that an individual is not a leased employee unless he or she performs services under the "primary control" of the recipient, provides the most appropriate standard.

Although the control test would be a major improvement over the historically performed test, it is not a panacea. Even if the control test is adopted, there will still be many non-abusive situations in which employers will be forced to classify outside service providers as employees or will be left uncertain as to whether they must do so. To mitigate this problem, Congress should adopt safe harbors which would exempt employers from the leased employee rules in situations in which it is clear that no abuses are involved. In particular, the leased employee rules should not apply to an employer if 70% of its workforce is non-highly compensated or if 50% of its payrolled workforce is covered by the Fair Labor Standards Act. These safe harbors, along with the replacement of the historically performed test by the control test, would go a long way towards limiting the scope of the leased employee rules to the abusive situations for which they were intended.

VI. FUNDING LIMITS FOR MULTIEMPLOYER PLANS (SECTION 304 OF S. 1364)

The full funding limit of 150% of current liability is unnecessary for multiemployer plans and the Chamber supports the provisions of S. 1364 that would eliminate this restriction. The Chamber also believes that employers who inadvertently violate the funding limits of the Internal Revenue Code should be relieved of liability for excise taxes if they acted in good faith.

VII. NEW MODEL SIMPLIFIED EMPLOYEE PENSION (SECTION 307 OF S. 1364)

The Chamber believes that small employers should be permitted to offer retirement plans that are not subject to the complex and burdensome nondiscrimination requirements of the Internal Revenue Code. For many startup businesses, as well as many very small employers, a simplified employee pension ("SEP") may be the only feasible form of plan. The Chamber therefore supports the provisions of S. 1364 that would make SEPs containing a salary reduction feature available to employers with up to 100 employees, compared to the current limit of 25 employees. The Chamber also supports replacing the requirement that contributions be made on behalf of all employees with service in 3 of 5 years with a requirement that contributions be made on behalf of employees with one year of service. This would conform the rules governing SEPs to those applicable to other retirement plans and also would simplify administration of SEPs.

While salary reduction SEPs would be an attractive option for some employers, SEPs also have some serious drawbacks. Under a SEP, an employee can make withdrawals at any time, as long as he or she is willing to pay income tax and a 10% excise tax In practice, many employees make frequent withdrawals from SEPs and do not accumulate substantial assets for retirement. Many small employers would therefore prefer to establish 401(k) plans, but have refrained from doing so because of the administrative burdens involved. In order to assist them, Congress should reduce the administrative burdens of 401(k) plans by adopting the safe harbors discussed above.

VIII. EXTENSION OF 401(K) PLANS TO TAX-EXEMPT EMPLOYERS (SECTION 311 OF S. 1364)

Under current law, state and local governments can offer a salary deferral plan to their employees in the form of a section 457 plan, while taxable employers can offer a 401(k) plan. Tax-exempt organizations, however, cannot offer either type of plan unless they are eligible to maintain a 401(k) plan under the grandfather rule provided by the Tax Reform Act of 1986 or quality for one of the other limited statutory exceptions. The exclusion of tax-exempt organizations from both types of plans is a serious inequity in current law and the Chamber therefore supports allowing tax-exempt organizations to offer 401(k) plans.

S. 1364 properly recognizes that only tax-exempt employers, and not state and local governments, should be permitted to offer 401(k) plans. As already noted, governmental employers are permitted to offer section 457 plans to their employees and there is no need to allow them to offer a second type of salary deferral plan- Moreover, as a result of the new section 3121(b)(7)(F) of the Internal Revenue Code, state and local governments will have a strong economic incentive to expand coverage of their retirement plans. Finally, and most importantly, extending 401(k) plans to governmental employees would result in a massive loss of tax revenue to the federal government, which would likely be offset by reducing the benefits of private-sector employees.

