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REPORT
No. 93-383

PRIVATE PENSION PLAN REFORM

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TOGETHER WITH ADDITIONAL AND SUPPLEMENTAL VIEWS

ON

S. 1179

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PRIVATE PENSION PLAN REFORM

AUGUST 21, 1973.—Ordered to be printed
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Mr. LONG, from the Committee on Finance, submitted the following

REPORT

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

[To accompany S. 1179]

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

I. SUMMARY

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

In broad outline, the bill is designed—

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

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

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

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

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

Present tax treatment of qualified plans

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

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

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

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

Problem areas

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

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

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

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

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

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

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

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

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

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

Provisions of the bill

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II. REASONS FOR THE BILL

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

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

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

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

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

THE ENCOURAGEMENT OF NONDISCRIMINATORY PLANS UNDER PRESENT LAW

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

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

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

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

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

Year	Coverage[1] end of year (in thousands)			Employer contributions (in millions)			Employee contributions (in millions)			Number of beneficiaries, end of year (in thousands)[2]			Amount of benefit payments (in millions)			Reserves, end of year (in billions)		
	Total	Insured	Non-insured	Total	Insured	Non-insured	Total	Insured	Non-insured	Total	Insured	Non-insured	Total[3]	Insured	Non-insured	Total	Insured	Non-insured
1950	9,800	2,600	7,200	$1,750	$720	$1,030	$330	$200	$130	450	150	300	$370	$80	$290	$12.1	$5.6	$6.5
1955	15,400	3,800	11,600	3,280	1,100	2,180	560	280	280	980	290	690	850	180	670	27.5	11.3	16.1
1960	21,200	4,900	16,300	4,710	1,190	3,520	780	300	480	1,780	540	1,240	1,720	390	1,330	52.0	18.8	33.1
1961	22,200	5,100	17,100	4,830	1,180	3,650	780	290	490	1,910	570	1,340	1,970	450	1,520	57.8	20.2	37.5
1962	23,100	5,200	17,900	5,200	1,240	3,960	830	310	520	2,100	630	1,470	2,330	510	1,820	63.5	21.6	41.9
1963	23,800	5,400	18,400	5,560	1,390	4,170	860	300	560	2,280	690	1,590	2,590	570	2,020	69.9	23.3	46.6
1964	24,600	6,000	18,600	6,370	1,520	4,850	910	310	600	2,490	740	1,750	2,990	640	2,350	77.7	25.2	52.4
1965	25,300	6,200	19,100	7,370	1,770	5,600	990	320	670	2,750	790	1,960	3,520	720	2,800	86.5	27.3	59.2
1966	26,300	6,900	19,400	8,210	1,850	6,360	1,040	330	710	3,110	870	2,240	4,190	810	3,380	95.5	29.3	66.2
1967	27,500	7,700	19,800	9,050	2,010	7,040	1,130	340	790	3,410	930	2,480	4,790	910	3,880	106.2	31.9	74.2
1968	28,000	7,900	20,100	9,940	2,240	7,700	1,230	340	890	3,770	1,010	2,760	5,530	1,030	4,500	117.8	34.8	83.1
1969	29,000	8,700	20,300	11,420	3,030	8,490	1,360	350	1,010	4,180	1,070	3,110	6,450	1,160	5,290	127.8	37.2	90.6
1970	29,700	9,300	20,400	12,580	2,860	9,720	1,420	350	1,070	4,720	1,220	3,500	7,360	1,330	6,030	137.1	40.1	97.0

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

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

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

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

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

PROBLEM AREAS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

OBJECTIVES OF THE MAIN PROVISIONS OF THE BILL

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. REVENUE EFFECT

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

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

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

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

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

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

[1] Takes effect Jan. 1, 1974

[2] Takes effect Jan. 1, 1974, for proprietary plans adopted after July 24, 1973, and Jan. 1, 1975, for proprietary plans in existence on July 24, 1973

[3] Takes effect Jan. 1, 1975.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. GENERAL EXPLANATION

A. Administration

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

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

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

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

B. Participation and Coverage

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

1. PLAN PARTICIPATION—AGE AND SERVICE REQUIREMENTS

Present law

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

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

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

General reasons for change

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

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

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

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

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

Explanation of provisions

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

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

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

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

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

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

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

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

Effective date

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

Revenue effect

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

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

Present law

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

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

General reasons for change

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

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

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

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

Explanation of provisions

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

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

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

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

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

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

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

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

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

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

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

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

Effective date

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

Revenue effect

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

C. Vesting

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

Present law

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

Employees must also be granted vested rights if the plan terminates or the employer discontinues his contributions.

However, qualified employer plans are generally not required to provide vested rights to participating employees before normal retirement age unless this is considered to be necessary—in view of the likely pattern of employee turnover—to prevent discrimination against the rank and file employees in favor of officers, shareholders, supervisors, and highly paid employees. In other words, preretirement vesting is required only where its absence would cause discrimination in favor of officers, etc., who could be expected to remain with the firm long enough to retire and qualify for benefits, while the rank and file employees would continually be separated from the firm and lose their benefits.

Under an owner-employee plan,[1] the rights of all employees must vest in full as soon as they become participants. (sec. 401(d)(2)(A)).

General reasons for change

Unless an employee's rights to his accrued pension benefits are nonforfeitable, he has no assurance that he will ultimately receive a pension. Thus, pension rights which have slowly been stockpiled over many years may suddenly be lost if the employee leaves or loses his job prior to retirement. Quite apart from the resulting hardships, the committee believes that such losses of pension rights are inequitable, since the pension contributions previously made on behalf of the employee may have been made in lieu of additional compensation or some other benefits which he would have received.

Today, slightly over two-thirds of the private pension plans provide some vested rights to pension benefits before retirement. However, as a general rule, employees do not acquire vested rights until they have been employed for a fairly long period with a firm or are relatively mature. Since there is no general applicable legal requirement for preretirement vesting, some plans do not offer this type of vesting at all, and among those plans which do, there is no uniformity in the vesting rules as provided. At present, only one out of every three employees participating in employer-financed plans has a 50-percent or greater vested right to his accrued pension benefits. Even for older employees, a substantial portion do not have vested rights. For example, 58 percent of covered employees between the ages of 50 and 60, and 54 percent of covered employees 60 years of age and over, still do not have vested rights to even 50 percent of their accrued pension benefits.[2] As a result, even employees with substantial periods of service may lose pension benefits on separation from employment. Extreme cases have been noted in which employees have lost pension rights at advanced ages as a result of being discharged shortly before they would be eligible to retire. In addition, the committee believes that more rapid vesting is desirable because it will improve the mobility of labor, and in this manner promote a more healthy economy.

For reasons indicated above, the committee concluded that it is necessary and desirable to provide a minimum standard of vesting

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

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

for all qualified pension plans. (Clearly, however, it would be counterproductive to increase employer costs by more rapid vesting to such an extent as to significantly curtail the creation of new retirement plans (or to significantly curtail the increase of benefits in existing plans). The committee bill deals with this problem by requiring relatively early vesting (beginning not later than an employee's fifth year of service or 30th birthday, whichever occurs later) for some of the employee's rights but does not require that they be vested fully until after 15 years of service or age 40. This is known as gradual (or graded) vesting.

Explanation of provisions

General rule.—The committee's bill provides that a qualified retirement plan (whether trusteed or insured) would be required to give each employee vested rights to at least 25 percent of his accrued benefit from employer contributions after 5 years of service, plus 5 percentage points a year for each of the next 5 years and 10 percentage points a year thereafter. This would mean that there must be 100 percent vesting after 15 years of service.[3] (Note that, because of the participation rules described above, vesting could be delayed in the case of an employee who started employment before age 25.)

This approach has the advantage of providing some vesting at a relatively early point in the employee's career. Thus, if the employee changes jobs after 5 years of service, he would be protected in his rights to at least some of his accrued pension benefits.

Also, because vesting occurs gradually under the committee bill, this tends (by comparison to proposals presented to the committee that would have required full vesting in as short a time as five years) to bring down the cost of the vesting requirement to manageable levels by minimizing the cost of establishing a new plan or improving benefits under an existing plan. It also avoids the serious "notch" effect of providing 100 percent immediate vesting after any specified number of years. In other words, if employees receive too much of their vested rights in any one year, it could give the employer an incentive to dismiss an employee rather than to absorb the resulting sharp increase in pension plan costs.

The committee bill takes the approach of being "age-neutral," which means that an employee's rights to vested benefits depend solely on his years of service, rather than on some combination of service and age. Age-weighted proposals have been advocated to the committee because they provide early vesting to the older worker.[4] However, the committee believes that this approach would tend to discourage the hiring of older employees, who already are faced with difficult problems in finding employment, and would not generally protect the rights of younger employees, who are more likely on the average to change jobs and, therefore, lose pension rights. Such continual losses of pension rights when they are young tends to make it difficult for employees to accumulate adequate pensions over their working careers.

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[3] Under the bill, each employee would have to be fully and immediately vested in his accrued benefit derived from his own contributions. In general, the rules described in the text relate only to benefits derived from employer contributions.

[4] It is recognized that age has some effect in that it may be relevant to participation (see B Participation and Coverage, above); however the committee's decision on vesting gives no direct effect to age.

Moreover, even when an adequate pension is to be provided, the loss of pensions accrued in previous employment due to the absence of vesting at an early age may throw most of society's cost of providing an adequate pension (if it is to be provided) on the employers for whom the employee works in his later years.

It should be made clear that the standards of vesting provided in the committee bill are only intended as minimum standards. The bill's provisions are not intended to prohibit plans with more rapid vesting than that required under the standards in the bill.

The provisions of the committee bill relating to vesting, of course, are not intended to modify the anti-discrimination requirements of current law. Presently, more rapid vesting requirements are sometimes required to prevent discrimination under a plan in favor of officers, shareholders, or highly compensated employees. The committee has not modified the present relationship between the vesting and anti-discrimination provisions. On the one hand, the higher vesting standards provided in the bill are likely to reduce somewhat the need to apply vesting in order to prevent discrimination. On the other hand, there undoubtedly still will be cases where it will be necessary to provide additional vesting over and above the minimum vesting standards in this bill in order to prevent discrimination. It has also been suggested to the committee that the antidiscrimination provisions have not been interpreted uniformly throughout the country, and it believes that appropriate guidelines should be provided to the district offices to achieve a uniform interpretation of the law.

Pre-participation service.—Once an employee becomes eligible to participate in a pension plan, his years of service with an employer before becoming a participant in the plan, up to a maximum of 5 years, are to be credited toward his required years for minimum vesting. This means that if an employee joins a firm at age 25, he would have to become a plan participant on or before age 30 (the maximum permissible attained age requirement, under the participation provisions of the bill). However, he would at that time (because of his 5 years of preparticipation service) have to become at least 25 percent vested in any pension benefits he accrues after becoming a participant. For purposes of this "look back" rule, however, years of preparticipation service would not be counted unless the pension plan was in existence during those years.

Although the committee recognizes the desirability of permitting the exclusion of transients by setting up participation requirements (the one-year-of-service and age-30 rules described above), it seemed to the committee that those years ought to count for something once the employee has stayed long enough to be a participant. This provision requires that the employee receive credit for up to 5 years of preparticipation service in computing his position on the vesting schedule. There is precedent for such a "look back" rule, since the committee has been informed that many existing pension plans already take preparticipation service into account for vesting purposes.

Benefits accrued in the past.—Generally, the vesting requirements of the bill are to apply to all accrued benefits, including those which accrued before the effective date of the provision. Years of service prior to the effective date also are to be counted for purposes of determining

the extent to which the employee is entitled to vesting. For example, if an employee joined a company at age 30 (at which time a plan was in effect), became a participant in the plan at age 35, and was age 40 on the effective date of the vesting provisions, he would have to become at least 50-percent vested at that time. However, he might not have more than 5 years of accrued benefits since the minimum benefit accrual is based on participation.[5] This would occur because of his 5 years of participation under the plan plus his 5 years of preparticipation service. Without this pre-effective date rule, it was apparent to the committee that employees who are now older employees would receive the advantages of required vesting only for the accrued benefits they would be able to build up gradually in the future and would receive no protection for benefits accrued prior to the effective date of these provisions, which would usually be the bulk of the benefits earned during their lifetimes.

The committee considered various methods of providing that pre-effective date service be taken into account in the case of older employees only, but concluded that most such methods provided some type of undesirable "notch" effect and in most cases would result in little cost saving to the employer relative to the rule adopted by the committee on this point.

Multiemployer plans.—In the case of a multiemployer plan governed by a collective bargaining agreement, the vesting requirements of the committee bill generally are to be applied as if all employers who are parties to the plan constituted a single employer. For example, years of service with employers A and B under the plan will be counted together in determining vesting, even though the employee now works for employer C.

Service that is seasonal, intermittent, etc.—For purposes of the minimum vesting rules, an employee is to be treated as having performed a year of service if he was actually employed at least 80 hours a month, for at least 5 months during the year (which may be a calendar, plan, or fiscal year, whichever is applied on a consistent basis under the plan). A plan would be permitted to provide that up to 3 of the 5 years of service required for minimum vesting must be consecutive. Service with a predecessor of the employer would also be counted, for purposes of the vesting rules, to the extent provided in regulations. The committee anticipates that the regulations in this area will prevent a situation where an employee might lose his rights to vesting as the result of a business reorganization.

Once having satisfied the consecutive service requirement, however, an employee would not lose his vesting because of breaks in service. For example, an employee with 5 years of service and 4 years of participation who left the plan and rejoined in a later year would become a 25-percent vested participant immediately, and he would become 30-percent vested in his accrued benefits after one additional year of service, 35 percent after a second additional year, etc. Even if the employee had received a lump sum distribution of the benefits accrued during his prior period of service, because of that earlier service the

[5] The employee need have only 5 years of accrued benefits, because the vesting provisions are to apply to pre-effective date service only to the extent of the employee's accrued benefits. The new participation standards are not to apply before the effective date of those standards; if these facts were to occur in the future, the employee would be at least 50-percent vested in at least 9 years of accrued benefits.

employee would still be partially vested in any additional pension benefits which he accrued during his later service.

Recordkeeping requirements.—To carry out the intent of the vesting provisions (primarily those involving intermittent employment), the employer would be required to keep records of the years of service of his employees and the percentage of vesting which the employees had earned, together with any additional information required by the Secretary or his delegate in order to determine the employee's benefits. In the case of a multi-employer plan, the employer would furnish the required information to the plan administrator (who would be required to maintain the records), in accordance with regulations.

Failure to maintain or furnish the required records would result in a civil penalty of $10 for each employee with respect to whom the failure occurs, unless it is shown that the failure is due to reasonable cause. The committee expects that the necessary records will be retained by employers for at least 10 years following a break in service. After that, the employee could still establish his right to vesting based on prior service, but the burden of producing the evidence would shift to the employee.

Class year plans.—A class year plan is a profit-sharing or stock bonus plan which provides for the separate vesting of employee rights to contributions (or rights derived from contributions) to a plan on a year-by-year basis and the withdrawal of these amounts on a class-by-class basis as they mature. The minimum vesting requirements of the bill applicable to a class year plan are satisfied under the bill if the plan provides for 100-percent vesting of the employer contributions within 5 years after the end of the plan year for which the contributions were made. A separate rule is needed for class year plans since they are structured differently than most other types of plans. The 5-year full vesting rule provided in this case by the committee bill assures an employee who terminates his employment under a class year plan that he will not forfeit his rights to more than 4 years of employer contributions.

Permitted forfeitures of vested rights.—A qualified retirement plan under the committee bill may provide that an employee's vested rights in accrued benefits derived from employer contributions (but not from his own contributions) may be forfeited in the event of the employee's death (although this exception is not to apply if the employee had retired and had elected to take a survivor annuity prior to his death).

Also, in the case of retirement plans requiring mandatory employee contributions, an employee who voluntarily withdrew all or part of his contributions[6] may forfeit all of the benefits derived from any employer contributions made on his behalf. A class year plan may provide that an employee will forfeit all of the benefit derived from employer contributions—if he withdraws any part of his own mandatory contributions, but these forfeitures may only occur on a class-year-by-class-year basis.

The committee is very concerned, however, that an employee withdrawing his own mandatory contributions should be made fully aware

[6] So long as part of the employee's contributions remained in the plan, he would retain a vested right to the benefits derived from those contributions.

of the consequences of doing so, and expects that the Service and the Labor Department will coordinate efforts to require that plans containing these forfeiture clauses make full and adequate disclosure to the employee, prior to withdrawal, including disclosure of the current value of the accrued right the employee will forfeit and (at least in the case of a defined benefit plan) the amount of the pension he could expect to receive at normal retirement age.

With the limited exceptions noted above, no rights, once they are required to be vested, may be lost by the employee under any circumstances (although, as under present law, the plan may pay the employee the actuarial value of his vested rights upon separation from service).[7] For example, a vested benefit is not to be forfeited because the employee later went to work for a competitor, or in some other way was considered "disloyal" to the employer.[8] Also, rights to benefits are not to be forfeited merely because the employer (or plan administrator) cannot find the employee. However, in such a case, if it appears that the employee's whereabouts would remain unknown for so long a time that the value of the benefits would escheat to the State, then before that happens the plan is to transfer the value of the benefits to the Pension Benefit Guaranty Corporation to be created under Title IV of the bill.

Prohibited discrimination.—Under present law, there are regulations designed to ensure that in the event of early plan termination, the benefits under the plan are not paid to employees who are officers, shareholders, or highly compensated employees in a discriminatory manner. The committee bill contains a provision to make it clear that the vesting requirements under the bill are not intended to operate to overturn these rules. Thus, for example, in the event of an early plan termination, a highly compensated employee might receive less than his otherwise vested benefit under the bill, if this were necessary to prevent discrimination.

Plan termination.—Under present law, all accrued benefits in a qualified pension plan must become fully vested (to the extent then funded) in the event of a termination, or the complete discontinuance of contributions under a pension plan. This rule will no longer be necessary with respect to discontinued contributions, because the committee bill (sec. 241) now provides for an excise tax on underfunding. However, the committee bill makes clear that this rule of full immediate vesting is still to apply in the case of a termination, or a partial termination. (Examples of a partial termination might include, under certain circumstances, a large reduction in the work force, or a sizeable reduction in benefits under the plan.)

Accrued benefits.—Under the committee bill, the vested employee is protected in his rights to all, or a certain percentage, of his "accrued benefit." This term refers to pension or retirement benefits and is not intended to apply to certain ancillary benefits, such as medical insurance or life insurance, which are sometimes provided for employees

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[7] In turn, this distribution may be transferred tax free by the employee to the portability fund, or to the qualified plan of his new employer under provisions in title III of the bill.

[8] Some plans also provide that an employer may have lien rights against employee interests in a pension plan. These clauses would also be prohibited under the committee bill, except where the plan requires that the employee be given prior notice of any inpending lien and there is a judicial hearing on the probable validity of the employer's claim.

in conjunction with a pension plan, and are sometimes provided separately. To require the vesting of these ancillary benefits would seriously complicate the administration and increase the cost of plans whose primary function is to provide retirement income. Also, where the employee moves from one employer to another, the ancillary benefits (which are usually on a contingency basis) would often be provided by the new employer, whereas the new employer normally would not provide pension benefits based on service with the old employer.

It is necessary to provide a statutory definition of an "accrued benefit" because, unless this is a defined amount, vesting of an "accrued benefit" in whatever form is specified by the plan has little, if any, meaning. In the case of any retirement plan other than a defined benefit pension plan, under the bill the employee's "accrued benefit" is the balance in his plan account. This would include, for example, a money purchase pension plan and a profit-sharing plan. In the case of a defined benefit pension plan (under which benefits may vary with such factors as wages and service), the bill provides that the minimum accrued benefit is to be a fraction of the amount the employee would receive at normal retirement age, under the plan as in effect at the time for which the accrued benefit is to be determined. (As discussed below under F. Insurance, a collectively-bargained plan in which the employer participates in the setting of defined benefits is a defined benefit plan, even though the collective bargaining agreement may specify only the level of contributions.) In making this computation, the retirement benefit is to be computed as though the employee continued to earn the same rate of compensation annually as he had earned during the years which would have been taken into account under the plan, had the employee retired on the date in question. This amount is then to be multiplied by a fraction, the numerator of which is the employee's total number of years of active participation in the plan up to the date when the computation is being made and the denominator of which is the total number of years of active participation he would have if he continued his employment until normal retirement age.[9] The term "normal retirement age" is to be defined by regulations. It is expected that a minimum and maximum age will be taken (perhaps 55 and 65) and that the "normal retirement age" in this range will be based on the age at which the retirement benefit has the greatest actuarial value.

In the case of a defined benefit pension plan funded through ar surance contract, the accrued benefit is to be the annuity which m be purchased by the cash surrender value of the policy. In the case of a variable annuity plan, the term accrued benefit is to be defined by regulations.