IX. MISCELLANEOUS PROPOSALS

The Chamber supports the proposals to base cost of living adjustments on September 30 data (and to round the resulting limits) (Section 102 of S. 1364), change various age limitations from 59½ to 59 and from 70½ to 70 (Section 302), conform the treatment of Keogh plans to that of corporate plans (Section 303), clarity the definition of affiliated employer for purposes of establishing a VEBA (Section 305), and eliminate the special penalties for failure to report pension distributions (Section 310).

X. DATE FOR PLAN AMENDMENTS (SECTION 312 OF S. 1364)

Recent experience, under the Tax Reform Act of 1986 and other statutes, has demonstrated the importance of an extended transition period for employers to implement required plan amendments. S. 1364 recognizes this by providing that amendments to implement the provisions of the bill need not be made until the first plan year beginning on or after January 1, 1993, as long as the amendments are retroactive to the effective date of each provision and the plan complies in operation with each provision. Congress should adopt this extended amendment period and should also ensure that any provisions imposing new requirements or restrictions on employers not become effective until at least the 1993 plan year. In the case of those provisions of S. 1364 that provide relief from some of the limitations and requirements of the 1986 Act and other recent legislation, however, the employer should be permitted to elect to make the relaxed provision effective retroactively to the date of the 1986 Act or other legislation that imposed the original requirement.

STATEMENT OF WAL-MART STORES, INC., BY DEBBIE DAVIS CAMPBELL

Mr. Chairman, I submit this statement to you as a 9½-year associate of Wal-Mart Stores, Inc. As an associate of Wal-Mart, I am privileged to participate in a Profit Sharing/ESOP Plan that is $1.5 billion in size and covers over 200,000 associates of Wal-Mart Stores, Inc. As an associate, I also serve as Administrator of the Profit Sharing Plan and my office has had the opportunity to talk to thousands of our people throughout the country. I submit this statement in an effort to represent their feelings as well as mine on issues that will impact our Profit Sharing accounts and our futures. I also intend to express the impact that this legislation would have on the administration of Profit Sharing Plans.

First, permit me to give you some background information on our Plan. Wal-Mart believes strongly in sharing its success with those who make it possible - our employees whom we call associates. As such, we have a Profit Sharing/ESOP Plan that sets aside a portion of company profits each year for our associates. Since our Plan is also an Employee Stock Ownership Plan (ESOP), the majority of our assets are invested in company stock. Our associates have a two-fold incentive to be productive and efficient in their jobs. First, the more profitable we make our company, the more the company can contribute to our Profit Sharing accounts. Secondly, the better we perform our jobs, the better our stock will ultimately perform.

It is that motivation that has made our company successful and has financially rewarded many of our long-term associates. It is not unusual for us to have hourly (non-management) associates such as Cash Office Clerks, Department Managers, Salesclerks, Distribution Center workers, Accounting Clerks, etc., leave Wal-Mart with over $100,000 in their individual Profit Sharing accounts. A number of these are able to retire prior to age 59½ and do not wish to rollover to IRA's. Some of them take their payouts in shares of Wal-Mart stock and continue their ownership in the company, but can gradually sell shares to provide retirement income. There is basically little, if any, benefit to rolling over stock to an IRA.

Since the various pension simplification bills have been introduced, I have received numerous calls from our associates across the country. They are outraged that the government would consider dictating to them how they must handle their Profit Sharing payouts. It is causing some of them to consider retiring early to avoid the impact of this legislation. That is usually not in their best interest, nor in our company's best interest. However, they feel it is important to them to be able to choose how they handle the payout they are entitled to after their many years of service to our company.

There are already very real incentives in place to encourage rollovers. The Tax Reform Act of 1986 assessed tax penalties and took away beneficial averaging treatment for most people; therefore, there is no need to mandate rollovers. Mandated rollovers are, quite frankly, an infringement of individuals' rights to handle their finances as they deem suitable.