Allocations between employer and employee contributions.—In plans where there are both employer and employee contributions, it will be necessary to allocate the accrued benefit between the portion derived from the employer contributions, and the portion derived from the employee contributions. This allocation may have to be made because the employee is always fully vested with respect to amounts attributable to his own contributions but not necessarily with respect to those of the employer. Also, information of this type would be

[9] The fraction may not exceed one, under the committee bill, since at this point the employee would receive the full pension to which he was entitled under the plan.

needed if an employee, upon leaving employment, desires to withdraw his own contributions.

In the case of any plan other than a defined benefit pension plan, the accrued benefit derived from the employee's contributions under the bill is the amount in his own separate account. If employee and employer contributions were not accounted for separately, the employee-contributed portion of the total accrued benefit would be treated as the fraction of the total which is the ratio of employee to total contributions (after taking account of withdrawals, and, to the extent necessary, the timing of the contributions).

In the case of a defined benefit pension plan which provides an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), the accrued benefit derived from mandatory employee contributions would be treated as the total amount of the employee's "accumulated contributions" multiplied by a conversion factor.[10] In general, the conversion factor, which initially is to be fixed at 10 percent for a normal retirement age of 65, is to be used to convert the amount of the accumulated contributions to a single life annuity commencing at normal retirement age. For other normal retirement ages, the conversion factor is to be determined by regulations.

In determining the employee's accumulated contributions, under the bill, interest on the employee's mandatory contributions is to be compounded annually, initially at a rate of 5 percent (beginning with the first plan year subject to the vesting requirements imposed under the committee bill) to the date when the employee would reach normal retirement age. In addition, any interest accumulated on the employee's contributions (either compounded or simple) in accordance with the terms of the plan, prior to the date when the vesting provisions of the bill first apply to that plan, are to be treated as part of the employee's accumulated contributions.

The bill authorizes the Secretary or his delegate to adjust the conversion factor, and the assumed rate of interest on employee contributions, on a prospective basis, from time to time, as may be appropriate, but requires him to give at least one year's notice of any such action. The adjustment in the interest rate would be made by comparing the long-term money rates and investment yields for a 10-year period ending at least 12 months prior to the year in which the adjustment would first apply, with the corresponding rates and yield for the 10-year period from 1964 through 1973.[11]

The committee anticipates that the Treasury, in determining money rates and investment yields, will use a composite of a number of indicators. For example, one possible approach might be to give equal values to the dividend yields of the Dow-Jones Industrial Average and the Standard and Poor's 500-Stock Average, and to the interest rates of Barron's or Moody's highest-rated bonds and United States Treasury long-term obligations. This composite, for the 1964–1973 base period, would be set at 5, and the interest rate in the future would be determined by the Treasury Department's comparison of this com-

[10] Voluntary employee contributions are to be treated the same as a separate account.

[11] To forestall the need for plan amendments, the committee anticipates that a plan could satisfy the requirements of these provisions if it provided that interest on mandatory employee contributions would be computed at a rate of 5 percent, or at such other rate as may be required from time to time under the Internal Revenue Code of 1954, and the regulations issued thereunder.

posite for the base period, with the same composite for the then most recent 10-year period. It is contemplated that this interest rate will be adjusted less often than annually, and that due regard will be given by the Treasury Department to the impact of any such adjustment on existing plans.

Some of the principles discussed above may be illustrated by the following example. Assume that employee A was born on January 1, 1926. On January 1, 1975, A enters employment with company M and on January 1, 1976, A becomes a participant in M's pension plan, requiring mandatory employee contributions, providing an annual benefit, at the normal retirement age of 65, of 3 percent of average compensation for each year of active plan participation. From 1976 through 1984, A earns a salary of $10,000 per year. On January 1, 1985, A leaves the employ of M. As of that date, A's employee contributions to the plan, including interest at a rate of 5 percent per annum (compounded annually) total $6,000. A will become 65 on January 1, 1991.

The minimum vested benefit to which A is entitled equals the sum of (1) 100 percent of the accrued benefit derived from his own contributions and (2) 50 percent (due to his 10 years of service) of the accrued benefit derived from M's contributions.

If A had continued to work for M at the same salary until age 65, he would have been entitled to receive an annual benefit of $4,500 (3 percent of $10,000=$300 times 15 years of service=$4,500). His accrued benefit, commencing at age 65, is therefore 9 (years of participation in the plan) divided by 15 (years of participation if A had continued to work through normal retirement age) times this amount, or an annuity of $2,700 per year.

Interest on A's contributions, at an assumed rate of interest of 5 percent per year (compounded annually), plus the principal of this amount, would total $8,040.75 on January 1, 1991. After applying the conversion factor of 10 percent, this is determined to be the equivalent of an annual annuity of $804.08 as of the date when A will reach 65, and A is 100-percent vested in this annuity, because it is derived from his own contributions.

Then, taking the total accrued benefit of $2,700 per year, and subtracting from this amount the amount of $804.08 per year, there is determined to be an annuity of $1,895.92 attributable to the employer contributions. A is 50-percent vested in this amount. His total vested benefit from his 9 years of employment by M thus equals $1,752.04 per year (50% of $1,895.92, or $947.96, plus $804.08) starting on January 1, 1991.

Where a defined benefit plan provides a benefit other than an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), or if the employee's mandatory contributions are applied toward some other form of benefit, then the accrued benefit, or amount of accrued benefit derived from employee contributions, is to be the actuarial equivalent of the single life annuity (without ancillary benefits) as determined under regulations.

Comparability of plans having different vesting provisions under the antidiscrimination rules.—There are certain classes of employees, such as engineers, whose rate of job mobility is so high, that many of them would not receive protection even under the vesting provisions

provided under the bill. To be effectively covered under a pension plan, these employees would have to receive a very substantial amount of vesting during their first 5 years of employment. At the same time, if all employees were to be provided with vesting on this rapid a basis under the plan, the cost might be so high that the employer would terminate the plan, or drastically reduce the benefits under the plan. To meet this situation, the committee bill contains a provision which would allow the engineers and other employees with a similar problem, in effect, to trade off some of their benefits in exchange for earlier vesting.

Under present law a single plan may satisfy the antidiscrimination requirements (sec. 401(a)(4)), if either the contributions or the benefits do not discriminate in favor of certain enumerated employees. Generally, profit-sharing plans, stock bonus plans, and money purchase plans can satisfy this requirement if the contributions are nondiscriminatory even though the benefits may discriminate. Defined benefit plans can satisfy this requirement if benefits are nondiscriminatory even though the contributions are discriminatory. A target benefit plan, a type of money purchase plan, may satisfy the requirement if the benefits do not discriminate even though the contributions do. Also under existing law, two plans can be considered as one for purposes of satisfying the antidiscrimination requirements, either as to contributions or benefits.

Under the committee bill an employer might set up two retirement plans, one with very rapid vesting, the other with slower vesting, but with higher benefits. The bill provides that for purposes of applying the antidiscrimination rules, the two plans could be considered as a unit (as under present law) and the plan with more rapid vesting would not be considered discriminatory merely because of this feature (even if highly compensated employees were covered under the plan), if contributions were comparable or (in the case of defined benefit plans) if benefits under this plan were scaled down appropriately in relation to benefits provided under the plan with less rapid vesting. (Of course, each plan would have to at least meet the minimum vesting schedule provided in the commitee bill and would also have to be nondiscriminatory as to the employees covered by it.)

Thus, in the case of a defined contribution plan, the tax deductible contributions to both plans would be required to be the same in proportion to covered compensation. This would mean, in effect, that employees in the plan with less rapid vesting would receive increased benefits as the result of forfeitures,[12] whereas there would be relatively few forfeitures under the plan with earlier vesting.

In the case of a defined benefit plan, the same principle of comparability would apply, but here the level of benefits under the plan with earlier vesting would have to be lower, in relation to the benefits provided under the other plan. Generally, these comparisons would be made on an actuarial basis, in accordance with regulations.

By this provision the committee is clarifying this matter for the future. It intends that prior law on this point be determined as if this provision had not been enacted.

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[12] If the employer reduced his tax deductible contributions under the plan because of forfeitures, the tax deductible contributions to the plan with early vesting would also have to be reduced; comparatively, the employees in the plan with less rapid vesting would always have to accumulate a larger accrued benefit in proportion to compensation.

Effective date

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

In the case of a government plan, the provisions of the committee bill are not to apply to plan years beginning prior to January 1, 1981. These plans can generally only be amended by a legislative act, and the committee believes it is appropriate under these circumstances to afford such plans additional time to comply with the vesting requirements of the bill.

The committee bill also provides a transitional rule under which any plan which provides, on the date of enactment, for 100 percent vesting of employer contributions by the end of the 10th plan year in which the employee is a participant is not subject to the vesting schedule provided under the bill, with respect to employer contributions, until plan years beginning after December 31, 1980. Plans which provide full vesting after 10 years of participation are generally considered liberal under current standards and the 10-year-100-percent formula is commonly used in pension plans today. Thus, the committee believed that it was appropriate to give these plans additional time to comply with the vesting provisions of the bill. Such plans will have to comply with the participation requirements, and the vesting requirements with respect to employee contributions, however, as of the generally applicable effective date.

Revenue effect

Estimates of the revenue effect of the minimum vesting provisions vary with the assumption made about the relationship between additional employer contributions to pension plans and cash wages. If it is assumed that the additional employer contributions will be a substitute for cash wages, the estimated revenue loss is $130 million. On the other hand, if it is assumed that the additional employer contributions will be an addition to cash wages, the estimated revenue loss will be $265 million. The estimates under both cases assume that benefits under pension plans are not decreased and that no benefit increases are foregone as a result of the bill. The estimates are based on 1973 levels of income and employment.

D. Funding

(Secs. 241, 281 and 671 of the bill and secs. 275, 404, 4971, 4972, 6058, 6692, and 7517 of the Code)

Present law

The annual contributions to a qualified pension plan generally must be sufficient to pay the pension liabilities accruing currently (the normal pension costs) plus the interest due on unfunded accrued pension

liabilities (past service costs). This keeps the amount of unfunded pension liabilities from growing larger, but does not require any contributions to be made to amortize the principal amount of the unfunded liabilities.

Pension plan costs generally are estimates and are based on actuarial calculations. Consequently, all actuarial methods, factors, and assumptions used must, taken together, be reasonable and appropriate in the individual employer's situation. When applying for a letter of determination from the Internal Revenue Service that a plan is qualified, the actuarial methods, factors, and assumptions used generally must be reported to the Service, along with other information to permit verification of the reasonableness of the actuarial methods used. Changes in actuarial assumptions and methods must be reported annually to the Service.

The value of plan assets also affects the amount of contributions. Under administrative rulings, assets may be valued by using any valuation basis if it is consistently followed and results in costs that are reasonable.

Actual experience may turn out to be different from anticipated experience, resulting in experience loss or experience gain. Depending on the circumstances, the contributions needed to make up experience losses may be deducted currently or may be added to past service costs and deducted only on an amortized basis. Similarly, depending on the circumstances, experience gains may reduce the plan cost currently, or reduce costs under one of the spreading methods used to determine the amounts deductible.

If an employer does not make the minimum required contributions to a qualified plan, under administrative practice the deficiency may be added to unfunded past service costs. However, the plan also may be considered terminated, and immediate vesting of the employees' rights, to the extent funded, may be required.

General reasons for change

The available evidence has demonstrated that a significant portion of existing pension plans have not been adequately funded and are not accumulating sufficient assets to pay benefits in the future to covered employees. As a result, many employees now covered by pension plans may not actually receive the pensions they have been promised, because the needed funds will not be available. The committee believes that the present minimum funding requirement for plans qualified under the Internal Revenue Code is not adequate to prevent this underfunding, since it does not require any payment to reduce the amount of the outstanding unfunded liabilities, which may be substantial. As a result, the committee's bill provides that unfunded past service liabilities must be amortized over no more than 30 years (and experience deficiencies must be amortized over no more than 15 years).

The committee recognizes that the amount required to fund a pension plan is in large part determined by actuaries' estimates of future plan costs, which in turn are based on the actuarial methods and assumptions used for each plan. Consequently, the determination of the amount of contributions that must be made to a plan to adequately fund the plan benefits is significantly affected by the plan's actuary.

There is no existing government regulation or licensing requirement for actuaries as there is for, *e.g.*, lawyers and accountants, and the committee believes that minimum standards of competence should be established for persons who make actuarial computations for qualified plans. Consequently, the committee's bill requires the Secretary of the Treasury to set standards of competence for persons who make actuarial reports to the Internal Revenue Service. The bill also provides that actuaries enrolled to practice before the Service must certify the plan costs and report the actuarial methods and assumptions used for each pension plan. The committee also intends that the Secretary establish an actuarial advisory board to provide assistance in setting standards for enrolling actuaries, setting guidelines for actuarial assumptions and in other pertinent matters.

Additionally, the committee believes that current sanctions on an employer for failure to adequately fund his qualified plan are inappropriate, since they may not affect an employer's decision to underfund his plan. For example, an employer may not feel any reason to make the minimum required contributions to his plan if the only consequence of underfunding is to give his employees vested rights in the amounts that are already funded. To resolve this problem, the committee's bill provides an excise tax on the failure to meet the minimum funding requirements.

The committee also recognizes that, within limits, employers who are financially unable to meet the funding requirements should be allowed to postpone paying contributions to their plans. Therefore, the committee's bill allows the Internal Revenue Service to waive certain minimum funding requirements if the employer demonstrates that substantial business hardship will otherwise result. The amount waived must be amortized over no more than 10 years.

Explanation of provisions

Minimum funding rules, in general.—The committee's bill establishes new minimum funding requirements for qualified pension, profit-sharing, and stock bonus plans so these plans will accumulate sufficient assets within a reasonable time to pay benefits to covered employees when they retire. These rules apply to any pension, profit-sharing, or stock bonus plan which, after December 31, 1975, has qualified (or has been determined to qualify by the Internal Revenue Service) under section 405(a), section 404(a)(2) or section 401(a) of the Code. The minimum funding requirements will continue to apply to such plans and trusts even should they later lose their qualification.

Generally, under these requirements the minimum amount that an employer must annually pay under a defined benefit pension plan includes the normal costs of the plan (as under current law), plus amortization of past service costs, experience losses, etc. The minimum amortization payments required by the bill are calculated on a level payment basis—including interest and principal—over various stated periods of time. Generally, initial past service costs (and past service costs established by substantial plan amendments) must be amortized over no more than 30 years, and experience losses must be amortized over no more than 15 years. If an employer would otherwise incur substantial business hardship, the Internal Revenue Service may waive

payment of normal costs, and amounts needed to amortize past service costs and experience losses; the amount waived must be amortized in no more than 10 years, and no more than 5 waivers may be granted for any 10 consecutive years.

For money purchase pension plans and profit-sharing and stock bonus plans, the minimum amount that an employer must annually contribute to the plan is the amount that must be contributed for the year under the plan formula. For purposes of this rule, a collectively bargained plan which provides an agreed level of benefits and a specified level of contributions during the contract period is not to be considered a money purchase (or other type of defined contributions) plan. This type of plan is subject to the funding provisions of the bill, and must make contributions which are adequate to fund the agreed benefit on the basis required under the bill.[1]

Under the minimum funding rules, each plan must maintain a new account called a "funding standard account." This account is established to aid both the taxpayer and Internal Revenue Service in administering the new funding rules. The account also is used to assure that a taxpayer who has funded more than the minimum amount required is properly credited for that excess and for the interest earned on the excess. Similarly, where a taxpayer has paid too little, the account will assist in enforcing the funding standards, and will assure that the taxpayer is charged with interest on the underfunding.

Each year the funding standard account is charged with the liabilities which arise in meeting the minimum funding requirements. Also, each year the funding standard account is credited with contributions under the plan and with any other decrease in liabilities (such as amortized actuarial gains). If the plan meets the minimum funding requirements at the end of each year, the funding standard account will show a zero balance (or a positive balance, if the employer has contributed more than the minimum required). If the plan is underfunded, the funding standard account will show a deficiency.

The funding rules established by the bill are in addition to the present rules which provide the maximum deduction limits for contributions to a plan. However, in any event a contribution that is required by the minimum funding rules is deductible currently.

If the employer wishes to contribute and deduct more than the minimum required, the amount deductible will continue to be subject to the rules of present law (slightly modified by the committee bill). In general, under present law the maximum annual deduction available is normal cost plus 10 percent of accrued unfunded past service costs.[2] Since the 10 percent figure includes interest as well as principal, depending on the interest rate, it is estimated that an employer usually may deduct amounts needed to fund accrued past service costs over 12 to 14 years. As a result, the maximum allowable annual deduction which may be taken to fund past service costs generally is significantly higher than the minimum contributions required to fund these costs. If the contributions made are greater than the maximum allowable deductions in any year, as under present law, the excess may be carried over to future years and deducted at that time.

[1] The only exception might be an instance where employers, in the aggregate, had no substantial voice in the determination of the levels and forms of benefits.

[2] This is the deduction limit under sec. 404(a)(1)(C) of the Code; in some circumstances, greater deductions are allowed under sec 404(a)(1)(B).

Funding normal costs and initial past service costs.—The committee's bill specifically continues the requirement of present law that the normal costs (arising from current liabilities) of a defined benefit pension plan must be currently funded. However, in order to give assurance a plan will have sufficient assets to pay benefits, the bill establishes new minimum requirements for funding accrued past service costs. In general, the bill requires that an employer's contributions to a defined benefit pension plan for initial past service costs be sufficient to amortize these costs, on an accrued basis, over no more than 30 years from the date that the plan is established. For plans in existence on the date of enactment, unfunded past service costs existing as of the first plan year beginning after December 31, 1975, are to be treated as initial past service cost to come under the minimum funding rule and to be amortized over no more than 30 years.

The minimum funding requirement for initial past service costs in effect is analogous to payment over 30 years of a loan secured by a home mortgage. It requires the payment of a level amount over 30 years, and each payment includes both interest and principal. For example, if the past service cost is $1,000,000 at the time a plan is established, the minimum level payment that must be made each year, for 30 years, to meet the funding requirement (calculated at an interest rate of 6 percent per annum over the 30-year period) is $68,537 per year (assuming contributions are made at the beginning of each year). In addition, the employer would be required to contribute annually to the plan an amount equal to the normal cost of the plan.

The interest rate to be used in calculating the minimum payments under 30-year amortization is the same rate as that used in determining the plan cost, at the time the plan is established, or January 1, 1976, in the case of plans in existence prior to that time. (Similarly, the interest rate used to amortize past service costs arising from amendments, to amortize experience deficiencies, and to amortize contribution waivers also is the rate used to determine plan costs at the time the liability in question first arose.) If the interest rate used to determine plan costs is changed as of a later date in order to conform with experience, the initial amortization schedule of level payments is not to be changed prior to that date, but the consequent increase (or decrease) in plan costs is to be classified as an experience deficiency (treated in the manner described below).

Under the committee's bill, the minimum funding rules—both those which apply to all past service costs and those which apply to normal costs—require funding on the basis of accrued (that is, both vested and nonvested) liabilities, not merely on the basis of vested liabilities. The use of accrued liabilities for this purpose appears appropriate because it provides the most orderly and comprehensive method for funding the plan's entire costs. In this way, gradual payments will be made to fund all of a plan's present liabilities, including the presently nonvested accrued liabilities which are expected to vest in the future. Moreover, funding on the basis of accrued liabilities tends to produce somewhat more rapid funding, and as a result provides more protection to plan participants.

Generally, the 30-year amortization requirement initially adds only moderately to an employer's existing funding cost. This is true because under present law interest on unfunded accrued past service

costs (which accounts for the bulk of the level amortization payments required under the bill in the early years) must be contributed to a qualified pension plan. Therefore, the committee believes that 30-year amortization will not hamper an employer in starting a new plan, or in adding a plan amendment, that includes past service costs.

Plan amendments.—The committee bill provides that plan amendments that create substantial changes in past service costs are to be treated in the same manner as in the case of past service costs of new plans for purposes of the minimum funding rules. To establish an objective standard for "substantial" (for this purpose only), the bill provides that these are additional past service costs attributable to plan amendments which increase past service cost by at least 5 percent (at the time of amendment). Under the minimum funding rule these costs are to be amortized (separately) over a 30-year period from the date the amendment is adopted (even if this precedes the date on which benefits increase). Smaller plan amendments are to be amortized over the same period as experience losses (see next section below).

For example, where the unfunded accrued past service cost existing at the time of an amendment is $1,000,000, if the unfunded accrued past service cost added by an amendment is $100,000 (which is more than 5 percent of $1,000,000), the employer is to amortize this increase in past service cost in 30 annual payments of $6,854 (assuming an interest rate of 6 percent and that contributions are made at the beginning of each plan year).

Plan amendments which decrease past service costs (by decreasing plan benefits) are treated consistently with plan amendments increasing benefits; that is, those amendments which result in a decrease of 5 percent or more (at the time of amendment) are to be amortized over not less than 30 years. If the decrease is less than 5 percent, the decrease is to be amortized over the same period as experience gains. Consequently, the minimum amortized annual payments that must be contributed by an employer who decreases plan benefits generally will not be less, in any one year, than amortized payments required for an employer who started out with a plan providing the same (lower) benefits. (Of course, a decrease in benefits will usually decrease the normal cost which must be funded annually.)

Experience losses and gains.—During the course of a pension plan, actual plan experience often turn out to be poorer than anticipated. For example, the value of plan assets may turn out to be less than expected. Where this occurs, there will be an "experience loss" which must be funded if the plan is to pay the benefits owed. The committee's bill provides that under the minimum funding rule these losses are to be amortized (with level annual payments, including principal and interest) over not more than 15 years from the date the deficiency is determined, or over the average remaining service life of the plan participants if this is a shorter period.

The committee believes that a 15-year amortization period generally will provide adequate funding of experience losses, while at the same time protecting employers from potentially harsh financial burdens arising from uncontrollable events. However, where the average remaining service life of the participants is shorter than 15 years, the committee believes that it is appropriate for experience losses to be

funded over the shorter period, to be sure that the plan will accumulate assets at a sufficiently rapid rate to provide the plan benefits.

The 15-year period will prevent discrimination against pension plans such as "final pay plans" which increase accrued benefits as pay increases, and thus are generally desirable from the employer's view. Under final pay plans, an unexpected increase in pay can cause an experience loss that significantly increases plan costs. On the other hand, plan costs increase much less under other types of plans which are less favorable to the employees, such as career average plans. If a short period of time were required to amortize experience losses, it is feared that employers may be given a substantial incentive to shift out of final pay plans, to the detriment of their employees. However, the committee understands that with 15-year amortization, employers generally will not tend to avoid using final pay plans.

Additionally, it is believed that under the 15-year requirement employers will not be subject to unnecessary financial burdens where they have experience losses beyond their control. For example, if a plan is almost fully funded (with a high ratio of assets to liabilities), decreases in the market value of plan assets could require very substantial increases in employer contributions if the decrease in value were to be amortized over less than 15 years. With this same longer run point of view the committee concluded that short-run fluctuations in market value are not likely accurately to reflect the long-range value of the assets. As a result, the bill provides that, in determining experience deficiencies, plan assets are to be valued by using a moving average over 5 or fewer years. The 5 year moving average is discussed below.

A pension plan also may have experience gains during the course of its operation. These gains would occur because experience is more favorable than anticipated. For example, the value of plan assets may be greater than expected. The bill treats experience gains symmetrically with experience deficiencies, so that gains are spread over no less than 15 years from the date they are determined (or average remaining work life, if shorter).

The bill provides that changes in accrued plan liabilities resulting from changes in actuarial methods and assumptions are to be treated as experience losses (or gains). Generally, assumptions are only changed to reflect differences between assumptions and experience. Additionally, the bill provides that changes in plan cost that result from changes in the Social Security Act (or other retirement benefits created by State or Federal law) or in the definition of wages under section 3121 of the Code are treated as experience losses (or gains).

Waiver of funding requirements.—At times an employer's financial circumstances may prevent him from meeting the minimum funding requirements. The committee does not believe that in such a situation an employer should be forced to abandon his plan. To deal with cases of this type the bill provides that upon a demonstration by the employer of substantial business hardship, the Internal Revenue Service may waive all or part of the minimum funding requirements for a year, including normal costs, amortization of past service costs and amortization of experience losses. However, to limit the underfunding which may occur in cases of this type, the bill provides that

the Service may not waive all or part of the funding requirements for more than five years (whether or not consecutive) in any ten-year period. Also, the Service may not waive amortization of previously waived contributions.

In determining whether a waiver should be granted, the committee contemplates that substantial business hardship generally will only occur in situations where the employer did not foresee, and could not reasonably have been expected to foresee (at the time the plan or plan amendment which gave rise to the liability in question was established), the event which causes the business hardship. The committee contemplates that the Service will grant a waiver of funding normal cost only in unusual situations and will make a separate determination for each instance of waiving normal costs. Additionally, the committee expects that only in rare situations will the Service waive normal cost for more than one or two plan years based on the same business hardship.

The committee intends that in all cases the Service will condition a waiver of funding requirements by providing that the employer may not amend any plan in a way that would increase plan liabilities as long as there are any unfunded waived contributions outstanding under any of his qualified plans. (However, the committee contemplates that regulations will provide that an employer may reduce waived liabilities at a rate faster than that provided by the minimum funding requirements.) It is also expected that in considering whether a waiver should be granted, the Service will weigh as a factor against the waiver any recent plan amendment (i.e., within three years before the request for waiver) that increases plan liabilities; however, as a condition of waiver the Service may require plan amendments that eliminate these previous recent increases in liabilities and is to condition the waiver on the absence of future plan amendments increasing liabilities until the amount waived has been paid with interest. If a plan were to violate a condition of waiver, the committee intends that the amount waived and not yet amortized immediately become part of the current minimum funding requirement in the year the condition is breached (consequently this amount would immediately be charged to the funding standard account).

The amount waived by the Service must be amortized in no more than 10 equal annual payments (including interest and principal), beginning the year after the year the waived contributions were due. If a shorter period were required, after several years of waiver an employer's total contributions could be so high that it would be quite difficult to meet this obligation, particularly if the employer were just returning to financial stability. The bill provides that the amortization of the amount waived may not itself be waived in subsequent years.

The committee's bill provides a special relief provision for multiemployer plans in existence on the date of enactment and established under a collective bargaining agreement. Under the bill, the Internal Revenue Service may allow a period greater than 30 years to amortize the past service costs of such a plan existing on the effective date. This extension of time may be given at the discretion of the Internal Revenue Service, upon a finding that two requirements are met. First, in

the first year that the new funding requirements apply to the plan, these new requirements must require contributions to the plan to increase by more than 10 percent over the contributions that would have applied under present law (using the method for determining plan contributions used for the previous year). Second, for this special relief to be available, 30 year funding must be shown to impose a substantial business hardship upon a substantial portion of the employers contributing under the plan.

The Internal Revenue Service, upon finding that these two requirements are met, may allow amortization of initial past service costs over a period longer than 30 years to the extent that it is necessary to alleviate the substantial business hardship otherwise imposed on a substantial portion of the employers. The committee believes that a strong showing of hardship must be made for long extensions to be made available and it is intended that only rarely are amortizations of more than 45 years to be allowed. Furthermore, as is the case generally with waivers, the committee intends that if the plan is amended to increase plan liabilities during the period that the waived liabilities are unfunded, the waiver is immediately to terminate and the waived liabilities are to become a part of the current year's minimum funding requirements.

It is intended that applications for waiver be made before the last day for timely contribution of the amount in question, and be acted upon expeditiously by the Internal Revenue Service.

The funding standard account.—As previously indicated the committee's bill requires that each qualified defined benefit pension plan must maintain a funding standard account. The purpose of this account is to facilitate the determination of whether a plan has met the minimum funding standard. A plan will meet the minimum funding requirements only if, at the end of each plan year, the account does not, on a cumulative basis, have an excess of charges for all plan years over credits for all plan years. The account is to be charged each year with the normal costs for that year and with the minimum amortization of past service costs, experience losses, and waived contributions for each year. On the other hand the account is to be credited with the contributions made for the year, with amortized portions of cost decreases, resulting from plan amendments and experience gains, and with any waived contributions.

To determine if the plan meets the minimum funding requirements, the funding standard account is to be reviewed as of the end of a plan year. However, an employer may contribute to a plan after the end of his taxable year and up to the date of filing his tax return, and these contributions are to relate back to the previous taxable year. This should provide an employer with sufficient time to reconcile the funding standard account and make the contributions needed to avoid underfunding.

If the account has a positive balance at the end of the plan year, the employer will have contributed more than the minimum funding standard requires. Since the contributed amounts will earn income in the trust, the bill provides that the positive balance is to be credited with interest,[3] which will reduce the need for future contributions to

[3] As with the amortization requirements, the interest rate to be used is the interest used to determine plan costs.

meet the minimum funding standards. On the other hand, if the funding standard account has a deficit balance, the employer will have contributed less than required under the minimum funding rules, and the deficiency is to be charged with interest. Interest is charged in this case because the deficiency will become larger over time by the amount of income the trust would have been earned had the minimum requirements been complied with and the employer will have to pay more to the trust than just the amount he failed to contribute in the plan year.

An example of the operation of the funding standard account for a defined benefit pension plan is described below.

It is assumed that in 1978 the plan is established with a past service liability of $1 million and a normal cost of $70,000. The interest rate used to determine liabilities under the plan for 1978 and for all years in this example is 6 percent per year. In the first plan year, the employer contributes $138,537. The plan's funding standard account for 1978 will be as follows:

Credits:	
Employer contributions	$138, 537
Charges:	
Normal cost	70, 000
Amortization—initial past service cost (30 years)	68, 537
Total	138, 537
Net Balance	0

In the year 1979 the plan is amended, increasing past service liabilities by $100,000 (an increase of more than 5 percent of the past service cost existing at the time of amendment). The plan's normal cost for benefits as amended is $75,500. There is a net actuarial gain of $5,000 over the prior year, and the average remaining future service lifetime of plan participants exceeds 15 years. In this year, the employer's contribution is $165,975. The plan's funding standard account for 1979 will be as follows:

Credits:	
Employer contributions	$165, 975
Amortization—actuarial gain (15 years)	486
Total	166, 461
Charges:	
Normal cost	75, 500
Amortization—initial past service cost	68, 537
Amortization—past service cost from amendment (30 years)	6, 854
Total	150, 891
Balance	15, 570
Interest on balance	[1] 934
Net balance	16, 504

In 1980 the normal cost of the plan is $76,200. There is an actuarial loss for the preceding year of $10,000 and the average remaining future service lifetime of plan participants exceeds 15 years. The

[1] This assumes that all amounts other than interest are charged and credited at the beginning of the year.

employer contribution is $135,572. The plan's funding standard account for 1980 will be as follows:

Credits:	
Employer contributions	$135,572
Amortization—actuarial gains	486
Total	136,058
Charges:	
Normal cost	76,200
Amortization—initial past service cost	68,537
Amortization—past service cost from amendment	6,854
Amortization—actuarial loss (15 years)	971
Total	152,562
Net	−16,504
Balance from previous year	16,504
Balance	0
Interest on balance	0
Net balance	0

The funding standard account—special rules—insured plans.—If the qualified plan is funded with certain individual insurance contracts (described below), the committee's bill provides that the funding standard account is to be annually charged only with the annual contract premiums, and is to be credited with the premiums paid—thereby maintaining a zero balance in the account through the life of the plan if the premiums are timely paid. The committee believes that this is the correct result since if qualified insurance contracts are used to fund a plan, the plan generally will be properly funded.

The contracts that are to qualify for this treatment are level premium, individual insurance contracts where the premium is paid from the first date of an individual's participation in the plan (and from the time an increase in benefits becomes effective) and is not paid beyond the individual's retirement age. Also, the benefits under the plan must be the same as the benefits provided by the individual contracts at normal retirement age. In addition, the benefits must be guaranteed by the insurance company to the extent that premiums are paid. For the contracts to qualify, the insurance company must be licensed to do business in the State (or the District of Columbia) where the plan is located. Furthermore, premiums for all plan years must have been timely paid (or the policy reinstated), rights under the contracts must not have been subject to a security interest during the plan year, and no loans must have been made on the policy during the plan year. (If any of these requirements are not satisfied, then the normal rules with respect to the funding standard account must be followed by the employer.)

The funding standard account—special rules—full funding limitation.—In some cases, the difference between the total liabilities of the plan (normal cost for all years plus all accrued liability) and the total value of the plan assets may be smaller than the minimum funding requirements for the year. For example, this could occur where the plan assets had increased substantially and unexpectedly in value. Where the excess of total plan liabilities over assets is less than the minimum

funding requirement otherwise determined, the committee believes that an employer should not have to contribute more than the amount of this excess liability, for upon contribution of this amount the plan will become fully funded. As a result the bill provides that the amount to be charged to the funding standard account (and to be contributed), is to be limited to the difference between the total liabilities of the plan and the value of the plan assets.

In a year in which the value of the assets of the plan equals or exceeds the total plan liabilities, the amortization schedules for charges and credits to the funding standard account are to be considered as fully amortized, and these schedules are to be eliminated from the calculations under the funding standard account. However, if the plan is amended in later years to increase plan liabilities, a new amortization schedule would be established with respect to this increase in liabilities. For years after the full funding level is reached, the funding standard account will continue to be charged with the normal cost of the plan. Consequently, unless asset values increase correspondingly with the increase in plan liabilities, eventually the full funding limitation will not be applicable and the employer will have to make contributions to the plan to meet the minimum funding requirements.

If the employer fails to make the required contributions and the full funding limitation is applicable, the excise tax on underfunding, described below, is to be based only on any amount that should have been contributed, given the full funding limitation.

For the purpose of calculating the full funding limitation, the bill provides that plan liabilities are to be determined under the funding method used by the plan to determine normal costs for the year, if the liabilities can be directly calculated under this funding method. However, if this cannot be done under the plan's funding method, in order to allow the full funding limitation to apply, the bill provides that the accrued liabilities are to be calculated under the entry age normal method, solely for the purpose of determining the application of the full funding limitation. Additionally, the committee believes that short-run fluctuations in the value of plan assets will not accurately reflect value for the long-range purposes of retirement plans; consequently, assets are to be valued on the basis of a moving average for 5 or fewer years, determined in accordance with regulations prescribed by the Secretary of the Treasury.

The funding standard account—special rules—multiemployer plans.—In the case of a multiemployer plan maintained pursuant to a collective bargaining agreement, in maintaining the funding standard account, a plan year would be considered to extend for the term of the collective bargaining agreement. This provision is intended to adapt the minimum funding standard to those multiemployer plans where contributions are fixed by contract in accordance with a fixed standard, such as a specific dollar amount per hour of covered employment or a specific dollar amount per ton of coal mined. Under such a plan, if the actuarial assumptions were reasonable and the actuarial calculations were correct as of the beginning of the term of the agreement, and the agreed contributions were made, there would be no deficiency in the funding standard account for the term of the collective bargaining agreement. Any experience deficiencies could be made up

by adjustment of the contribution rate or the level of benefits for the term of the next agreement. The special definition of plan year would not affect the required periods of amortization or the computation of the excise tax.

The funding standard account—money purchase pension, profit-sharing, and stock bonus plans.—Generally, the funding standard account for money purchase pension plans and profit-sharing and stock bonus plans is to be charged annually with the amount that must be contributed for the year under the plan formula, and is to be credited with the amount that is paid. As a result, employers who have these plans must annually make the minimum payments required under the plan. If the employer does not make sufficient contributions to meet the minimum funding requirements, he is to be subject to the excise tax described below. However, the Internal Revenue Service may waive the contributions required, in the same manner as it may waive these contributions for defined benefit pension plans.

Valuation of assets.—Plan assets are to be valued under a moving average over 5 or fewer years in determining the minimum funding contributions and for purposes of determining the allowable deductions under a plan. The period chosen must be used consistently by the plan. The moving average method will be established under regulations issued by the Secretary of the Treasury. One possible way this might be defined would be as the average value of the entire portfolio as of the current valuation date and the preceding four valuation dates, with adjustment made for contributions under the plan and benefits paid under the plan. The adjustments might be made annually or more frequently. Income under the plan might be treated in the same manner as unrealized appreciation; administrative and investment expenses might be treated in the same manner as unrealized depreciation. It is contemplated that the regulations will provide that even if an asset is disposed of by the plan, the value of that asset will be used in calculating the prior year's portfolio values; this would appear necessary to prevent avoidance under the moving average method by changing the portfolio composition in a manner either that realizes only losses or only gains, depending on whether it is desired to move the asset balance up or down.

Government plans.—It has been argued that government plans should be exempt from funding standards since the taxing power can be viewed as a practical substitute for these standards. On the other hand, the committee is concerned with reports that in the case of a number of governmental units, such generous pension promises have been made and so little funds have been set aside currently, that the practical likelihood of imposing sufficient taxes to pay those benefits may be open to question. In view of this conflict, the committee does not believe present law should be changed at this time regarding government plans which are qualified under the Federal tax laws, and, therefore, that these plans will continue to be governed by present law. However, the bill requires the Secretary of the Treasury to study whether these plans are adequately funded and to report his findings and recommendations to the Senate Committee on Finance and the House Committee on Ways and Means no later than December 31, 1976.

Actuarial considerations—enrollment of actuaries to practice before the Internal Revenue Service.—Defined benefit pension plan costs generally are actuarial estimates of future costs of the plan. In estimating pension costs, actuaries must make assumptions ("actuarial assumptions") about a number of future events, such as the rate of return on investments ("interest"), employees' future earnings, and employee mortality and turnover. Actuaries also must choose from a number of methods to calculate future plan liabilities. The amounts required to fund any given pension plan can vary significantly according to the mix of these actuarial assumptions and methods. As a result, the assumptions and methods used by actuaries are basic to the application of minimum funding standards for defined benefit pension plans.

The committee believes that actuaries who perform services for qualified pension plans and report to the Internal Revenue Service regarding these plans should meet a reasonable standard of competence and be held to a standard of reasonableness in choosing their methods and assumptions. Consequently, the committee's bill requires that the actuarial assumptions which are used be reasonable in the aggregate; this restates present law. However, there is no existing government regulation of the actuarial profession as there is, for example, for lawyers and accountants. To resolve this problem, the committee's bill provides that the Secretary of the Treasury is to establish rules and regulations for actuaries to practice before the Internal Revenue Service and is to enroll persons who meet the standards of competence for practice before the Service (with regard to actuarial matters only).

The committee intends that actuaries be enrolled to practice before the Service under a procedure similar to that now used for enrollment of persons to practice before the Service who are neither attorneys nor certified public accountants. Generally, an examination will be required of persons who apply for enrollment, and proof of sufficient actuarial experience regarding pension plans may also be required. However, at the Service's discretion, the examination may be conducted by actuarial professional organizations, and not by the Internal Revenue Service. In addition, at the Service's discretion, the examination may be waived (for a limited period) for persons who present independent evidence that demonstrates they have special competence in actuarial matters relating to pensions because of their experience at the time the enrollment system is instituted. The committee contemplates that the procedure for enrollment of actuaries will appropriately recognize the need for independent, competent professional work, and consequently practice without enrollment will be allowed only in unusual cases.

The committee intends that the Secretary also establish duties relating to practice before the Internal Revenue Service by actuaries who are enrolled to practice. These duties may be similar to those required for attorneys, certified public accountants, and others who practice before the Internal Revenue Service, appropriately modified to take account of the special requirements of actuarial practice. For example, it is contemplated that the regulations will require an enrolled actuary to notify the Secretary if he discovers that an actuarial statement he prepared was not filed with the Secretary.

It is contemplated that the Secretary of the Treasury would reserve the power to suspend from practice before the Service any person en-

rolled to practice as an actuary after due notice and opportunity for hearing. Discipline might be imposed upon an enrolled actuary shown to be incompetent, or who refuses to comply with the rules and regulations established by the Secretary. The committee intends that proceedings brought against enrolled actuaries will be instituted in the same general manner as proceedings against others practicing before the Service and will follow the same general procedure as other disciplinary proceedings. Generally, disciplinary proceedings would involve a complaint served on the actuary, an opportunity for answer, and an evidentiary hearing before a hearing examiner who would render a decision (appealable to the Secretary of the Treasury). An actuary involved in such a proceeding would have a right to be represented by counsel. It is contemplated that the discipline imposed could include suspension from practice before the Service, and that under appropriate circumstances a petition for reinstatement could be granted.

Actuarial considerations—reports of actuaries.—The Internal Revenue Service must receive detailed information on the actuarial assumptions and methods used to be able to evaluate whether the costs of a qualified defined benefit pension plan have been properly determined. To resolve this problem, the committee's bill requires periodic actuarial reports to be filed with the Internal Revenue Service by plan administrators. Actuarial reports must be made for the first plan year (or the first plan year to which this section applies) and every third thereafter. Under the bill the Secretary may require more frequent reporting if necessary. The Secretary might require more frequent reporting in particular cases (for example, where a plan has had frequent or substantial actuarial losses) or in all cases. If the plan administrator fails to file the required actuarial reports, he will be subject to a penalty unless failure was due to reasonable cause.

The periodic actuarial reports must be prepared by actuaries enrolled to practice before the Internal Revenue Service. The reports must include a description of the plan, a description of the funding method and actuarial assumptions used to determine costs under the plan, a certification that the plan is adequately maintaining a funding standard account, and any other information regarding the plan as the Secretary may require. For example, it is contemplated that the periodic reports will include detailed information on the basis for any change in actuarial assumptions.

The actuary who prepares the reports must certify that, to the best of his knowledge, the report is complete and accurate. He must also certify that, in his opinion, the funding method is reasonable and the actuarial assumptions used to determine the plan costs are reasonable in the aggregate. It is contemplated that the actuary will be subject to discipline and may be suspended from practice before the Internal Revenue Service if he falsely certifies a report.