Please allow me at this point to address the impact that mandated rollovers would have on the administration of Profit Sharing and other qualified plans. The concept of mandating rollovers is not pension simplification. It will instead impose additional administrative burdens on companies that offer these plans and expose them to the risk of increased litigation. For instance, if a participant fails to designate the institution to make the rollover to, the plan's sponsor (company) will apparently have to make that choice and choose how it should be invested. If the participant is not satisfied with the investment performance, he/she may sue the Plan and/or the company.

A second question is whether Plan administrators will have to be responsible for ensuring that the IRA or other retirement plan we are making a rollover to is in fact a qualified plan. That is virtually an unmanageable task for large plans like ours that make over 12,000 payouts a year.

Another potential problem is whether a bank will accept rollovers if the individuals involved have not signed papers to open the account. That is the situation we would face with people who do not designate with whom they wish to have their IRAs.

To summarize, this seemingly simple idea of mandating rollovers to IRA's will ultimately result in complex regulations being issued to address the points I have raised and will make administration of Profit Sharing and other retirement plans even more complicated and expensive. That is totally contrary to the reasons cited for introducing pension simplification legislation. The mandatory rollover provision in Senate Bill 1364 would also infringe upon the basic right of the individual to choose how he/she should handle their own retirement. We urge the Committee to eliminate the mandatory rollover provision from this bill.

WESTINGHOUSE ELECTRIC CORP.,
Pittsburgh, PA, September 27, 1991.

Hon. DAVID PRYOR, *Chairman,*
Subcommittee on Private Retirement Plans,
Committee on Finance,
U.S. Senate,
Washington, DC.

Re: September 27 Hearing On Pension Simplification

Dear Mr. Chairman: We offer comments on S. 1364, which will be the subject of a September 27 hearing of your Subcommittee. We commend you for your continued efforts and attention to the important task of simplifying the employee benefit laws.

THE BURDEN ON WESTINGHOUSE

Westinghouse Electric Corporation has over 100,000 U.S. employees. We currently maintain 52 separate qualified plans. Our major pension and profit sharing plans each cover more than 60,000 workers. Various contracts with the Department of Energy require us to maintain specialized packages of benefits and separate qualified plans for workers at various locations throughout the country. Other smaller plans typically exist where we have preserved the existing benefit programs following an acquisition.

I am the Associate General Tax Counsel at Westinghouse, and personally have been involved in the employee benefit field at Westinghouse for 16 years. This period, beginning shortly after ERISA, has witnessed an explosive growth in restrictions on benefit programs. Wave after wave of so-called "anti-abuse" rules, designed to limit deferrals by highly compensated professionals, have created a complexity of nightmarish proportions.

With the complexity has come added cost. Last year Westinghouse spent about $37 million simply to administer our three major qualified plans. In the last few years we have spent over $8 million to computerize our administrative systems for these large plans, and still have not completed that task.