Since a change in the actuarial method used can have a substantial effect on a plan's cost, the bill also provides that the Internal Revenue Service must approve, pursuant to regulations, a change in the plan's funding method before the new method may be used to calculate plan costs. Similarly, approval must be obtained for a change of the plan year. It is expected that the regulations under this provision will establish rules similar (but appropriately modified) to the regula-

tions governing approval of changes in accounting methods. Therefore, it is expected that generally before a change in actuarial method or plan year will be approved a taxpayer must establish a substantial business purpose for the change and that consideration will be given to all the facts and circumstances with respect to the change. It is contemplated that a change in funding method is to be allowed only if it does not significantly adversely affect the funding of the plan. Also, the committee contemplates that upon approving a change in actuarial method or plan year, conditions are to be established to prevent distortion of income or distortion of funding of the plan.

The committee recognizes that frequently there is a range of actuarial assumptions which may be appropriate for determining the costs of a defined benefit pension plan, and the choice of the appropriate assumptions is very much a matter of judgment. In this circumstance, an employer may attempt to substitute his judgment for that of his actuary, which may lead to situations where plan costs are not being independently determined by an actuary. The committee believes that it is inappropriate for an employer to substitute his judgment in these matters for that of a qualified actuary, and the committee contemplates that if such a circumstance were to arise an actuary would have to refuse giving his favorable opinion with regard to the plan.

Actuarial considerations—actuarial advisory board.—The committee believes that the Secretary of the Treasury could be significantly aided in resolving a number of problems regarding actuaries and actuarial assumptions, etc., if he had the advice of experienced actuaries drawn from different areas of practice. Accordingly, the committee intends that the Secretary establish an advisory board chosen from among experienced actuaries in government, teaching, business and insurance, and independent consulting practice.

The committee intends that the board advise the Secretary in such matters as the enrollment system for actuaries, reasonable standards and criteria for determining actuarial assumptions to be used for plans, and determining what constitutes generally accepted principles of actuarial practice.

Enforcement.—The sanctions under present law on the failure to meet the minimum funding requirements appear to have little effect on an employer's decision to fund a plan at the required minimum levels. To resolve this problem, the committee's bill imposes an excise tax on the employer if he fails to fund the plan at the minimum required amounts (only if a waiver has not been obtained).

The tax initially is to be 5 percent of the accumulated funding deficiency—that is, the deficit in the funding standard account—at the end of the plan year. The 5 percent tax is to be imposed for each plan year in which the funding deficiency has not been corrected. For example, if a funding deficiency for 1978 is not corrected until the end of 1980, the tax with respect to the 1978 deficiency will be 5 percent of the deficiency for 1978, 5 percent (on the 1978 deficiency) for 1979, and 5 percent (on the 1978 deficiency) for 1980. Additionally, in any case in which the 5 percent tax is imposed and the accumulated funding deficiency is not corrected within the correction period allowed after notice by the Internal Revenue Service, a 100 percent tax is imposed on the

accumulated funding deficiency. In accord with present law respecting the excise taxes with regard to private foundations, neither the 5 percent nor the 100 percent taxes are to be deductible.

The minimum period allowed for correcting any funding deficiency after notice from the Service is 90 days from the date of mailing the notice. However, this period may be extended for the time that the Internal Revenue Service determines is reasonable and necessary to eliminate the accumulated funding deficiency (and is automatically extended for any period in which a deficiency cannot be assessed under section 6213(a) relating to petitions to the Tax Court). It is intended that the Secretary require significant reasons before granting an extension under this provision, and that in no case is the extension to be for a period longer than 10 years from the year the deficiency first occurred, that regular payments must be made toward funding the deficiency, and that (as a condition of the extension) no amendment increasing plan costs will be permitted until the deficiency is paid off. To correct a funding deficiency the employer must contribute to the plan the amount of the deficiency plus interest to the date of payment, at the rate used to determine plan costs for the years the deficiency remained unpaid.

Effective date

The new minimum funding requirements generally apply to plan years beginning after the date of enactment of the bill. However, with respect to qualified plans in existence on the date of enactment, the new funding standards apply to plan years beginning after December 31, 1975. However, if the existing plans are maintained under a collective bargaining agreement, then the new funding standard applies to plan years beginning after December 31, 1980, or the date on which the agreement terminates, whichever is earlier.

Revenue effect

It appears clear that the new funding provisions will give rise to additional income tax deductions by employers in the immediate years ahead. However, the statistical data available do not provide any method for determining the size of this revenue effect. It is believed, however, that it will not represent a large revenue loss. In the longer run, it appears unlikely that the greater immediate funding expected under this bill will have any appreciable effect on revenues. Although funding occurs earlier under the bill than under present law, the income tax deductions taken by employers under the bill would for the most part also ultimately be taken.

E. Portability

(Secs. 151, 152, 153 and 301 through 310 of the bill and secs. 402 and 403 of the Code)

Present law

Under administrative practice, when an employee changes jobs his vested interest in his former employer's qualified retirement plan may in certain circumstances, be transferred to the retirement plan of his new employer without the employee being taxed on the transfer.

For this to be done, both his former and new employers must agree to the transfer, the transfer must be possible under the terms of both the plans and trusts involved, and the Internal Revenue Service's administrative requirements as to the method of transfer must be met. However, transfers of employee interests between qualified plans upon changes in employment do not appear to be usual.

General reasons for change

The mobility of labor in the United States has been steadily increasing. From the standpoint of the economy, this is generally viewed as a desirable factor since it enables us to overcome labor shortages in limited areas or specific industries. It also tends to decrease frictional unemployment. However, those employees who move from job to job have had difficulty in earning vested retirement benefits, and even where these benefits are earned, they have faced difficulties in collecting the benefits upon retirement. On retirement, these employees will have to deal separately with each of their employers to arrange for their retirement benefits, and since each employer may have a different type of plan, working out retirement programs may be difficult for these employees. Also, the employees have had difficulties in contacting former employers if the employers have merged or changed name or address. Additionally, employees in some cases have not maintained sufficient records to enable them to determine from whom retirement benefits are due.

The committee's bill includes several provisions designed to help with these problems. First, the bill provides that employees who leave an employer may, with the consent of the employer (or directly if he receives a lump-sum distribution) have their vested retirement plan benefits transferred to a central portability fund. The employee can leave these amounts in the central fund until he retires or, with the consent of a new employer, can transfer his account to a qualified retirement plan of his new employer. Transfers between qualified plans and the central fund are to be tax free, and the central fund will be tax-exempt.

Second, the committee's bill allows an employee to receive a cash distribution from his former employer's plan and contribute it within 60 days to the plan of a new employer, without being taxed.

Third, the bill permits an individual, subject to limitations, where he receives a final distribution from an employer under a qualified plan, to contribute this amount to his own individual retirement account without these transfers giving rise to any tax.

Finally, the bill provides that the Social Security Administration is to keep records of the plans in which an employee has a vested interest, so upon retirement the employee (or his beneficiaries) will know who to contact for retirement plan benefits.

Explanation of provisions

Central portability fund, in general.—The committee's bill provides for a voluntary central portability fund that will enable an employee who changes jobs to consolidate all of his vested retirement benefits under one program. Under the bill, when an employee leaves an employer who has registered with the central fund, he may direct the employer's qualified plan to pay the value of his entire vested benefits

to the central fund. (Alternatively, if an employer makes a final distribution to an employee, as explained below, the employee can contribute this amount to the central portability fund without tax consequences.) Thereafter, the employee may leave his account in the central fund until his retirement or may have the fund transfer his account to the qualified trust of a new employer (who has registered with the fund and consents to the transfer). The central fund will invest its assets, and income earned will be allocated to the participants' accounts. However, this income will not be taxed until it is distributed to the participants or their beneficiaries. Transfers between the fund and qualified plans will be tax free.

The central fund will be operated by the Pension Benefit Guaranty Corporation; its administrative expenses are to be provided for by appropriations. The Corporation is to establish the rules which govern the fund's operation, including its relations with individual participants and employers. To the extent its assets are not needed for current operations, the fund may invest its assets in obligations of the United States, or may deposit its assets in interest bearing accounts (or purchase certificates of deposit) of banks, savings and loan associations and credit unions which are part of the Federal insurance system (e.g., Federal Deposit Insurance Corporation). However, no more than 10 percent of the fund's investment may be deposited with any one savings institution.

An annual report is to be made to the Congress on the operation and status of the central fund; annual reports will also review and recommend changes in policies governing the fund's management. In addition, the committee intends that the fund will be subject to an annual audit.

The central fund also will assist employers, labor unions, and plan administrators to provide better retirement protection for persons who leave employment. This assistance may include developing reciprocity and portability arrangements between plans in the same industry or geographical area.

Portability fund, registration by employers.—Employers with an employee benefit plan that is qualified under the tax law may register with the central fund, pursuant to its rules, so their employees may participate in the fund's program.[1] If an employer is registered with the fund, the persons who leave his employment may require his plan to pay to the central fund an amount equal to their total vested interest in the employer's qualified plan (or plans), on a tax-free basis. Also, new employees of a registered employer may, with the employer's consent, transfer the value of their accounts with the central fund to a qualified plan of the employer, on a tax-free basis.

It is contemplated that an employer may register at the time an employee leaving employment desires to have the value of his total vested rights transferred to the central portability fund. Also, an employer may register with respect to all of his employees, or may register for only a group of employees, if the group is reasonably defined and has a special need for the central portability program. This limited registration will make it easier for an employer to register

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[1] It is contemplated that a stock bonus plan will be able to sell stock held for an employee solely for the purpose of paying the total value of his interest to the central fund.

with the central fund for employees who have the greatest need for the portability program. (An employer otherwise may be reluctant to register because if substantial numbers of all his employees were to use the program, it might significantly limit the plan's ability to pay benefits.) For example, an employer of engineers who frequently change jobs may wish to register with the central fund only with respect to these engineers. In this case, only the employees within the registered class would be able to use the central fund.

It is expected that an employer will be able to withdraw his registration at any time. Additionally, he may re-register with respect to all or part of his employees. However, if an employer withdraws and re-registers in order to discriminate against a particular employee or group of employees in an unlawful manner or in a manner that violates the nondiscrimination rules (sec. 401(a) (3) or (4) of the Code), the employer will be treated as having been registered during the whole period in question.

For an employer to register with the central fund, his plan and trust must be qualified under the tax laws. It is contemplated that the central fund will require the employer to demonstrate that these requirements are met, and that usually a determination letter from the Internal Revenue Service stating that the plan and trust are qualified will constitute satisfactory evidence. Where a plan loses its qualified status, registration will be terminated. It is expected that the Internal Revenue Service will periodically notify the central fund of plans which it determines are no longer qualified. If the plan regains qualified status, the employer may again register with the fund.

Transfers to the portability fund.—If an employer is registered with the central fund, an employee who is within the registration group and is no longer employed by the employer may require the employer's qualified plan (or plans) to pay to the central fund an amount equal to his total vested benefits in the plan. However, amounts equal to the employee's nondeductible contributions to the plan may be distributed to the employee and not to the central fund, since these amounts generally may be withdrawn by the employee without tax. If the payment to the fund does not fully discharge the plan's liabilities to the employee, and this was due to reasonable cause, it is contemplated that upon discovery of the error a reasonable period will be allowed for correction. Transfers to the central fund by a qualified plan will not be taxed. Payment to the central fund must be in cash or its equivalent. Payment must occur within 180 days of notice by the employee, and the employee must give notice to the plan no later than one year after termination of employment. As is indicated below, where a final payment has been made to an employee from a qualified plan, he can also contribute this amount to the central portability fund.

On receipt of an amount from a qualified plan, the central fund will establish a separate account for the employee. The amounts received will be invested by the fund, and accounts will be periodically adjusted, under the rules of the fund, to reflect changes in the financial condition of the fund.

The taxation of benefits ultimately paid to the employee will be affected by the source of the contributions to his account. Consequently, when amounts are transferred from a qualified trust to the central

fund, the transferor (the former employer or the employee) will be required to provide the fund with information respecting this payment, such as the amount which constitutes the employee's contributions.

The central fund may receive transfers only from employee benefit plans (or from employees receiving final distributions from these plans) that are qualified under the Internal Revenue Code. If the fund receives notice from the Secretary of the Treasury that a final determination has been made that a plan was not qualified at the time that a transfer was made to the fund, the balance of each participant's account attributable to transfers from that plan (in the year the plan is not qualified) will be paid from the fund to the participant. The amount paid is to be included in the participant's income in the year it is paid to the participant. This generally follows present law, since plan participants currently are taxed as receiving ordinary income when they receive transfers from plans which are not qualified in the year of distribution.

It is intended that the fund may not receive transfers from a plan with respect to persons who have participated in the plan as self-employed persons (but employees of self-employed are covered) or as proprietary employees. Similarly, the central fund may not receive transfers from individual retirement accounts. These rules are necessary to prevent circumvention of the restrictions on owner-employees, proprietary employees, and individual retirement accounts. It is also intended that no amounts may be received by the central fund on behalf of a participant who is age 59½ or older. Under this limitation, the fund will be used to establish retirement programs, rather than becoming a depository for amounts which are transferred to the fund after retirement.

After a plan has paid a former employee's vested interest to the central fund, the plan generally will not have any further liability with respect to this employee.

Payments from the portability fund.—A participant in the central fund may leave his account with the fund until retirement. In this case, upon reaching age 59½ or becoming disabled the participant may direct the central fund to make a lump-sum payment to him in the entire amount of his account, or may direct that periodic payments of at least $100 be made to him. It is intended that these must be specified in advance but could be changed from time to time as designated by the participant. Alternatively, he may direct the fund to purchase an annuity contract on his behalf, and distribute the annuity contract to him. This may be a single premium life annuity payable during the participant's life and commencing no earlier than age 59½ (or disability) and no later than age 70½. (Or, this may be a single premium joint and survivor annuity payable during the lifetime of the participant and his spouse, beginning no sooner than the participant reaches 59½ (or becomes disabled) and no later than when he reaches, or would have reached 70½.) The participant may choose the insurance carrier which issues the annuity contract, but this carrier must be licensed to sell such contracts in the State in which the participant resides.

Amounts held by the central fund on behalf of a participant must be paid to him no later than age 70½. If the participant does not select

the method of payment, the fund will pay him the total amount credited to his account, in a lump sum.

If the participant dies before the entire amount credited to his account has been distributed to him (or to a qualified plan), the remaining amount would be paid to his beneficiary, designated pursuant to the rules of the fund. At the direction of the beneficiary, the amount will be paid in a lump-sum, or in periodic payments of at least $100, or used to buy an annuity contract. The total amount in the account must be distributed to the beneficiary within 10 years after the participant's death.

A participant (or his beneficiary) is to be taxed on receiving a payment from the central fund in the same manner as if he had received the payment from a qualified trust. The participant or beneficiary is not to be taxed upon the purchase of an annuity contract by the fund from a qualified insurance carrier, but is to be taxed when the annuity payments are made. In addition, the provisions of section 2039(c) and 2517 of the Code will not apply to accounts with the central fund.

If a participant in the fund obtains employment with another employer registered with the fund, he may request that the amount in his account be paid to the qualified plan of his new employer. A request for transfer must be made within one year after the person becomes a participant in a qualified plan maintained by this employer, or one year after the new employer registers with the plan, whichever is later. With the consent of the new employer, the central fund is to transfer the amount credited to the participant's account to the new employer's plan, to purchase benefits under the plan. (Because the status of each employee under a plan may be different, depending upon his age and the status and terms of the plan, it is expected that an employer may consent on a case-by-case basis with respect to transfers from the fund to his qualified plan, but the consent must not violate the nondiscrimination rules that govern qualified plans.) It is intended that the actuarial value of the benefits purchased be equal to the amount transferred from the central fund; it is also intended that the benefits purchased be immediately vested. The transfer from the central fund to a qualified plan is not to be taxable to the participant.

Tax-free "rollover" for transfers between qualified plans.—The committee's bill also facilitates the reinvestment for retirement purposes of amounts received from a prior employer's qualified plan. Under the bill, an employee may receive, tax-free, a complete distribution of his interest from a qualified retirement plan, if he reinvests the full amount of the assets received in another qualified plan or in the central portability fund within 60 days after receipt. (However, amounts equal to the employee's voluntary nondeductible contributions to the plan need not be reinvested with another plan.)

To prevent avoidance of the restrictions on self-employed plans, proprietary employee plans, and individual retirement accounts, the bill limits the rollover in these cases. The rollover is not available for transfers of amounts from an H.R. 10 plan with respect to a person who has been self-employed under the plan. Similarly, the rollover is not available for transfer of amounts with respect to a person who has been a proprietary employee under the plan. The rollover is available

for amounts transferred from a qualified plan to an individual retirement account (except for transfers by self-employed and proprietary employees as discussed above) and for transfers from one individual retirement account to another. However, the rollover is not available for transfers from an individual retirement account to any other type of plan.

The tax-free rollover is only available with respect to complete distributions of an employee's interest in a qualified plan that occur within a 12-month period after termination of employment. Therefore, the employee must receive the total amount of his account in the plan of his former employer within that 12-month period and must recontribute any amount received within 60 days of receipt.

If the employee does not receive the full amount of his account from the plan of his former employer within 60 days, he may contribute this to another plan or to the central fund in anticipation that he will receive a distribution of the entire amount of his account. However, if he is uncertain about whether he will ultimately receive the full amount of his account, it is intended that he may contribute the cash received to the central portability fund. If it turns out that the full amount is not distributed within a year, he will be taxed in the year of receipt on the amount he received, and any amount contributed to the central portability fund must be repaid to him.

Registration with Social Security.—The committee understands that, upon retirement, employees who frequently changed employment during their working years may have difficult problems in locating their former employers and the retirement plans in which they may have vested benefits. At times, this results from their former employers (or the plans) having changed name or address, or having merged with other organizations. At other times, the employees themselves may not have been able to maintain the records needed to enable them to contact their former employers. Alternatively, they may have forgotten that they had vested rights in plans with former employers.

To resolve this problem, the committee's bill provides that the Social Security Administration is to maintain records of the retirement plans in which individuals have vested benefits, and is to provide this information to plan beneficiaries.

The bill requires retirement plans to file an annual statement with the Secretary of the Treasury regarding individuals who have a right to a deferred vested benefit in the plan and who have terminated employment with the employer who maintains the plan. The Secretary of the Treasury will provide this information to the Secretary of Health, Education and Welfare; in this way it is contemplated that the statement can be filed together with other statements filed with the Secretary of the Treasury.

The annual statement must be made by each qualified pension, profit-sharing, stock bonus, or annuity plan, and pension plans operated by Federal, State, and local governments. The statement must include the name and taxpayer identification number (generally the Social Security number) of every individual who has terminated employment in the year for which the statement is filed and who has a right to a deferred vested benefit in the plan. The statement also must include any

other information required by the Secretary of the Treasury, such as the amount of the individual's deferred vested benefits in the plan. However, the statement need not include information about persons who terminated employment if they received retirement benefits, such as annuities, from the plan during the year of termination. In addition, if a plan has filed an annual statement at any time, it must notify the Secretary of the Treasury of any change of name or address, any plan termination, or any merger or consolidation with any other plan.

Upon the request of the participant (and in accord with regulations), the social Security Administration will furnish him any information which it has relating to his vested retirement plan benefits. In addition, when a person applies for Social Security retirement, disability, death, or hospital insurance benefits, on determining whether these benefits are due the Social Security Administration will also inform the claimant of any information which it has relating to the vested retirement plan benefits of the worker whose wages form the basis of the claim.

These provisions will take effect in years beginning after the date of enactment of this bill. However, the bill provides that, before the effective date of the registration provisions, the Secretary of the Treasury is also to receive reports relating to the vested retirement benefits of any person who has terminated his employment with the employer.

Effective date

The effective dates of both the provisions regarding the central portability fund and the provisions relating to the tax-free rollover are taxable years beginning after December 31, 1974. The effective date of the Social Security Administration provisions is taxable years beginning after the effective date of this bill.

Revenue effect

The revenue effect of the central portability fund provisions, the tax-free rollover provisions, and the Social Security Administration registration is expected to be negligible.

F. Plan Termination Insurance

(Secs. 401 through 482 of the bill and secs. 162, 401, and 4981 of the Code)

Present law

Present law does not require pension, profit-sharing, etc., plans to insure their liabilities.

General reasons for change

If a pension plan terminates, for example, because of a closing of operations or a sale of assets by the employer, employees who are pension plan participants may receive nothing or receive less than they had expected if their rights are not fully funded at the time of the termination. The classic illustration of this danger resulted from the closing of the Studebaker plant at South Bend, Indiana, when some 4,000 employees between the ages of 40 and 60 received only approximately 15 percent of their vested benefits although the plan's vesting

was fairly generous and the funding would apparently have been adequate had the plant remained in operation.

A joint study by the Treasury Department and the Department of Labor indicates that there were 683 plan terminations in the first seven months of 1972 that were reported to the Internal Revenue Service.[1] These terminations resulted in the loss of benefits with a present value of some $20 million, by about 8,400 pension claimants (participants, retirees, and beneficiaries) in 293 of the terminated plans. The average loss of benefits for claimants amounted to $2,400. About $11 million of the total losses were suffered by 3,100 claimants who were retired, eligible for retirement, or vested in their benefits. Their losses averaged $3,600 per person.[2]

On the average, retirees and beneficiaries lost 42 percent of the value of their current pensions, participants eligible for retirement lost 57 percent of the value of their benefits (one-tenth of them lost their entire benefits), participants who were fully vested but not yet eligible for retirement lost 65 percent of the value of their benefits (two-fifths of them lost their entire benefits), and former employees with deferred vested benefits lost 97 percent of the value of their benefits.[3]

This survey did not take into account the extent, if any, to which employees left the employer before their rights to benefits vested, during the year or so before formal termination of the plans. It was suggested to the committee during the hearings[4] that sometimes formal plan terminations are delayed while employees are laid off to reduce the aggregate amount of liabilities, by allowing forfeitures, thus increasing the benefits of those who remain.

The data thus far published from the Treasury-Labor study covers a short period (only 7 months) and there is no indication that this period is representative of the past or, more importantly, of what may fairly be expected for the future. Nevertheless, as imprecise as these data may be, they are the best available starting point in estimating the magnitude of the losses that might be expected for the future.

On the one hand, it is noted that only 0.04 percent of all pension plan participants suffered any losses (both vested and unvested) during this period. Also, on the basis of the losses suffered by retirees and their beneficiaries, participants eligible for immediate retirement, participants with vested benefits and former employees with vested benefits, it is frequently estimated that public losses covered by the insurance program would approximate $18–20 million a year. On the other hand, it is noted that, in the Studebaker case alone, more than 4,000 participants age 40 to 60 lost $14 million (then current value) of vested benefits—about 85 percent of the then current value of their vested benefits.[5] Also, if 0.04 percent of participants lost benefits on account of terminations in only 7 months, then perhaps one-quarter to one-third of a million participants may lose benefits over 20 years.

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[1] Department of the Treasury and Department of Labor, Study of Pension Plan Terminations, 1972—Interim Report, February, 1973; p. 2.

[2] Treasury-Labor Study, *op. cit.*, p. 18.

[3] Treasury-Labor Study, *op. cit.*, p. 23

[4] See testimony of Prof. Merton Bernstein, June 4, 1973.

[5] Hearings on Private Pension Plans before the Subcommittee on Fiscal Policy of the Joint Economic Committee, 89th Cong., 2d Sess., pp. 103–106 (Clifford M. MacMillan, Vice President, Studebaker Corp.) and 123 (Willard Solenberger, Assistant Director of the Social Security Department, UAW). Also other workers under 40 lost some unspecified amount of vested benefits.

With a strengthening of funding requirements, plan participants would be more assured of receiving their full vested benefits upon the termination of a plan. Nevertheless, so long as the new funding requirements do not (and could not, as a practical matter) provide for immediate funding of all unfunded vested liabilities, including past service liabilities and "actuarial deficiencies", plan participants will be endangered by premature plan terminations.

To deal with these problems, the committee bill requires that pension plan benefits be insured up to specified limits (in general, not more than the lesser of $750 per month or 50 percent of wages). The bill creates a corporation, the Pension Benefit Guaranty Corporation, to administer the insurance program and set premium-type taxes (initially, the tax rates are to be 50 cents or 70 cents per participant per year). It is expected that treating the insurance charges as taxes, rather than premiums, will greatly reduce the costs of collection.

Several provisions are designed to protect against abuse, among them are: (1) no coverage for benefit improvements put into effect in the 3 years before the plan fails and (2) residuary liability on an employer for a portion of any losses incurred by the insurance system on account of failure of his plan. A higher premium rate is established for those who wish to avoid this residuary liability, but the insurance then would not cover benefit improvements from plan amendments put into effect in the 5 years before the plan fails.

Different premium tax rates are to be permitted ultimately in the case of multiemployer plans.

Explanation of provisions

Administering agency.—To administer the insurance of employee benefits, the committee bill (sec. 402 of the bill) creates a Pension Benefit Insurance Fund, to be administered by a federal government corporation known as the Pension Benefit Guaranty Corporation (sec. 401 of the bill). This Corporation is to be governed by a board of directors consisting of the Secretaries of Commerce, Labor, and Treasury. The Secretary of the Treasury is to be the chairman of this board of directors unless the board should decide to appoint another chairman. The Secretary of Labor is to have the Corporation's bylaws published in the Federal Register not less often than annually.

To facilitate the carrying out of the duties of the Corporation, the committee intends that the Corporation and the Internal Revenue Service coordinate their requirements as to any forms that are required by either of those agencies, that either agency notify the other of any actions taken (or, generally, proposed to be taken) with respect to a pension plan or trust, and that other relevant information (such as W-2 forms filed by employers or sec. 6103 disclosure of tax return data) be made available by the Service under regulations to the Corporation.

Plans covered.—Pension plans (under sec. 401(a)) and employees' annuity plans (under sec. 404(a)(2)) that are "qualified" for the special tax treatment granted certain employee benefit plans under the Internal Revenue Code at any time after December 31, 1974, must participate in the insurance program (sec. 421 of the bill). For these purposes, a successor plan (i.e., a plan for substantially the same employees, which provides substantially the same benefits) is to be treated as the continuation of a predecessor plan. This type of con-

tinuation may arise, for example, when a plan of one employer is merged into another plan of that employer (with or without a reorganization involving the employer) or is merged into a multiemployer plan.

Excluded from participation in the insurance program are: money purchase, profit-sharing, and stock bonus plans; government plans; and (under certain circumstances) church plans.

Money purchase, profit-sharing, and stock bonus plans are excluded from the insurance program since they generally are characterized by some type of promise with regard to contributions and no promise with regard to benefits—the participant is merely entitled to benefits determined by reference to his own account. Since no particular benefits are promised in these cases there appears to be no appropriate amount to insure. A collective bargaining plan where defined benefits are determined under a process in which the employers in the aggregate have a voice (e.g., under sec. 302(c)(5)(B) of the Labor Management Relations Act of 1947, where employers are required to have a substantial voice) in the determination of the forms and levels of benefits, is not to be treated as a money purchase plan for these purposes (in the insurance provisions, and elsewhere under the committee bill where distinctions are made between defined benefit plans and money purchase or other kinds of defined contributions plans), even though the collective bargaining agreement may specify only the level of employer contributions into the plan. Thus, these collective bargaining plans are covered by the insurance program.

In the case of government plans, it is believed that the ability of the governmental entities to fulfill their obligations to employees through their taxing powers is an adequate substitute for termination insurance.

At the option of an exempt church (or of a convention or association of churches), plans covering its employees may be included in the insurance coverage. The committee is concerned that the examinations of books and records that may be required in any particular case as part of the careful and responsible administration of the insurance system might be regarded as an unjustified invasion of the confidential relationship that is believed to be appropriate with regard to churches and their religious activities. However, if the church itself has determined to consent to such examinations, to the premium tax payments, and to the contingent employer liabilities, then it may elect to have the insurance program apply to its plan or plans. The Corporation is to prescribe the manner and time of the elections.

The insurance system is to apply to a church plan, even in the absence of such an election, if the plan is only for employees of the church's unrelated trades or businesses, or if the plan is a multiemployer plan and one of the employers in the plan is not a church.

Benefits covered.—In general, the insurance under the bill covers vested benefits, but not more than $750 per month and not more than 50 percent of wages (sec. 422). This limitation is placed on the insurance coverage because the insurance is not intended as a full replacement of a pension plan, but rather as covering the basic retirement benefits provided under it. However, in practice, it is expected that this will fully cover the great bulk of all benefit payments. In addition, there is an advantage in not fully covering all pension bene-

fits in that this encourages those receiving the larger benefits, and who often are in a management position, to see to it that there is adequate funding of the pension plan.

In addition to vested benefits, the insurance covers such ancillary benefits as the plan may provide (of the type and to the extent that the plan could do so without losing qualified status) which the participant or his beneficiaries would be entitled to upon the occurrence of a specified contingency. Thus the insurance protection is to be comprehensive. The insurance is to cover the current value of the benefit and not necessarily the form of the benefit. For example, if the insurance covers a disability policy, under the insurance coverage there might be distributed to the beneficiary (if the plan fails) the current value of that policy. Similarly, the insurance of a basic annuity could be paid out in the form of a lump sum, an annuity contract from an insurance carrier, or periodic annuity payments.

As a way of applying the $750–50 percent limitations to the ancillary benefits, the bill provides that the actuarial value of the entire package of insured benefits is not to exceed the actuarial value of a monthly benefit in the form of a life annuity (with no ancillary benefits) commencing at age 65, equal to the lesser of $750, or 50 percent of the employee's average monthly wage during his highest paid 5 years of employment.[6]

In order to take into account inflation and the possibility of increases in costs of living, the $750-per-month maximum is to be adjusted according to changes in the contribution and benefit base for Social Security.[7] This adjustment is to bear the same ratio to the $750-per-month initial maximum as the Social Security contribution and benefit base for the year the plan terminates bears to the base for 1974. So, if the base in the year the plan terminates were to be $13,200 (an increase of about 4.8 percent over the 1974 base of $12,600), then the maximum insured annuity would be $786 per month (an increase of about 4.8 percent over the 1974 base of $750 per month).

To prevent avoidance of the limitations by including an individual in two or more plans, this maximum limitation is also to apply to all payments by the Corporation with respect to a participant, inclusive of all types of benefits and numbers of plans in which he participated. For example, the benefits of a participant entitled to retirement benefits under plans of two unrelated employers would be guaranteed only to the extent of the $750-per-month limitation, even though the participant had insured vested benefits of $500 per month under each of these plans (or $1,000 per month combined). If one plan were to fail with no assets available for payment of this benefit, the insurance system would pay $500 per month (or its equivalent). If the second plan were then to fail with no assets available for payment of this benefit, the insurance system would cover only $250 per month of the vested benefits under the second plan.

In order to prevent abuse of the insurance system, the committee bill provides that the insurance is not to cover benefits arising from a plan

[6] Under this rule, for example, a right to receive $750 per month beginning at age 60 would be less than fully insured, since it exceeds the value of a right to receive $750 per month beginning at age 65.

[7] Under section 230 of the Social Security Act (42 USC 430), as amended by section 202(b) of Public Law 92–336 and sec. 203(c) of Public Law 93–66, the contribution and benefit base for 1974 is to be $12 600, and is to be adjusted in multiples of $300 in proportion to changes in average taxable wages.

or amendment put into effect less than 36 months before the plan fails. The committee was concerned that otherwise there might be a temptation to increase benefits irresponsiblly.[8]

The time a plan has been in effect is to include for this purpose the time a predecessor plan was in effect. For these purposes, a plan or amendment is treated as having been put into effect on the later of the date it is adopted or the effective date of the plan or amendment.

If, under the plan, benefits depend on the participant's wages and the participant receives a raise, the resulting increase in benefits is not considered as arising from a plan amendment. However, a scheduled future raise in benefits (or a future cost-of-living increase in benefits) is to be treated as arising from a plan amendment. In effect, the insured benefits are to be calculated in accordance with the facts as of the time the plan fails, but are not to exceed what would have been available under the plan provisions and benefit schedule in effect 36 months earlier.

For example, suppose that A begins to participate in a plan in 1980 and that the plan fails in 2000. In 1998, the formula for calculating benefits is changed from 1.5 percent of high 5-year average wages times years of service, to 1.6 percent of high 3-year average wages times years of service. Also, suppose that A receives a raise in 1998. In this case, since the changes from 1.5 percent to 1.6 percent and from high-five to high-three were adopted less than 36 months before the plan failed, the insured benefits would be calculated on the basis of 1.5 percent and the high-five years. However, since in this hypothetical the pre-1997 rules would take wage raises into account, the 1998 wage rate would be used in computing the high-five average.

As indicated below (under *Effective date*), the insurance system covers losses of plans failing after December 31, 1977. This postponed effective date is to allow the build-up of a fund out of which to pay the claims and also to gain experience in determining the appropriate premium tax rate.

Benefits under plans and amendments put into effect before January 1, 1973, are to be covered in full in the case of plan failures occurring after December 31, 1977. Benefit increases and plans put into effect after December 31, 1972 (in the case of plan failures occurring after December 31, 1977), are to be covered in full after 6 years, covered to the extent of 80 percent after 5 years, to the extent of 60 percent after 4 years, and to the extent of 40 percent after 3 years. These limits, relating to the time the plan and its amendments have been in effect, are to be applied before the limitations discussed above (the $750-per-month or 50-percent-of-wages limit and the treatment of several plans as one plan).

Under the bill, to encourage at least minimum funding, the amount of benefits otherwise payable by the insurance Corporation to an owner-employee[9] or a proprietary employee[10] is to be reduced but

[8] See *Employer liability*, below, for a discussion of contingent employer liability for insurance system losses and for the circumstances under which a 60-month waiting period is to be substituted for this 36-month period.

[9] An owner-employee, in an "H.R. 10 plan", is a sole proprietor or a partner with a greater than 10-percent interest in capital or profits (sec. 401(c)(3)).

[10] A proprietary employee (discussed in I. Limits on Contributions, below) is a 2-percent owner of a corporation, where those 2-percent owners' accrued benefits in the plan have an aggregate present value of more than 25 percent of the present value of all benefits in the plan.

only by his *pro rata* share of any accumulated funding deficiency [11] of the plan at the time the plan terminates. This is the same amount on which a 5 percent excise tax applies because of under-minimum funding. The deficiency, in such a case, is to be allocated among the owner-employees (or proprietary employees) in proportion to their benefits otherwise payable from the insurance fund. This limitation is to be applied to anyone who is an owner-employee (or proprietary employee) at any time during the plan year in which the plan terminates, or during any of the three next preceding plan years.

The committee bill generally covers accrued benefits of qualified plans (and certain types of employees' annuity plans under sec. 404(a)(2)). If a plan ceases to be qualified or ceases to meet the requirements of section 404(a)(2), then the insurance guarantee is not to apply to any benefits accrued after the date the Internal Revenue Service issues a notice that the plan has ceased to qualify or to meet the appropriate requirements. If this cessation of preferred status results from an amendment to the plan, then the insurance guarantee can be applied to post-notice accrued benefits if the amendment is, as of the date it was first effective, revoked or amended to comply with the requirements.

Allocation of assets.—To protect against evasion of the above-described limits on insurance benefits by use of pension fund assets to first pay uninsured benefits (e.g., those resulting from recent amendments, those exceeding the 50-percent or $750-per-month limits, or those which would be reduced because of an accumulated funding deficiency) the committee bill (sec. 444) sets forth an order of priorities for allocation of plan assets on failure of the plan. Plan assets are to be allocated, in order, to voluntary contributions of employees, mandatory contributions of employees, benefits "in pay status" for at least three years, and insured benefits (other than those falling into any of the prior categories). Where all these categories could be paid in full from plan assets, there would be no insurance corporation losses. Any remaining assets would then be allocated under any order of priorities that would allow the entire allocation to meet the antidiscrimination requirements.

The assets to be so allocated are those that are available for the payment of benefits; i.e., net of investment liabilities such as mortgages or commercial borrowings that may have been made in order to provide needed liquidity or to permit additional investments.

Accrued benefits derived from voluntary contributions of employees (and the plan assets represented by the contributions) are to be treated as being under separate plans which are not subject to these insurance provisions (this allocation section authorizes them to be set aside first, in the event of failure of a plan).

The second priority of allocations is for mandatory contributions of employees—the amounts contributed to the plan by the participants, which amounts are required as a condition of participation in the plan, or in order to obtain benefits under the plan attributable to employer contributions. The mandatory contributions are to be offset

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[11] In general, an accumulated funding deficiency is the shortfall in employer contributions compared to the minimum the employer should have contributed to the plans. (See D. Funding, above.)

by the amounts paid to the employee under the plan prior to the plan's failure. If the assets are insufficient to cover all the mandatory contributions, they are to be allocated among the participants in the same proportion as the mandatory contributions of the participants.

After the allocations of voluntary and mandatory contributions, any remaining assets are to be allocated to participants who began receiving benefits at least three years before the plan failure (without regard to the $750 and 50 percent limitations). This allocation is to be in accordance with the value (as of the date the plan fails) of the remaining benefits of each participant, at the benefit level in effect 36 months before the date the plan failed. In other words, increases in benefit levels during this 36-month period are not to receive this priority status. (Of course, those increases could, if appropriate, be paid under one of the other allocation priority categories.) As with mandatory contributions, if there are insufficient assets to meet these obligations, the assets available for this priority level are to be allocated pro rata in proportion to the present values of the benefits at this priority level.

The next priority category is for other benefits guaranteed under this pension insurance system. If the plan's assets are insufficient for this purpose, they are to be allocated pro rata in proportion to these other guaranteed benefits.

As indicated above, assets remaining after this allocation are to be allocated in accordance with the plan's provisions, to the extent that, together with the priority category allocations, they conform to the antidiscrimination requirements of the Internal Revenue Code.

Recapture of certain payments.—In order to prevent the use of lump-sum or other preferential distributions to evade the above-described limitations, the Corporation is authorized to recapture all or part of any distributions which commenced within the 3-year period immediately preceding the failure of the plan (sec. 445). If a lump-sum distribution was made more than 3 years before the plan's failure, or an annuity or similar series of distributions began more than 3 years before the plan's failure, then those distributions are not to be recaptured under this provision.

Even though the distributions began during this 3-year period, they are not to be recaptured if (1) they were made on account of the participant's death, (2) the participant's death occurred before the plan's termination, even though the distributions did not relate to the participant's death, or (3) the distributions were made on account of the participant's disability and the participant is eligible to receive disability benefits under the social security laws.

If none of these exceptions apply then the distributions to be recaptured are the amounts actually received by any person, reduced by the sum of (1) the amounts the participant would have received during this period if he had elected to receive his interest as a straight annuity beginning at age 65 (adjusted by actuarial values) and (2) the amount by which the present value of that participant's insured benefits exceed his pro rata share of the insurance Corporation's total liability on account of the plan's failure.

Since the distributions to be recovered in this case presumably would have been taxed to the recipient in the years when they were paid, the

recipient, upon payment of the recovery to the insurance Corporation, is to be permitted to file amended tax returns for those years. In order to permit such amended tax returns, the statute of limitations for any such year is not to expire until 1 year after the recovery by the insurance Corporation.

Establishment of Fund (premiums, etc.).—The insurance Corporation is to establish a Pension Benefit Guaranty Fund, into which there is to be deposited funds, as appropriated each year, equal to the insurance premium tax collections which this bill authorizes for the Pension Benefit Guaranty Fund. In addition, there is to be deposited in this fund amounts borrowed by the Corporation from the United States Treasury, any income received by the Corporation from the investment of its assets as provided under the bill (sec. 402 of the bill), and any recoveries of employer liability.

The premiums determined by the Corporation are to be assessed and collected as a tax and permanently authorized for appropriation to the Fund. The premium tax rates are to be set at such levels that, together with any earnings on Fund investments, they may be expected to cover the insurance benefits provided by this system and the administrative and operational costs of the Corporation. Although the entire assets of the Fund are to be available for any of the liabilities of the Corporation, separate risk accounts are to be maintained for regular plans and for multiemployer plans (discussed below), and for limited-employer-liability plans and for no-liability plans (discussed below). The bill establishes the premium rates to be charged for the first three years under the system (plan years that begin after December 31, 1974, and before January 1, 1978). Thereafter, the tax rates (and the bases to which the rates apply) may be set from time to time by the Corporation. However, the new rate is not to go into effect until it has been approved by concurrent resolution, originating in the House of Representatives and approved by both Houses of Congress. Under the bill, the Congress has the right only to approve or reject the corporation's proposal to change the rate as of a specified effective date. The bill provides for expedited procedures to be used by each of the Houses in dealing with any such proposed rate changes.

For plan years beginning during the first three years of the program, the basic premium tax rate is to be 50¢ per participant in any covered plan. The premium is to be imposed upon each multiemployer plan and is to be imposed upon each employer who maintains a plan other than a multiemployer plan. If an employer maintains more than one plan, and some of his employees are participants in more than one plan, then that employer will be required to pay the premium for each plan the employee participates in. (The premium tax rates for no-liability plans will be discussed below, under *Liability of employer.*)

For the first three years, no benefits are to be paid under the insurance system. The premium taxes to be collected are to be used to establish a basic fund to enable the Corporation to have adequate reserves and to give it an opportunity to collect such data as may be helpful in determining the levels of losses to be insured against. Although the committee recognized that logical arguments could be made for one or another premium rate base (e.g., accrued liabilities, unfunded vested liabilities, current normal costs), the committee concluded that insti-

tution of any such rate base was apt to be complicated and difficult to establish by the time the insurance system is to go into effect. For this reason, the committee determined that the premium rate for the first three years of the system should be based on a relatively simple "head tax".

These premiums are to be assessable against the employers who maintain covered plans (other than multiemployer plans) and against the assets of multiemployer plans. The premiums are to be deductible as ordinary and necessary business expenses in most circumstances.

The bill authorizes the Corporation to borrow up to $100,000,000 from the United States Treasury, by the issuance of notes or other obligations, with such maturities and subject to such other terms and conditions as may be prescribed by the Secretary of the Treasury.

The assets in the Fund may be invested in banks insured by the Federal Deposit Insurance Corporation, savings and loan institutions insured by the Federal Savings and Loan Insurance Corporation, and credit unions insured under title II of the Federal Credit Union Act. Also, they may be invested in certificates of deposit issued by such financial institutions and in United States Treasury obligations. In no event is more than 10 percent of the assets of the Fund to be invested in any one institution at any time.