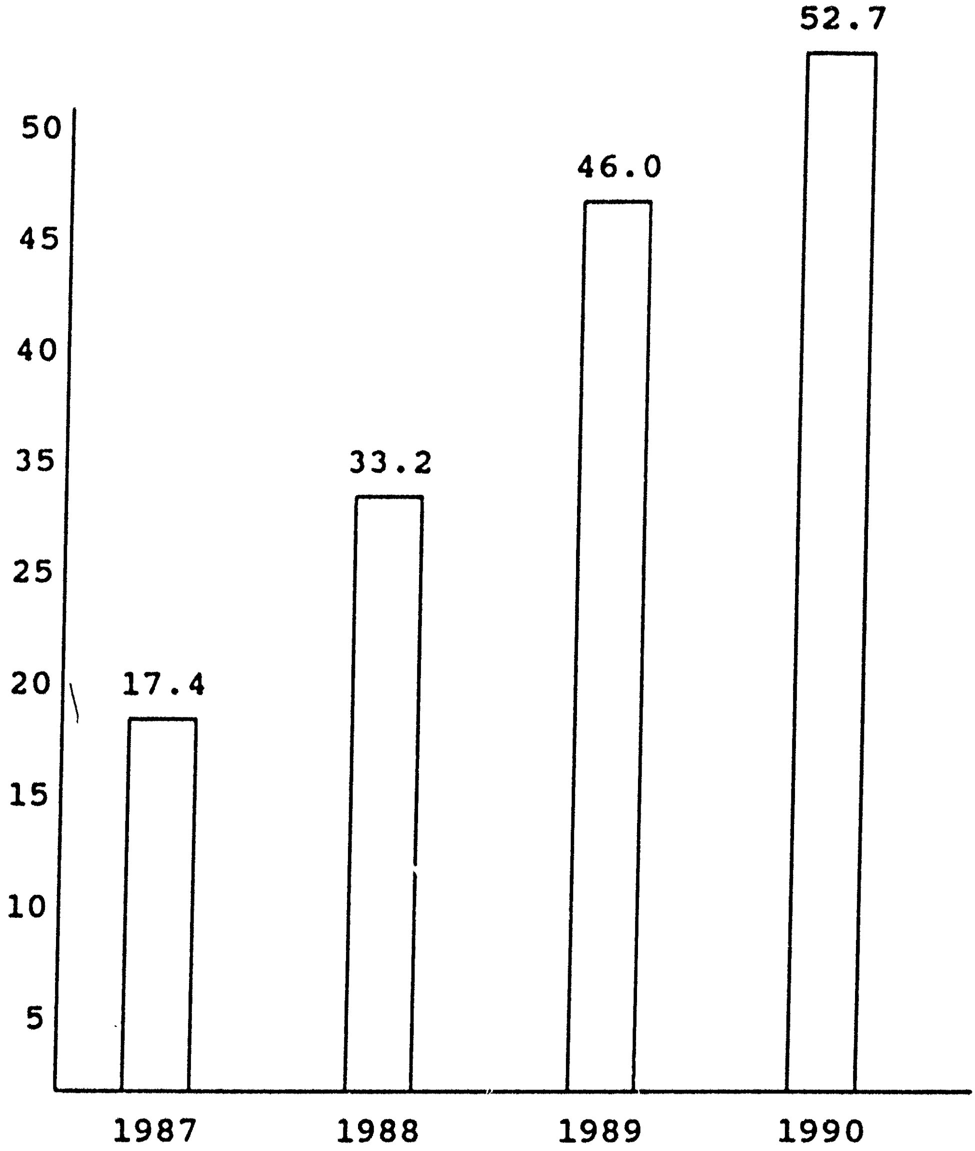
TAXATION OF DISTRIBUTIONS

We are very pleased that all of the legislative initiatives would simplify the taxation of distributions from qualified plans. This area is not only among the most complex, but it applies to individual participants, who struggle to make sense of the rules and the possibilities. Westinghouse employs 55 people who spend all of their time advising employees and retirees about qualified plans. This group receives an average of 550 calls a week, and half of these concern the taxation of distributions. We also believe the present rules are simply bad tax policy; they encourage premature consumption of retirement savings.

Current law discourages the elimination of the lump sum option in the Westinghouse Pension Plan; it also forces us to use interest assumptions that encourage retirees to take a lump sum. Throw in the present tax incentives for lump sums—such as 5-year averaging and the 1986 grandfather rules—and the result is a triple whammy against lifetime income options.

Below is a chart showing the increasing number of our retirees who have taken the lump sum option over the last four years. This figure has gone from 17% in 1987 to 53% in 1990. Last year we paid out over $168 million in lump sums from the Westinghouse Pension Plan alone.

WESTINGHOUSE PENSION PLAN LUMP SUMS AS A PERCENTAGE OF TOTAL RETIREMENTS (BASED ON NUMBER OF PARTICIPANTS)



This trend, which we believe is typical of many other companies, is troublesome for several reasons. It frustrates Westinghouse's primary purpose in providing a defined benefit plan—to provide workers with an income that cannot be outlived or wasted. While the lump sum problem as a whole may be beyond the scope of the September 27 hearing, there is no need to retain complex tax incentives for premature consumption.