Liability of employer.—Concern was expressed to the committee that in the absence of appropriate safeguards under an insurance system, an employer might establish or amend a plan to provide substantial benefits with the realization that its funding may be inadequate to pay the benefits called for. Such an employer might, it was argued, rely on the insurance as the backup which enables it to be more generous in promising pension benefits to meet labor demands than would be the case if it knew that the benefits would have to be paid for entirely out of the assets of the employer. On the other hand, it was clear to the committee that the imposition of heavy obligations on employers would discourage provisions for adequate pension plans.

To deal with these competing considerations, the committee determined to impose on the employer a limited liability to reimburse the insurance system for a portion of the payments that must be made by the insurance Corporation in satisfaction of its obligations if the employer's plan fails. Under the bill (sec. 461 of the bill), the employer generally is to be liable to reimburse the Corporation in an amount equal to the lesser of (1) one-tenth of the insurance Corporation's insurance liabilities on account of the plan failure or (2) one-half of the net worth of the employer. If the employer is a corporation whose stock is traded on a national exchange, then the employer's net worth is the aggregate value of the corporation's stock. Otherwise, the net worth is to be determined as the fair market value of the employer's assets less its liabilities (determined in a manner consistent with the estate tax rules). If some of the employer's ownership securities are traded on an exchange and some are not (as where the common stock is traded on an exchange and the preferred is held either by a single family or traded over the market), then the aggregate value of the ownership interests is to be determined by the Corporation in a manner consistent with what would be done for estate tax purposes if all of the ownership interests in the employer had been held by one decedent.

In order to avoid manipulation of the market on the date the plan fails (which otherwise might be done in order to limit liability), the bill provides that this valuation is to be made as of 120 days before the date of the failure of the plan and is to be determined without regard to any liability of the employer under this provision. If the employer has more than one plan, the liability of the employer under this provision in the case of the second or any later plan to fail is not to be reduced on account of the employer's liability for any earlier plan's failure. However, in this connection, it must be noted that the limitations on the benefits that may be insured as to any one employee ($750 per month, 50 percent of wages), described above, may well operate so as to significantly reduce the insurance Corporation's liabilities on subsequent plan failures. Since the employer's liability to reimburse the Corporation is not to exceed 10 percent of the Corporation's losses, any reduction of the Corporation's losses will reduce indirectly the liability of the employer.

The committee was concerned that this contingent liability of the employer, which is rarely likely to be converted into a current liability, should not be permitted to significantly affect the opportunity of employers to obtain necessary business credit. As a result, the bill provides that the employer's liability is to be subordinated to all claims of general creditors existing at the time the plan terminates.

Under the bill, a successor employer is treated as the employer to which the liability rules apply—whether the change has come about because of a reorganization which involves a mere change in identity, form, or place of organization, or by reason of a liquidation into a parent corporation, or by reason of a merger or consolidation. In other words, a potential liability cannot be avoided where the employer is bought out by another company and ceases to exist because it is merged into the other company. Indeed, the committee understands that such mergers have, in numerous instances in the past, been the occasion for termination of existing pension plans to the great injury of many participants. The committee intends that the Corporation so administer these rules that such transfers of ownership will not result in incentives to terminate plans in the future. If experience indicates that the authority granted to the Corporation under this provision is insufficient for this purpose, then the matter will be reexamined. The Internal Revenue Service and the insurance Corporation, as the agencies most apt to acquire information about such mergers or buy-outs, are expected to make studies of the resulting plan terminations (those where the termination results in no insurance loss as well as those where insurance losses occur); they are expected to provide this information to the Congress and are expected to make any recommendations that may be appropriate if their studies reveal that participants continue to be injured as a result of these buy-outs or mergers.

Although the employer's liability under this section is to be subordinated to claims of general creditors, it is not to be defeated by transfers of assets which have the effect of dividends or distributions in full or partial liquidation to the employer's shareholders or to others who have, as a practical matter, ownership interests in the employer.

The Corporation is authorized to make arrangements with employers for payment of their liabilities under this provision, including arrangements for deferred payment on such terms and for such periods as the

Corporation concludes are equitable and appropriate. In making its determinations, the Corporation is to give due regard to hardships that may result to the employer and to the employer's shareholders. However, the Corporation is to apply these rules in such a way as to not defeat the purpose for imposing this contingent liability—deterrence of unrealistic promises and of abuse of the insurance system.

As indicated above, if an employer elects to pay the appropriate increased premium tax (for the first 3 years under the program, the premium tax is to be 70 cents per participant in each plan, rather than the regular 50-cents rate) the employer is permitted to avoid the contingent liability discussed above. In such a case, there is to be no contingent liability unless the employer remains in business after the plan terminates. A reorganization, merger, or liquidation of the sort described above is to result in the employer being treated as continuing in business and therefore subject to this contingent liability. If the employer ceases business at that location but carries on a similar business elsewhere, then this liability remains. As a safe harbor, if the employer's gross sales during the year of plan termination are less than 25 percent of the average for the 3 preceding years, the employer is to be treated for these purposes as having ceased to do business.

In order to obtain this limited liability, the employer must have been paying the increased premium tax rate (the 70-cents per person rate for the first 3 years of the insurance program) for at least 5 years immediately preceding the plan's failure. For these purposes, payment with respect to a predecessor plan is to be treated as payment with respect to the current plan. The insurance Corporation is to provide for the manner and the time of election to pay the higher premium tax in exchange for the elimination of contingent liability. If the employer has chosen this higher rate, then liabilities are not covered under the insurance system to the extent they arise from plans or plan amendments put into effect less than 5 years before the plan's failure. In the case of benefits that first became effective before January 1, 1973, the insurance will cover the entire amount of the benefits as to plan failures occurring in 1980 or thereafter. Benefit increases and plans put into effect after December 31, 1972, are to be covered in full after 10 years, 90 percent covered after 9 years, 80 percent after 8 years, 70 percent after 7 years, 60 percent after 6 years, and 50 percent after 5 years. These limits, relating to the time the plan and its amendments have been in effect, are to be applied before the $750-per-month or 50-percent-of-wages limit and before the rules regarding the treatment of several plans as one plan, discussed above under *Benefits covered.*

If, after termination of the plan, the value of the assets (hence, the extent of the insurance Corporation's liability to pay benefits under the program) changes, or if the liability changes because other events (such as death or disability) have occurred, then these experience losses are to be borne by the insurance Corporation and these experience gains are to inure to the benefit of the insurance Corporation, and are not to affect the contingent liability of the employer.

Multiemployer plans.—The figures in the Joint Treasury-Labor Study suggest that termination losses are less likely to occur on termination of multiemployer plans.[12] In view of this, the committee con-

[12] Department of the Treasury and Department of Labor. Study of Pension Plan Terminations, 1972-Final Report, August 1973; pp. 3, 65 *et seq.*

cluded that it is appropriate to authorize the insurance Corporation to establish separate premium rates for multiemployer plans. Since there is insufficient experience at present on which to base a determination as to the extent to which the premiums for multiemployer plans should differ from the premiums for other plans the bill establishes no difference in rates for the first 3 years (1975 through 1977), but authorizes differences for the future. Although separate risk accounts are to be maintained, on the basis of which future rates are to be determined, the funds derived from all the premiums are to be available to pay benefits for any plan losses, without regard to whether any particular funds were derived from multiemployer plans or from other plans.

A multiemployer plan is a plan to which more than one employer is required to contribute; is established or maintained pursuant to a collective bargaining agreement between employee representatives and employers; and is a plan where the benefits are payable with respect to each participant without regard to whether that participant's employer is still making contributions to the fund. All employers who are members of the same affiliated group (sec. 1504(a)) are to be treated as one employer for purposes of this definition. A plan is not a multiemployer plan for any year with respect to which the liability of any one employer for contributions to the plan is as much as 50 percent of the aggregate liabilities of all employers for contributions to the plan for that year.

A plan administrator of a multiemployer plan must notify the Corporation whenever a "substantial employer" [13] withdraws from that plan. The Corporation, upon notification of the withdrawal, will notify the substantial employer of a contingent liability that is the substantial employer's pro-rata share of the total amount of payment that would be made by the Corporation for the entire plan if the plan were terminated on the date of the withdrawal of the substantial employer. The total potential loss of the Corporation is to be apportioned in accordance with the relative amounts of liabilities for plan contributions during the 5 years ending with the withdrawal. As an alternative to payment of this contingent liability into an escrow account, the substantial employer could be required to furnish the Corporation a bond insuring payment of the substantial employer's contingent liability. The limitation to liability of 50 percent of the employer's net worth would be separately applied to each employer.

If the multiemployer plan is not terminated in the 5 years following the withdrawal of the substantial employer, the contingent liability payment would be returned to the substantial employer, or the bond would be cancelled, as the case might be. If the plan does terminate within that time, the Corporation would be entitled to the contingent liability payment, plus any additional amount required to meet the substantial employer's portion of the liability as finally determined.

The liability of an employer (other than a substantial employer) in a multiemployer plan for losses of the insurance fund because of terminations of the plan is generally to follow the rules for determin-

[13] If an employer's liability for plan contributions for each of two consecutive years is at least 10 percent of all employer liabilities for plan contributions for each of those years, then that employer is a "substantial employer" for each of the next 2 consecutive years.

ing the liability limitations for plans of individual employers. The 50-percent-of-net-worth limitation is to be applied separately to each employer.

Within 6 months after the close of each plan year, the plan administrator must notify each substantial employer of its status as a substantial employer. Furthermore, any employer in a multiemployer group who contributes 10 percent or more of the total contributions to the plan during a plan year is to be notified of that fact even if it is not yet a substantial employer (because it has not been in this status for two consecutive years).

Termination—by plan administrator.—Before terminating a plan, the plan administrator must notify the insurance Corporation of the planned termination (sec. 441). This is to give the Corporation an opportunity to determine whether the plan can meet all of its liabilities before the termination occurs. No benefits are to be paid under the termination procedure of the plan until 90 days after the notice (or, if sooner, until the Corporation supplies the plan administrator with the notice of the Corporation's determination that plan assets are sufficient to discharge plan liabilities). Benefits already being paid as of date of the notice are to continue to be paid unless the plan administrator is informed by the Corporation that plan assets are insufficient to pay all benefits, if that should be the case.

If, after receiving a notice of sufficiency and proceeding with the termination, the plan administrator determines that the assets are insufficient, he is to so inform the Corporation. If the Corporation agrees, it is to terminate the plan.

If, upon notification by a plan administrator, the Corporation determines that the plan has insufficient assets to meet all guaranteed liabilities, the plan is to be treated as terminated on the date the Corporation so notifies the plan administrator.

The 90-day period during which the plan administrator may not proceed to terminate a plan without the Corporation's notice of sufficiency of assets may be extended by agreement for succeeding 90-day periods.

Termination—by Pension Benefit Guaranty Corporation.—The insurance Corporation may take steps to terminate a plan whenever the Corporation determines that (1) the plan has failed to meet the minimum funding standards (discussed above, under D. Funding), (2) the plan is unable to pay benefits when due (to the extent guaranteed under the insurance system), (3) if the plan is not terminated, the liability of the insurance Corporation is likely to increase, or (4) there is a lump-sum distribution in excess of $10,000 to a proprietary employee or an owner-employee and afterwards there are unfunded vested liabilities in the plan.

If the Corporation determines to institute procedures to terminate a plan, it is to notify the plan administrator of this determination and set forth the reasons. The notice is to specify what activities, if any, the administrator may engage in prior to the termination (or a notice from the Corporation directing the administrator to continue to operate the plan). If the administrator violates the conditions of the notice, the Corporation may apply to a Federal district court for equitable relief (injunction, mandamus, replacement of trustee, etc.). In

addition, violation of the provisions of the notice is to be a violation of the administrator's fiduciary obligations.

The plan administrator has 15 days after the notice has been issued to demonstrate that termination is improper or no longer necessary. If the Corporation concludes that it is necessary to terminate the plan, it may apply to the appropriate district court (1) for appointment of a trustee and (2) for a court decree to terminate the plan. This action may be brought in the judicial district where the plan administrator resides or is doing business or where any property of the trust forming a part of the plan is situated. The court to which this action is brought may issue summonses regarding this action in any other judicial district. This power is provided so that the court may act promptly and effectively regardless of where the assets or the administrator of the plan may be located at any particular moment. In general, a trustee appointed under these provisions is to be subject to the same duties as a trustee appointed under section 47 of the Bankruptcy Act.

In order to simplify the administration of the Insurance Fund and to avoid abuses, the plan administrator is to be required to report promptly to the Corporation the occurrence of certain events: (1) a loss of qualified status by the plan or its trust, (2) plan amendments that would decrease a benefit of any participant, (3) a decrease in participants to less than 80 percent of those participating at the beginning of that plan year or less than 75 percent of those participating as of the beginning of the previous plan year, (4) a termination or partial termination of the plan under the Internal Revenue Code, (5) a failure to meet current funding requirements or to pay current benefits, (6) a charge by the Secretary of Labor that a fiduciary standard has been violated, or (7) a lump-sum distribution in excess of $10,000 (made other than on account of death or disability) to a proprietary employee or an owner-employee if, after the distribution, there are unfunded vested liabilities. In addition, the Internal Revenue Service is required to independently notify the Corporation of the first and fourth of the above-noted events since these would be normally brought quickly to its attention in the course of its duties.

For the purposes of the seventh category of reportable events described above, a distribution of an annuity contract is to be treated as a lump-sum distribution. Any lump-sum distribution which is a reportable event may be recaptured at any time within 3 years after the insurance Corporation is notified of the distribution.

If an insurable plan is changed in nature, to one not covered by the insurance provisions (e.g., is converted into a money-purchase plan), the change will be treated as a plan termination.

The trustee to administer a termination under the Corporation is to be appointed by a court order. This may be obtained regardless of the pendency of any bankruptcy, lien, foreclosure, liquidation, etc., proceeding.

Termination—powers and duties of trustees.—A trustee appointed pursuant to a decree to administer a plan is to have the power to do anything the plan administrator or any plan trustee might do under the terms of the plan or under the provisions of this bill. He could require the transfer to himself as trustee of all or any part of the assets, records, or other information pertaining to the plan; invest

and reinvest the assets in accordance with the plan provisions and the applicable rules of law; and limit benefits to the amounts guaranteed under the insurance provisions. If the final determination is that a plan termination is improper, the trustee is to transfer back to the plan administrator all the assets, without liability for losses except for willful misconduct.

After a final decree that a plan should be terminated, the trustee is to collect amounts due the plan, pay benefits in accordance with the allocation rules already discussed, and receive payments from the insurance Corporation for funding of guaranteed benefits. In addition, he could perform the expectable functions of a fiduciary in such a situation, including arranging the liquidation of plan assets.

After his appointment, the trustee must give notice of that fact to the plan administrator and to all plan participants, beneficiaries, and employers who might be liable for insurance losses or who made contributions to the plan during the current or any of the previous three years.

The Corporation is to furnish the trustee and the court with a report showing benefits payable with respect to each participant, the amount of those benefits that are guaranteed, the value of the aggregate guaranteed benefits as of the termination, the fair market value of the plan assets as of the termination, and such other information as may be necessary to effectuate the insurance provisions.

Effective date

The insurance provisions generally are to take effect after the date of enactment. Premium taxes are to be collected after December 31, 1974. Insurable benefits are to be guaranteed beginning January 1, 1978.

Cost

The cost of plan termination insurance coverage to individual employers would be 50 cents per year per participant or, if the employer should choose to avoid limited employer liability, 70 cents per year per participant. It is estimated that this would produce about $18 million per year for the insurance fund. The Treasury-Labor Department study on planned terminations which has just been completed indicates a loss of vested benefits of $34 million in 1972. However, for several reasons, it is believed that this substantially overstates the revenue cost of providing term insurance. First, the term insurance payments with respect to any losses need not be paid immediately, but instead can be spread out over the lifetime of the annuitants. Second, the increased funding provided by this bill will significantly lessen the insurance losses. Third, the requirement that employers provide up to 10 percent of the liabilities arising from their own plan failures (except where the additional premium insurance cost is incurred) will further lessen the insurance cost to be paid from the corporation. Fourth, the requirement that improvements in the plan not be taken into account for 3 to 5 years before termination will still further reduce the insurance costs. Fifth, no amounts are paid out in the first 3 years with the result that the revenues raised in these years will be available to help meet future costs. Sixth, limits are provided on the size of the insurance payments which can be made with respect to

individuals. For these reasons, it is believed that an annual $18 million premium commencing January 1, 1975, and collected 3 years in advance of the first years of insurance claims should be an adequate fund to cover insurance losses.

It is estimated that a revenue loss of $9 million per year will be realized on account of the plan termination insurance provisions, because of the tax deductions taken by employers for their premium payments to the Insurance Fund.

G. FIDUCIARY RESPONSIBILITY

(Secs. 501 and 551 of the bill and secs. 503 and 4973 of the Code)

Present law

A retirement plan trust may be qualified under the Internal Revenue Code only if it is impossible under the governing instrument for trust funds to be used for any purpose other than the exclusive benefit of the employees or their beneficiaries (sec. 401(a)(2)). In addition, a retirement plan trust will not be exempt from taxation if it engages in any of the specifically defined "prohibited transactions" (sec. 503).

Under administrative rulings, an investment generally meets the "exclusive benefit" requirement if it meets the following standards: the cost of the investment does not exceed fair market value, a fair return commensurate with the prevailing rate is provided, sufficient liquidity is maintained to permit distributions, and the safeguards and diversity that a prudent investor would adhere to are present. (IRS Publication 778 (February 1972)).

"Prohibited transactions" include the lending of funds to certain interested persons without receipt of adequate security and a reasonable rate of interest. Other prohibited transactions with disqualified persons include payment of excessive salaries, providing the trust's services on a preferential basis, substantial purchases or sales of property for other than adequate consideration, and engaging in any other transaction which results in a substantial diversion of trust assets.[1] If the trust engages in any prohibited transaction, it will lose its tax-exempt status for at least one year.

General reasons for change

Under present law, a trust forming part of a qualified retirement plan loses its exemption from taxation if it engages in a prohibited transaction. With loss of exemption, special tax benefits relating to qualified plans also may be denied, including deferral of taxation by employees and loss of deductions by employers contributing to the trust. In practice these sanctions have not been satisfactory in discouraging prohibited transactions. An employer, needing working capital or in bad financial condition, may forego a deduction in order to divert trust assets to his own use, and the trust fiduciary may acquiesce in his demand.

In addition, the present law's sanctions for engaging in prohibited transactions tend to fall upon innocent employees. For example, if a trust is disqualified because of an act of the trustee and the employer,

[1] More stringent rules govern trusts benefiting owner-employees who control the business (sec. 503(g) of the Code).

the income tax imposed upon a disqualified plan may be paid out of funds otherwise available to provide employees' retirement benefits. Furthermore, because of the prohibited act of an employer and trustee, an employee may have to pay tax on contributions made on his behalf before he actually receives the amounts attributable to the contributions. This possible loss to innocent employees has caused the Service to be reluctant to impose the sanctions.

To resolve these problems, the committee bill changes the method of enforcing the prohibited transaction rules. It imposes sanctions for prohibited transactions upon the parties in interest and fiduciaries who engage in these transactions in place of the sanctions now imposed on the employee benefit trusts.[2] Under the bill the parties in interest and fiduciaries who engage in a prohibited transaction are to be subject to a two-level excise tax on the amount involved in the prohibited transaction. The first-level tax on parties in interest is to be 5 percent of the amount involved (2½ percent on certain fiduciaries) for each year. If the transaction is not corrected to make the trust whole, a second-level tax of 100 percent is to be imposed on the parties in interest (50 percent on fiduciaries who do not agree to correct the transaction). In accord with current law regarding similar taxes respecting private foundations, neither of these taxes is to be deductible. Since payment of the 100-percent tax would be more expensive than restoring the amount involved to the trust (and since payment of the tax would in no event remove the obligation to make the trust whole), it is expected that the trust will be the ultimate beneficiary of the possible imposition of these sanctions.

In some cases an additional remedy may be needed. For example, sometimes it is difficult to quantify the amount involved in a prohibited transaction and therefore difficult to impose a tax. Also, equitable remedies are sometimes necessary. To resolve these problems, the bill provides that the Secretary of Labor and plan participants and beneficiaries may sue to remedy a breach or anticipated breach of fiduciary obligations. This provision is analogous to the provisions in the Tax Reform Act of 1969 that strengthen the ability of State attorneys general to restore or correct acts of self-dealing involving private foundations.

An additional problem exists because of the present definition of prohibited transactions. Currently, transactions generally are prohibited when the dealings involved are on other than an arm's-length basis. However, arm's-length standards require substantial enforcement efforts, resulting in sporadic and uncertain effectiveness of these provisions. This is the same problem which was faced by the Congress in 1969 when it acted with respect to prohibited transactions and private foundations. At that time the Congress concluded that in most cases arm's-length standards did not preserve the integrity of private foundations, and amended these definitions of prohibited transactions for the most part to prohibit outright questionable transactions between the trust and interested parties. The committee's bill generally follows the approach that was developed in 1969, establishing definitions for prohibited transactions that will make it more practical to enforce the law. The committee's definitions of prohibited transac-

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[2] When the term "trust" is used in this section, it means plan, whether or not in trust form.

tions, and the exceptions from these definitions, however, are designed to take account of the unique situation of employee benefit trusts.

Explanation of provisions

Excise tax on prohibited transactions, in general.—For the reasons indicated above the committee bill establishes an excise tax on parties in interest and fiduciaries who participate in certain specified prohibited transactions respecting an employee benefit trust. The new provisions apply to a trust which after August 20, 1973, has qualified (or has been determined to qualify by the Secretary of the Treasury) under section 401 of the Code (and a plan described in section 404(a) (2), and a qualified individual retirement account under section 408(a)). The prohibited transaction rules and excise tax sanctions are to continue to apply even if the trust, etc., should later lose its tax qualification. Under the bill, a trust is not to lose its exempt status because it engages in a prohibited transaction, but the parties in interest and fiduciaries who engage in the transaction are to be subject to tax. These provisions (including the civil action provisions to be administered by the Labor Department, discussed below) are not to apply to church plans unless there has been an election with respect to these plans to obtain insurance coverage (See *F. Plan Termination Insurance*, above).

This excise tax generally follows the same procedures as the tax on self-dealing enacted in the 1969 Tax Reform Act with respect to private foundations. The tax is at two levels; initially, parties in interest who participate in a prohibited transaction are to be subject to a tax of 5 percent of the amount involved in the transaction per year. A second tax of 100 percent is imposed if the transaction is not corrected after notice from the Internal Revenue Service that the 5-percent tax is due.

The committee believes that where the party in interest and not the fiduciary benefits from the prohibited transaction, primary responsibility under the excise tax provisions should be on the party in interest and not on the fiduciary. Therefore, in these cases the tax rates generally are to be lower on fiduciaries than the party in interest. However, where the fiduciary benefits from the prohibited transaction, he is to be treated as a party in interest. Where the fiduciary is subject to tax as an interested party for a given transaction, he is not to be also subject to the fiduciary tax at that level for that same transaction.

The tax on a fiduciary who participates in a prohibited transaction, but does not benefit from it, is initially to be 2½ percent of the amount involved per year. To be liable, the fiduciary must have known (or would have known if he had exercised reasonable diligence), it was a prohibited transaction, and if his participation was not willful, and was due to reasonable cause, he would not be subject to tax. The second level of tax on a fiduciary who does not benefit from the transaction is to be 50 percent of the amount involved, where the fiduciary refuses to agree to part, or all, of the correction required to make the trust whole. Both the first- and second-level taxes on a fiduciary who does not benefit from the transaction are limited to $10,000 (for each tax) with respect to cash transactions.

The first-level tax is owed for each taxable year (or part of a year) in the period that begins with the date when the prohibited transac-

tion occurs and ends on the earlier of the date of correction or the date of mailing of a deficiency notice for the first level tax (under section 6212 of the Code). The first-level tax (except in the case of a fiduciary who does not benefit from the transaction) is imposed automatically without regard to whether the violation was inadvertent.

If more than one person is liable for the prohibited transaction tax on parties in interest (or the tax on fiduciaries), they all are to be jointly and severally liable. For example, if the prohibited transaction involves $100.000, all parties in interest who participated in the transaction will be jointly and severally liable for the first-level tax of $5,000 (per year in the taxable period) and also jointly and severally liable for the second-level tax of $100,000.

The excise tax on a prohibited transaction is a function of the amount involved in the transaction. The bill provides that the amount involved is the greater of the fair market value of the property (including money) given or received in the transaction. However, with regard to services which are necessary to the operation of the plan and which generally may be paid for if the compensation is not excessive, the amount involved is the excess compensation. For the first-level tax, the amount involved in a prohibited transaction is valued as of the date of the transaction. However, for the second-level tax the amount involved is valued at the highest fair market value during the correction period. The higher valuation is used for the second-level tax so the person subject to tax will not delay returning the amount involved to the trust in order to earn income with this amount.

A prohibited transaction may be corrected to avoid the second-level tax at any time before the 90th day after the Internal Revenue Service mails a notice of deficiency with respect to the first-level tax. However, the 90-day period may be extended by any period within which a deficiency cannot be assessed (because of petitions to the Tax Court), and may also be extended for a period which the Internal Revenue Service determines is both reasonable and necessary to correct the prohibited transaction. To correct a prohibited transaction, the transaction must be undone to the extent possible, but in any case the final position of the trust must be no worse than it would have been if the prohibited transaction had not occurred. The higher valuation to be used in computing any second-level tax that might be applicable, is also the valuation to be used in correcting the transaction. In other words, correction requires that the trust receive the benefit of whatever bargain turns out to have been involved in the transaction.

Prohibited transactions and exceptions, in general.—The bill removes qualified trusts from the present arm's-length prohibited transaction rules, and in place of these limitations establishes a set of comprehensive definitions of the prohibited transactions that apply to qualified trusts. Generally, the committee bill defines as prohibited transactions the same type of transactions that constitute prohibited self-dealings with regard to private foundations, with modifications that are appropriate in the employee benefit trust area. As with private foundations, the bill prohibits both direct and indirect dealings of the types specified.

Sale, exchange, or leasing of property.—Under the bill, the sale, exchange, or leasing of any property between the trust and a party

in interest (with the exceptions noted subsequently) is a prohibited transaction. Under this rule, the transaction is prohibited whether or not the property involved is owned by the trust or the party in interest, and the prohibited transaction includes sales, etc., from the party in interest to the trust and also from the trust to the party in interest. Additionally, following the private foundation rules, a transfer of property by a party in interest to a trust is treated as a sale or exchange if the property is subject to a mortgage or similar lien which the party in interest placed on the property within 10 years of the transfer to the trust, or if the trust assumes a mortgage or similar lien placed on the property prior to transfer. This rule prevents circumvention of the prohibition on sale by mortgaging the property before a transfer to the trust.

Loans.—The bill also prohibits all lending of money or other extension of credit between the trust and a party in interest but with the exceptions noted below. The committee recognizes that at times a trust may need financial aid and a party in interest may be the only person willing, or able, to provide that aid. The committee believes that the problem of need and the problem of practical administration in this case can be reconciled where an independent third party makes the loan and the interested party guarantees the loan. Therefore, the bill provides that an interested party may guarantee a loan to a qualified trust if a reasonable rate of interest is charged. In this way, there will be an independent lender to keep the interest rate from being too low (which would avoid the contribution limits), and the trust will have an interest in keeping the interest rate from being too high (which could drain money from the trust to the detriment of the employees). The committee contemplates that a party in interest may guarantee a loan to the trust only where the loan is made by a person who is independent of and not related to the party in interest (or fiduciary), and that the party in interest (or fiduciary) must not provide the lender any direct or indirect consideration for making the loan other than the guarantee.

Following current practice, the bill also allows a loan by the trust to a participant or beneficiary to the extent of the vested accrued benefit of the borrower. To be permitted, such loans must be available to all participants and beneficiaries on a nondiscriminatory basis, and must be made in accord with specific provisions in the plan governing such loans. In addition, a reasonable interest rate must be charged and the loan must be adequately secured. However, it is intended that loans to persons who have been, at any time within 3 years before the loan is made, or while the loan is outstanding, owner-employees or proprietary employees under the plan are not available under this exception; otherwise, the prohibition of premature distributions to such persons could be circumvented.

It is intended that prohibited loans include the acquisition by the trust of a debt instrument (such as a bond or note) which is an obligation of a party in interest. (However, the transition rules, described below, establish special rules regarding certain debt instruments held by the trust on August 21, 1973.) Similarly, the committee intends that it would be a prohibited transaction (in effect, a loan by the trust to the employer) if the employer funds his contributions to the trust with his own debt obligations.

Furnishing goods, services, and facilities.—The committee bill also prohibits the furnishing of goods, services, and facilities between the trust and parties in interest. However, a party in interest may furnish goods, services, and facilities to a trust if this is necessary for the operation of the plan and the compensation paid is not excessive.

However, since a substantial portion of a trust's activity is usually investment of assets, the committee intends that "personal service" not include the activities of a broker, for this activity can give rise to substantial conflicts of interest (e.g., "churning" of assets).

Also, a trust may furnish goods, services, or facilities to a party in interest if the terms on which the goods, etc., are offered are no more favorable than the terms on which they are made available to the general public.

Transfer or use of trust income or assets.—The bill prohibits the transfer of any trust income or assets to, or for the benefit of, a party in interest. It also prohibits the use of trust income or assets by or for the benefit of any party in interest. As in other situations, this prohibited transaction may occur even though there has been no transfer of money or property between the trust and any party in interest. For example, securities purchases or sales by the trust in order to manipulate the prices of the securities to the advantage of a party in interest constitute "a use by, or for the benefit of, a party in interest of any income or assets of the trust."

To prevent discrimination against fiduciaries and parties in interest, the bill permits these persons to receive any benefits to which they are entitled as participants or beneficiaries in the plan.

Payment of compensation.—The bill also generally prohibits payment of compensation, or payment or reimbursement of expenses, by a trust to any party in interest. However, this prohibition does not apply to the payment of compensation, or payment or reimbursement of expenses, by the plan to a fiduciary or other party in interest for personal services which are reasonable and necessary to the plan, if the compensation for payment or reimbursement is not excessive. To prevent double payment, this exception does not apply with regard to a fiduciary who is receiving full-time pay from a party in interest whose employees or members participate in the qualified plan. Also, in accord with present law, it is intended this exception will not apply to payments to owner-employees (or proprietary employees) or to certain of their relatives or to corporations controlled by them.

Transactions primarily involving conflicts of interest and fiduciaries.—The committee bill generally prohibits a fiduciary from dealing with the income or assets of a trust in his own interest or for his own account. However, this does not prohibit the fiduciary from dealings where he has an account in the employee benefit trust and the dealings apply to all trust accounts without discrimination.

The bill also prohibits fiduciaries from receiving consideration in connection with a transaction involving the trust from any party who deals with the trust. This prevents, e.g., kickbacks to a fiduciary.

Transfer of assets outside the United States.—In order to prevent "run-away assets", the bill prohibits any assets of the trust from being held, deposited, or invested outside the United States unless the assets remain within the jurisdiction of a United States district court, except as authorized by the Internal Revenue Service under regulations.

Any such exceptions should be made only where, as to categories of circumstances, it is clear that neither the interests of the trust participants and beneficiaries, nor the interests of the United States in protecting the integrity of its taxing and regulatory and pension guaranty systems would be likely to be jeopardized by the trust assets being outside the United States.

Acquisition of securities of the employer.—The committee bill generally prohibits employee benefit plans from acquiring stock or other securities of the employer. This is provided because generally investment in an employer's securities subjects plan participants to a double risk of loss. If an employer has severe financial reverses, his employees may not only lose their jobs (and the employer's contributions for their retirement may substantially decrease), but also they may suffer a loss from decreases in the securities' value and dividends. Also, if the trust is permitted to invest in securities of the employer, the fiduciary may well be subject to great pressure to time the purchases and sales so as to improve the market in those securities, whether or not the interests of protecting retirement benefits of plan participants may be adversely affected.

However, the bill provides a special rule for profit-sharing plans because the concept of these plans is that employees should share in profits through dividends and appreciation as well as through employer contributions out of profits. As a result it is not to be a violation of this securities-of-the-employer rule for a profit-sharing plan to invest all or any part of its assets in securities of the employer if the securities are readily tradable in an established securities market. However, where the securities are not tradable on an established market, then no more than 10 percent of the profit-sharing trust's assets is to consist of the employer's securities. This limit is needed because of the greater difficulty in selling such securities and therefore the greater risk involved in this situation.

Moreover, the bill does not limit acquisition of employer's stock by stock bonus plans, since limitations in these cases would be inconsistent with the nature of these plans.

An employer's securities includes the securities of any controlled group of corporations (as defined in section 1563(a) of the Code) of which the employer is a member. The prohibition applies not only to the purchase of securities, but also to acquisition in other ways, such as acquisition on default of a loan where stock was security for the loan (this latter example is to apply only where the stock was made security for the loan after August 21, 1973).

The 10-percent test, applicable in the case of profit-sharing plans where the securities are not tradable on an established securities market, is to be applied at the time the securities are acquired. Consequently, if the 10-percent test is met at the time of acquisition, ownership of employer securities is not to be prohibited at a later time when the securities may represent more than 10 percent of the trust assets (e.g., because of a change in the values of the assets of the trust).

The committee bill does not change present law which provides, for qualified trusts, that trust funds may not be used for any purpose other than for the exclusive benefit of the employees or their beneficiaries. Under administrative rulings, an investment generally meets

the "exclusive benefit" requirement if its cost does not exceed fair market value, a fair return is received, sufficient liquidity is maintained, and the safeguards and diversity adhered to by a prudent investor are present. The exclusive benefit rule currently applies to investment in an employer's securities and it is intended that the rule continue to so apply.

The committee bill also does not prohibit a plan from acquiring shares in a regulated investment company (defined under section 851 of the code) which holds or acquires securities of the employer as a regular part of its investment program. However, where the mutual fund acquires securities of the employer as part of the arrangement under which the employer acquires shares in the mutual fund, this exception is not to apply.

Investments that jeopardize income or assets.—The bill also treats as a prohibited transaction investments which jeopardize the income or assets of the trust. This is similar to the rule that private foundations must invest in a manner that does not jeopardize the carrying out of their exempt purposes. It is expected that, under this rule, investment standards will be established for employee-benefit trusts that are similar to the investment standards which have been established for private foundations. In this case also it is not intended that a "legal list" of investments for pension trusts be established. Of course, the prohibited transaction provisions do not prevent an employer, on termination of his plan, from recovering assets not needed to pay plan benefits. Because of this the Internal Revenue Service should take care that this jeopardy rule is administered with due regard to the interests of present and future participants and beneficiaries. If termination is contemplated, it should be clear that investments are not being made or maintained with the interests of potential remaindermen in mind in any case where this is in conflict with the interests of the participants or beneficiaries.

Miscellaneous exceptions from prohibited transaction rules.—In the interests of making the prohibited transaction rules work in as practical a manner as possible, certain exceptions are provided to them. One of these exceptions provides that a transaction (such as an exchange) between a trust and a party in interest pursuant to a corporate adjustment, such as a liquidation, merger, redemption, or recapitalization is not to be a prohibited transaction if all the securities of the class held by the trust are subject to the same terms. However, a redemption in which only the stock held by the trust plan is redeemed would have to serve a bona fide business purpose.

Recognizing current practice, the bill also does not prohibit a person from serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

In addition, the bill provides that plans subject to the prohibited transaction rules are not to include funds held by certain insurance carriers, funds held by an investment company subject to the Investment Company Act of 1940, or plans administered by Federal or State governments or by any agency or instrumentality of these governments.

Transition rules for prohibited transactions.—To prevent undue hardship, the committee bill provides transition rules for situations where employee benefit trusts are now engaging in activities which

do not violate current law but which would be prohibited transactions under the bill.

One of the transition rules permits the leasing or joint use of property involving a trust and a party in interest under a binding contract in effect on August 21, 1973 (or pursuant to renewals of the contract), to continue for 10 years beyond that date, until August 22, 1983. For this transition rule to apply, the lease or joint use must remain at least as favorable to the trust as an arm's-length transaction with an unrelated party, and must not otherwise be a prohibited transaction under present law. A similar 10-year transition rule applies to loans or other extensions of credit under a binding contract in effect on August 21, 1973 (and renewals thereof), where the loan remains as favorable as an arm's-length transaction and is not prohibited under present law.

Under the general rule in the bill, a trust may not generally acquire or hold a bond or other evidence of indebtedness issued by a party in interest, since it would be a prohibited loan. However, if on August 21, 1973, the trust holds any bonds, debentures, notes, certificates, or other evidence of indebtedness which were issued by a corporation and that have interest coupons or are in registered form, and the holding of these debt obligations is not prohibited under present law, then the trust may continue to hold those bonds, without time limit. However, to the extent the bonds are disposed of by the trust, they cannot be reacquired and held under these transition rules.

In order to avoid disruption of markets where a pension plan already holds employer securities (or where a profit-sharing plan subject to the 10-percent limit discussed above, holds more than that limit), the bill does not require divestiture of present holdings of those securities. For this purpose, additional shares acquired as a result of a stock split or stock dividend are to be treated as securities already held. However, exercise of a right to acquire securities (e.g., through conversion of a convertible security), is not to be permitted. If a trust subject to these limitations disposes of some of its present holdings, it may not thereafter acquire new securities of the employer, unless that acquisition is permitted under the general rules (as distinguished from this transitional provision). For example, a pension trust would not be permitted to reacquire present holdings of employer securities after it had sold them; a 10-percent profit-sharing trust would not be permitted to reacquire present holdings of employer securities after it had sold them, unless it could do so within the 10-percent limit. Present holdings, for these purposes, are holdings as of August 21, 1973, the date the committee bill is reported.

The bill allows a trust to sell property, at arm's-length terms, to a party in interest where the property is now under a lease or joint use which qualifies for the 10-year transition rule described above. Sales of this type must occur before August 22, 1983. A transitional rule of this type is provided because it appears that such leases are not uncommon, and in such cases often a party in interest is the best available buyer.

Definitions used in prohibited transaction provisions.—The committee bill contains a number of definitions of terms used in describing the operation of the prohibited transaction provisions. These are described below.

The committee bill defines "fiduciary" as any person who exercises any power of control, management, or disposition with respect to any moneys or other property of the plan, has authority or responsibility to exercise these powers, or is a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for the plan (as described in sec. 7701(a)(6)). Under this definition, fiduciaries include officers and directors of a trust, members of the trust's investment committee, and persons who select these individuals. Consequently, the definition includes persons who have authority and responsibility with respect to the transaction in question, regardless of their formal title.

The bill's definition of a "party in interest" includes the following general categories: (1) managers (and employees) of the plan, (2) persons providing benefit plan services to the plan, (3) the employer and its officers, directors, and highly compensated employees, and controlling or controlled parties, or parties under common control, (4) employee organizations (e.g., labor unions, including the national and international unions where a plan covers any local) with members covered by the plan, and officers and directors of those organizations and (5) fiduciaries who benefit other than in their capacity as plan fiduciaries from the particular prohibited transaction. Additionally, certain relatives and certain partners of parties in interest are treated as parties in interest.

It is intended that "benefit plan services" include investment advisory, actuarial, legal, accounting, computer and bookkeeping, and other similar services necessary for plan operations. Additionally, attribution rules for ownership of stock are provided which are similar to the attribution rules under the private foundation self-dealing rules. Also, in addition, the bill provides that an open-end mutual fund, the mutual fund's investment advisers, and the mutual fund's principal underwriters are not to be considered as plan fiduciaries or parties in interest merely because an employee benefit trust purchases shares in the mutual fund. Mutual funds are currently subject to substantial restrictions on transactions with affiliated persons under the Investment Company Act of 1940, and also it appears that unintended results might occur (such as preventing a trust from redeeming its mutual fund shares) if mutual funds were not excluded from these definitions.

Civil actions.—The committee recognizes that there are breaches of fiduciary responsibility which may not appropriately be subjected to an excise tax either because the amount involved in the transaction is difficult to determine, or because formal injunctive action may be necessary or desirable. Also, the committee recognizes that many persons have a direct interest in seeing that trustees do not breach their fiduciary responsibilities. Consequently, in addition to establishing an excise tax on prohibited transactions, the committee bill strengthens the enforcement of fiduciary duties by providing that individual participants and beneficiaries may bring civil actions in State or Federal courts to redress or prevent fiduciary breaches. Additionally, the bill provides that the Secretary of Labor may enforce breaches of fiduciary duty through civil actions in Federal court.

In providing for enforcement by the Secretary of Labor, the committee bill is similar to the 1969 Tax Reform Act which included pro-

visions to strengthen the ability of State attorneys general to enforce the self-dealing rules regarding private foundations. However, since State attorneys general usually do not have the same common law responsibility to oversee employee benefit trusts as they do private foundations, it was believed that the Secretary of Labor was generally the more appropriate Government official in whom to vest enforcement powers.

Under the bill, civil actions to enforce fiduciary duties generally may be brought with regard to any employee benefit plan which maintains a fund of money or other assets in connection with the plan, and is established or maintained by an employer engaged in or affecting interstate commerce or by an employee organization representing employees so engaged. However, plans established by Federal or State governments or agencies or instrumentalities of these governments are excluded, as are workmen's compensation and unemployment compensation disability insurance plans and plans of churches (in accordance with their exception from the insurance provisions, as described above). Employee benefit plans include plans which provide for retirement, medical, surgical, hospital care, sickness, accident, disability, death or unemployment benefits. These plans also include profit-sharing plans and plans with a trust fund subject to the Labor Management Relations Act of 1947 (sec. 302(c) of that act).