Westinghouse strongly supports proposals to eliminate all of the special averaging and other rules, including 5-year averaging, the 1986 grandfather rules, and the special rules for net unrealized appreciation, or "NUA." We disagree with those who would delay repeal or retain various parts. The existing complexity should be completely scraped as soon as possible.

We understand and appreciate the comments of those who point out the tax savings for some under the special lump sum rules. However, these "savings" are often measured against immediate taxation as ordinary income, and the benefits of preserving assets in retirement form and deferring tax are rarely estimated. We also see situations where workers receive distributions, typically from defined contribution plans, that they cannot rollover under present law. We believe liberalized rollover rules are a fair trade for workers, a trade that would substantially decrease anxiety and confusion for persons contemplating retirement, and administrative costs. We think the balance strongly favors simplification in this area.

We would like to make a special comment about net unrealized appreciation, or NUA. Frankly, we have had a devil of a time trying to figure out, administer, and communicate to participants the rules in this area. Although our major defined contribution plan holds $2.5 billion in assets, only $324 million of this is Westinghouse stock, and only 11% of distributions include stock.

NUA has the effect of deferring tax. Liberalized rollover rules would accomplish the same basic result, and be simpler for all. If the rollover rules are liberalized, there is absolutely no reason to retain the enormous complexity of the NUA concept.

TREATMENT OF UNION EMPLOYEES

Many of our employees are unionized, and covered by collective bargaining agreements. Ou: basic approach has been to cover represented workers in the same qualified plans that benefit the nonrepresented workers at a particular site. The very recent fina! IRS tax regulations regarding coverage contain only narrow and limited relief on this important point.

We support the proposal [1] to confirm that companies may count represented workers in testing the coverage of a plan. The statute already appears to say this, and we do not think that Congress intended any distinction. To us, it is a simple matter of fairness. If Westinghouse were not unionized, these persons would be counted. It is startling that a tax law would specifically penalize a company merely for being unionized. As a matter of fairness, this result should be revised.

LEASED EMPLOYEES

Westinghouse strongly supports proposals to simplify the definition of "leased employee." This is a prime example of a rule originally designed to prevent manipulation by professionals that has evolved, taken on a life of its own, and now leads to absurd results. Companies such as Westinghouse have no clear standards for determining who to count. The basic idea should be that if an employer is telling a person how to do his or her job—in other words, treating the person like a common law employee—the person should be counted as an employee for benefit testing purposes. We favor the proposed statutory language of H.R. 2641 in this regard, because it sets out a straightforward test that we can apply. We are concerned about vague multi-factor "control" tests, such as contained in S. 1364. They are virtually impossible to apply, and we have not had good luck getting reasonable regulations where the statute is overbroad.

CONCLUSION

We offer a final concern. Care should be taken that any proposals ultimately adopted are a genuine simplification, and not merely a change. All of the proposals that we have specifically endorsed here today would essentially require no new plan amendments and no new administrative systems. In addition to complexity, a major problem in the qualified plan area has been constant changes. We urge the Subcommittee to develop a package that does not require major or immediate plan amendments, and that will not be difficult to administer and communicate.

In conclusion, Westinghouse supports your efforts to simplify the rules for qualified plans. If you or your staff have any technical remarks or questions on these comments, please contact our outside counsel on such matters, Douglas W. Ell of Groom and Nordberg, Chartered, who may be reached at (202) 857-0620.

Very truly yours,

VERNON J. CARPENTER, *Associate General Tax Counsel, Westinghouse Electric Corp.*

[1] Section 310 of H.R. 2641.

STATEMENT OF W.L. GORE & ASSOCIATES, INC.

Thank you for considering a change in the tax laws which will help working people who feel a need to diversify their retirement investments.

2,780 Associates participate in the W. L. Gore & Associates, Inc. Associate Stock Ownership Plan (ASOP). Our ASOP is an Employee Stock Ownership Plan (ESOP), a qualified retirement plan which is substantially invested in the common stock of our privately-owned company. While Associates are highly motivated by the ownership opportunity ASOP provides, some wish to diversify their retirement investment. Our Plan documents are structured to permit this. ASOP participants who have completed 15 years of service with the company, or are 55 years of age and have at least 10 years of service, or are 65 years of age may withdraw up to a total of 50 percent of their plan benefit while still working.

The tax law prevents meaningful exercise by Associates of a diversification option at the present time. With a small exception, the combination of IRC Sections 402(a)(5) and 402(e)(4) prevent in-service distribution of plan benefits, even to an IRA, without payment of tax at ordinary income tax rates on the full value of the withdrawal. Added to this is the 10% penalty on pre-retirement withdrawals under IRC Section 72(t).

The small exception is the IRC Section 401(a)(28) mandatory distribution option, which does not yield a significant benefit to Gore Associates.

While 214 of ou› 2780 Plan participants qualify for early distribution under our Plan provision, only 40 qualify under the tax law providing for an early distribution option. Many Associates eligible for pre-retirement distribution under the Plan have not yet reached age 55, the starting age for IRC 401(A)(28) distributions. 50% of the balances of the 214 Associates are available under the ASOP, but only 4% under the tax law, as account balances from which the IRC Section 401(A)(28) withdrawal may be taken are limited to balances based on stock acquired after December 31, 1986.

Only three Associates have taken a distribution under the tax law's complex rules, while 71 elected the option to remove 50% of their account -- we assume and in some cases know in order to diversify -- in the period from 1984 to 1989 when it was possible to "rollover" into an IRA.

S 1364, HR 2730, HR 2641 and the POWER proposal all contain provisions which would help ASOP participants and members of other ESOPs achieve their diversification needs while continuing their work in the business enterprise sponsoring the plan. We perceive this as an important positive step; many of my Associates are writing their elected representatives to express their support for this effort.

Below is a chart addressing issues presented by these legislative proposals which affect the rollover itself or the taxation of benefits received from an ESOP. We have catalogued these issues in an effort to show how each proposal impacts ASOP participants.

ROLLOVER/BENEFIT TAXATION FEATURES OF PENSION BENEFITS SIMPLIFICATION PROPOSALS

	Rollover in service	Trustee to Trustee Transfer	5 year Averaging	10 year Averaging	Exclusion of Unrealized Appreciation	Capital Gains Treatment Option
HR 2730	yes 60 days	option/ notification of 60 day rule	repeal[1]	repeal[2]	repeal[2]	repeal[2]
S 1364	yes 60 days	required w/exceptions	repeal[1]	continue	continue	continue
HR 2641	yes 60 days	not required	repeal[1]	continue	continue	continue
POWER	yes 60 days	option/ notification of 60 day rule	repeal[1]	repeal[2]	repeal[2]	repeal[2]

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[1] Gore ASOP has many distribution options, including distribution over time, which minimize the impact of this feature.

[2] This applies to people 55 or older. Loss of this option decreases flexibility on which ESOP beneficiaries, now close to retirement, may have counted. Impact on Gore ASOP beneficiaries is minimized by the plan's many distribution options, but the loss of freedom to pursue a planned course of action so close to retirement may adversely impact even some Gore Associates. The impact could be serious for beneficiaries of other ESOPs.

S 1364 is the preferred vehicle, as it allows rollover treatment of in-service distributions without restricting options now present in the tax law on which Associates approaching retirement may have based their retirement income plans. The fact that distribution is to be made directly to another qualified retirement vehicle is not a burdensome constraint under the circumstances.

HR 2730 also provides for the rollover treatment of in-service distributions we seek, though at a loss of some flexibility in how the benefit will ultimately be received after retirement.

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