A fiduciary is subject to civil action for breach of fiduciary duty if the plan meets these definitions, regardless of the legal form of the plan. The definition of fiduciaries subject to civil actions includes the same types of persons as the definition of fiduciaries who are subject to the prohibited transaction rules under the excise tax, described above. (However, the plan need not be a qualified plan for tax purposes for a person to be a fiduciary subject to civil action.)

The fiduciary duties which may be enforced through civil actions include the transactions which are prohibited transactions (in the above discussion on prohibited transactions, prevented by excise taxes), and include other fiduciary responsibilities as well. If a fiduciary engages in a transaction which is a prohibited transaction subject to the excise tax, or which would be prohibited and subject to tax if the plan were qualified under the tax laws, the fiduciary's misconduct may be redressed (or prevented) by civil action. In addition, the bill provides that a fiduciary must not jeopardize the income or assets of a plan. Also, a fiduciary must not represent any other party dealing with the plan or act on behalf of a party adverse to the plan or its participants or beneficiaries. Breaches of these duties also may be remedied (or prevented) by civil action.

The bill also provides that fiduciaries must act solely in the interests of the participants and their beneficiaries, and in accordance with the documents and instruments governing the plan (if consistent with the bill). These rules now govern plans qualified under the tax laws and, through the civil action provisions, are extended to other plans of employers which affect commerce (or plans of employee organizations whose members affect commerce).

It is intended that under the rule which prohibits a fiduciary from jeopardizing the income or assets of a plan, fiduciaries will be subject to the usual trustees' duties such as (but not limited to) the duty to

keep and render clear and accurate accounts, take and keep control of the plan property, protect the plan property from loss and damage, enforce claims of the plan and defend actions against the plan (unless it is reasonable not to do so), and keep plan property separate from other property. It is intended that the investment standard that must be met by a fiduciary is to be the standard established by the prohibited transaction rule discussed above which prohibits investments that jeopardize the income or assets of a trust.

The bill also prohibits a person who has been convicted of a number of specified crimes from acting as a manager, fiduciary, employee, or consultant to an employee benefit plan for 5 years after conviction or after imprisonment. Any willful violation of this prohibition is subject to a penalty of $10,000 and 1 year imprisonment; the same penalty is applicable to anyone who knowingly permits another person to violate this prohibition. Upon an administrative hearing and after giving notice to prosecuting officials, the Board of Parole of the Department of Justice may remove the restriction on serving with a plan if the Board finds that this would not be contrary to the purpose of the bill. The Board's determination will be final.

Under the bill, the Secretary of Labor and participants and beneficiaries of a plan may bring civil actions for any appropriate legal or equitable relief to redress or restrain a violation of fiduciary duties. The bill specifically makes a fiduciary who breaches any of the specified duties personally liable; the fiduciary must make good any losses which the plan sustained from the breach and must restore to the plan any profits which he made using plan assets. However, a fiduciary is only personally liable where he knew, or would have known if he exercised reasonable diligence, that his act or failure to act constituted a breach of his responsibility. The bill also provides that fiduciaries have a duty to prevent their co-fiduciaries from breaching a fiduciary responsibility and must compel a redress of a breach. However, if the co-fiduciary objects in writing to the specific action and files a copy of the objection with the Secretary of Labor, he will not be liable for any act (or failure to act) of another fiduciary. Furthermore, the bill specifically prohibits exculpatory clauses.

The bill also makes a party in interest who participates in a prohibited transaction (or a transaction which would have been a prohibited transaction if the plan were qualified under the tax laws) personally liable for any losses sustained by the plan and for any profits made through using plan assets. A party in interest is so liable only if he knew that the transaction was prohibited or would have known after exercising reasonable diligence. This liability is appropriate because in these situations often the party in interest is a major beneficiary of a fiduciary breach; in addition, this liability is in accord with the excise tax liability discussed above regarding prohibited transactions. Fiduciaries and parties in interest who are liable on account of a breach of duty in which they both participated are to be jointly and severally liable.

Appropriate equitable relief may be granted in a civil action. For example, injunctions may be granted to prevent a violation of fiduciary duty, and a constructive trust may be imposed on the plan assets, if needed to protect the participants and beneficiaries. Also, the bill

specifically provides that a fiduciary may be removed through civil action brought by the Secretary or participants or beneficiaries if he has violated any of the specified fiduciary obligations, or is serving in violation of the criminal conviction provisions. (The Attorney General also may bring an action to remove in the latter case.) It is expected that a fiduciary (other than one serving in violation of the criminal conviction provisions) may be removed for repeated or substantial violations of his responsibilities, and that upon removal the court may, in its discretion, appoint someone to serve until a fiduciary is properly chosen in accordance with the plan.

The bill provides that participants and beneficiaries may bring civil actions to redress a breach of fiduciary responsibility in any State or Federal court of competent jurisdiction. Actions by participants and beneficiaries brought in Federal district court are subject to the $10,000 jurisdictional requirements (28 U.S.C. sec. 1331). (However, the $10,000 limit does not apply to actions brought by the Secretary of Labor or the Attorney General.) Where participants and beneficiaries bring a civil action, the Secretary of Labor must be served with a copy of the complaint or petition, and the Secretary may intervene in the action and remove an action from a State court to a Federal district court. Removal is available only when the Secretary could have brought the action initially.

The bill provides that participants or beneficiaries may bring class actions under certain circumstances. Further, in an action by participants or beneficiaries, a court may allow reasonable attorney's fees and costs and may require the plaintiff to post security for payment of these fees and costs. Liberal venue and service provisions are established for actions brought in Federal district court.

If the fiduciary breach is disclosed in a report filed with the Secretary of Labor, civil action may be brought no later than 3 years after the report is filed. In other cases, an action may be brought within 3 years after the plaintiff knows or has reason to know of the violation, but no action may be brought more than 10 years after the transaction occurred. Additionally, where there is a willfully false or fraudulent statement, misrepresentation, concealment or failure to disclose a material fact to the Secretary of Labor, action may be brought within 10 years of the violation.

Effective date

The effective date of the fiduciary responsibility provision is January 1, 1975.

Revenue effect

The fiduciary responsibility provisions are not expected to have any significant effect on the revenues.

H. Administration and Enforcement

(Secs. 101 and 102, 601, 602, and 641 of the bill, and secs. 4974, 7476, 7477, and 7802 of the Code)

The committee bill relies heavily on the tax laws in order to secure compliance with the new requirements that it imposes on employee

pension, profit-sharing and stock bonus plans. The bill, in providing new standards of coverage, vesting, funding and fiduciary responsibility, continues the administration of these provisions in the Internal Revenue Service.

Many aspects of compliance have been discussed in conjunction with the various substantative provisions described in the bill. This includes, for example, the new excise taxes imposed with respect to underfunding and those imposed in connection with transactions which are prohibited to qualified plans.

In a number of other ways, however, efforts have been made to improve the provisions of existing law. The provisions of this type discussed here are the new office set up in the Internal Revenue Service to administer the new standards in this bill as well as those of existing law, together with the audit fee tax designed to provide for this administration. In addition, the bill deals with the problem raised as to the absence under existing law of a judicial review for letters of determination as to the qualification status of plans. Procedures are also set out whereby employees can question the qualification of plans. Finally, the bill establishes procedures in the Department of Labor for an administrative review of employee claims as to their rights under qualified plans.

1. INTERNAL REVENUE SERVICE

Present law

Under present law, the national office of the Internal Revenue Service is organized on a general activity basis rather than a tax or subject basis.[1] At the present time, there are six Assistant Commissioners of Internal Revenue in the national office whose activities are broken into the following categories: collection and taxpayer service, compliance (including auditing), inspection (internal security), planning and research, technical (rulings) and administration housekeeping). Similarly, the field offices of the Service are organized on a similar line. Within each of these broad categories there are Service units whose jurisdictional breakdown is by subject matter under examination. For example, the Miscellaneous and Special Provisions Tax Division under the Office of Assistant Commissioner (Technical) contains a Pension Trust Branch and an Exempt Organization Branch. However, various other aspects of national office employee benefit plan and tax exempt organization administration are under the Office of Assistant Commissioner, Accounts Collection and Taxpayer Service and the Office of Assistant Commissioner, Compliance.

General reasons for change

Concern has been expressed in the case of the administration of employee benefit plans (and also tax exempt organizations) as to whether the Internal Revenue Service with its primary concern with the collection of revenues is giving sufficient consideration to the purposes for which these organizations are exempt. Many believe that the

[1] Reorganization Plan No. 1 of 1952 which went into effect on March 15, 1952. For a description of the present organization of the Internal Revenue Service, see Statement of Organization and Functions (C.B. 1970–1, 442).

present organization of the Service causes it to subordinate concern for the protection of the interests of plan participants (or the educational, charitable, etc., purposes for which the exemptions are provided).

On the other hand, the enormous growth in retirement plans during the last third of a century has proceeded largely under the tax regulations of the Internal Revenue Service. Moreover, clearly the greatest single protection for rank and file employees during this time has been the Internal Revenue Service's administration of the provision denying any special tax treatment for contributions or benefits discriminating in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. The thrust of this provision is to require broader substantial participation in the plans than would be provided but for the Service's administration of the statute.

At the same time, it must be recognized that the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of exemption provisions. Similar concern has been expressed in the past over the Service's administration of the provisions of the tax law relating to exempt organizations.

The committee believes that in the employee benefit plan and tax exempt organization area it should be easier to emphasize the basic objectives involved if the activities relating to these plans and exempt organizations were more closely coordinated, if the activities in these areas relating to auditing, rulings, etc. whether in the field or in the national office are brought together and if the top direction for these activities also has specialized in them. For the reasons outlined, the bill establishes a separate office in the Internal Revenue Service, headed by an Assistant Commissioner for Employee Plans and Exempt Organizations to deal primarily with plans that are (or claim to be) qualified under section 401 of the code and organizations that are (or claim to be) exempt from income taxes under section 501(a) of the code. This includes pension, profit-sharing and stock bonus trusts and plans, religious, educational, charitable, organizations and foundations as well as the various other exempt organizations described in section 501(c) of the code. Similar units are to be established in the various regional and district offices. In addition, the committee has decided to earmark half of the 4-percent private foundations excise tax on investment income as well as the proceeds from a new audit-fee excise tax for the funding of these new offices.

Explanation of provisions

Office of Assistant Commissioner, Employee Plans and Exempt Organizations.—The bill establishes within the Internal Revenue Service a new office of Assistant Commissioner to be known as the Office of Assistant Commissioner, Employee Plans and Exempt Organizations. This office is to have the supervision and direction of the basic activities of the Internal Revenue Service in connection with pensions, etc. plans (governed by secs. 401 through 414 of the code) and tax exempt organizations (exempt from tax under

sec. 501(a) of the code). The bill authorizes the prescribing of the activities this office is to be responsible for in connection with organizations exempt from tax (under sec. 501(a) of the code) and plans to which the special tax benefits of the deferred compensation provisions of the tax laws (secs. 401 through 414 of the code).

In connection with deferred compensation plans it is intended that this office will be made responsible for, among other things, the question as to the qualification of the plan and the related trust and the exemption from tax of the trust. It also is intended that questions as to the deductibility of contributions to a plan, the taxability of a beneficiary of an employees' trust and the taxation of employee annuities be included in the jurisdiction of this office. In addition, it is planned that this office would have responsibility over the minimum standards relating to funding of the plan and the excise tax for underfunding, including the enrollment and reports of actuaries. The new rules relating to prohibited transactions also come within the activities it is intended should be administered by this office.

In connection with organizations exempt from tax (under sec. 501(a) of the code) it is intended that this office have the responsibilities as to an organization's exempt qualification, the taxes on unrelated business income of an organization exempt from tax, and the rules relating to the private foundation provisions of the Internal Revenue Code.

To carry out the provisions of this bill, it is intended that the principal activities referred to above will be transferred from the various Assistant Commissioners' offices to the new Office of the Assistant Commissioner (Employee Plans and Exempt Organizations). With these transfers it is intended that the Assistant Commissioner (Employee Plans and Exempt Organizations), under the direction and supervision of the Secretary, or his delegate, will have the authority to direct national and field office policy in connection with the basic activities of the Service relating to employee plans and exempt organizations.

Salaries.—The bill provides that the Assistant Commissioner (Employees Plans and Exempt Organizations) is to be classified at a GS–18 level and is in addition to the number of positions authorized by present law (sec. 5109 of Title 5 of the U.S. Code). Present law also is amended (sec. 5108 of Title 5 of the U.S. Code) to provide that in addition to any positions already provided (and without regard to any other restriction of present law) there are to be a total of 20 new positions in the Internal Revenue Service in levels GS–16 and GS–17. These increases are to become effective on the date of the enactment of the bill.

Authorization of appropriations.—The responsibilities and functions allocated to this new office are to be funded by separate appropriations, authorization for which is made in this bill. For this purpose, the bill authorizes that the revenue from the annual $1 audit-fee tax imposed on the employer for each plan participant (sec. 4974) plus one-half of the revenues from the 4 percent excise tax on foundation investment income (sec. 4940) is authorized to be appropriated to this office for purposes of carrying out the functions of the office.

The investment income tax on foundations currently is yielding $56 million. This suggests that given the present level, $28 million would be authorized for the new office from this source. It is estimated, based upon the present number of covered pension participants, that $30 million will be collected from the new $1 audit fee tax. Thus, based upon present levels of revenue and participants the revenue provided for the new office is expected to amount to $58 million. Presently the costs of administering the provisions of the tax law relating to exempt organizations is about $20 million and the cost of administering the provisions relating to employee plans is about $22 million. This suggests a total of $42 million, but with the new activities provided in the case of pension plans and the expanded requirements under the 1969 Act with respect to exempt organizations, it is anticipated that significantly more revenue than this will be required to carry out these functions in the future.

Because the authorization for the new office is to be based upon estimates of collections from the two taxes referred to above, it is necessary to have collection data available for purposes of this authorization. As a result, the bill provides that generally the amount of the authorization is to be based upon collections for the second preceding fiscal year. Since the audit fee tax is a new tax first going into effect in the calendar year 1974, the collections from this tax will be first realized in the last half of fiscal year 1974, i.e., the first six months of calendar year 1974. This means that collections for the second preceding year with respect to this portion of the revenue of the new office will not be available before the fiscal year 1976. As a result, as a substitute for the audit fee tax in the years 1974 through 1976, the bill authorizes $35 million a year for the new office. This is in addition to the authorization of half of the collections from the foundation investment income tax.

The funds provided by these two taxes which are authorized for the new office in the Internal Revenue Service are to be used only for activities delegated to this new office and may not be transferred or used by the Internal Revenue Service in any other manner.

Effective date

These provisions are to be effective as of the date of enactment of the bill.

Revenue effect

It is not believed that this provision will have any revenue effect (but, for revenue raised by the audit-fee tax, see below.)

2. EXCISE TAX FOR AUDITING

Present law

As indicated above, the present annual cost of administering employee benefit plans subject to the special tax provisions of the Internal Revenue Code is about $22 million. With the increased costs arising from the expanded duties it is estimated that additional costs will in the near future raise this total to about $35 million. Under present law no audit fees or taxes are paid with respect to a qualified employee plan in order to cover the costs of the Internal Revenue Service in administering qualified employee plans.

General reasons for change

The committee's bill (sec. 101) has established a new Office of Assistant Commissioner for Employee Plans and Exempt Organizations to administer the qualified employee plan provisions and the exempt organization provisions of the code. Under present law, private foundations pay a 4 percent excise tax on their investment income (sec. 4940) half of which under the provision described above is to be used to meet the administration of the exempt organization provisions and other costs of the new office. In contrast, qualified employee plans do not presently contribute funds for the administration of the provisions of the tax law relating to their qualified status. The committee believes that qualified employee plans like exempt organizations should contribute to the cost of their administration. Accordingly, the committee has decided to impose a $1 audit fee excise tax on the employer for each plan participant in a qualified employee plan. As indicated in the provisions described above, the revenue from the $1 audit fee is to be authorized to be used to meet the portion of the joint cost of the new Office of Assistant Commissioner, Employee Plans and Exempt Organizations, which is attributable to pension plans.

Explanation of provisions

The bill provides that for the calendar year beginning on January 1, 1974, and subsequent years an excise tax is imposed of $1 per participant under an employer pension, profit-sharing, or stock bonus plan (described in sec. 401(a)), or an annuity plan (described in sec. 403(a)), or a bond purchase plan (described in sec. 405(a)). The $1 tax imposed is to be paid by the employer of each participant under a qualified plan.

For purposes of administration and collection of this tax the employment tax provisions (subtitle C) of the code are to be applicable. Thus, the audit fee tax becomes the liability of the employer when contributions are first made during a calendar year by, or on behalf of, an employee to a qualified employee plan. However, contrary to the employment taxes, the $1 audit fee excise tax is to be deductible as a trade or business expense (i.e., sec. 3502 does not apply).

The tax imposed under this provision is not to apply to participants under a plan of an agency or instrumentality of the United States, a State or political subdivision. For purposes of this provision a plan established by the employer includes a plan established by a predecessor of the employer.

To be a participant, an individual must be actively employed by the employer at any time during the calendar year. Further, the individual must be entitled to have amounts contributed to or under a qualified plan on his behalf by the employer (or to make contributions to the plan) and must not currently be receiving benefits under the qualified plan (that is, is not a retiree).

The Treasury Department is authorized to prescribe such regulations as may be necessary to carry out the provisions imposing the $1 excise tax.

Effective date

The $1 excise tax is to be applicable to calendar years beginning after December 31, 1973.

Revenue effect

The enactment of this provision is expected to produce approximately $30 million of excise taxes at 1973 levels of employment.

3. TAX COURT DETERMINATIONS

Present law

Plans which meet the requirements of the Internal Revenue Code (that is, are exclusively for the benefit of employees, are nondiscriminatory in regard to coverage and benefits, do not engage in prohibited self-dealing transactions and meet certain other qualifications) receive special tax treatment designed to foster their growth. It is not necessary, in order to receive this special tax treatment, that a prior determination be obtained from the Internal Revenue Service as to the qualification of a plan. However, to assist employers in their development of plans or plan amendments, the Internal Revenue Service issues determination letters indicating whether or not proposed plans or amendments qualify for the special tax treatment. As a practical matter, since taxpayers generally want assurance in advance that their plans or amendments will qualify, in most cases they obtain prior determinations from the Internal Revenue Service before adopting a plan or modification. Such a determination relates both to the qualification of the plan (sec. 401 of the Code) and the tax-exempt status of the related trust (sec. 501 of the Code).

Under the Internal Revenue Service's published procedures, this generally takes the form of a determination letter issued by a district director. The district director may request technical advice from the national office on issues arising from a request for a determination letter. Also, the applicant may request national office consideration of the matter if the district director does not act within 30 days from notice of intent to make such a request, or acts adversely.

Standards are set as to the type of situation in which the national office will entertain a request for consideration of a case. It will, for example, consider a case where the contemplated district office action is in conflict with a determination made in a similar case in the same, or another, district. The procedure provides for a conference in the national office, if it is requested by the applicant.

General reasons for change

In most cases an employer is ultimately able to obtain national office consideration of a request for a determination by means of a request for technical advice by a district director or by appeal to the national office of a district director's determination or failure to make a determination. In some cases, the Service has refused to make a determination with respect to the status of a plan and related trust. In either case, however, the employer has exhausted his remedies after the action by the national office.

As a practical matter, there is no effective appeal from a Service determination (or refusal to make a determination) that a proposed pension plan fails to qualify for the special tax benefits. In these cases, although there may be a real controversy between the employer and the Service, present law permits the employer to go to court only after he has made contributions to the plan, deducted them, and had

those deductions disallowed. The long time period and the related uncertainty, coupled with the threat of the ultimate loss of the tax deduction, almost always causes the employer to go along with the Service, even if he disagrees with the Service's position. In addition, the determination letter procedure does not permit employees, or their unions, to question the qualification of plans.

The committee believes that both employers and employees should have a right to court adjudication in the situations described above. The bill deals with the problem by providing that, in the event of an unfavorable determination (or failure to make a determination), the employer may ask the Tax Court for a declaratory judgment as to the status of a new plan, a plan amendment or a plan to be terminated. In addition, the committee has decided that interested employees should be allowed to participate in the consideration by the Service of an employer's request for a determination and any controversy connected with it. An employee who intervenes in the Service's determination procedure is to be entitled to receive a copy of the determination issued by the Service in connection with the proceeding. If the employee questions a Service determination with respect to the qualification of a particular plan, he may petition the Tax Court to issue a declaratory judgment as to the status of the plan.

The committee believes that this procedure is desirable because it will permit all interested parties to the controversy (the Government, the trustee, the employer, and his employees) to have an opportunity to participate in the administrative determination of the matter and to have an opportunity to contest the Service determination of the matter.[2]

While the committee decision permits employers and their employees to petition the Tax Court for a declaratory judgment in connection with a new plan, a plan amendment, or a plan termination, the committee also expects the Service to establish procedures whereby interested parties (including employees regardless of whether they are plan participants or plan beneficiaries) may question the continued qualification of a plan and a related trust and obtain a determination from the Service. In such a case, it is believed that the Service should afford the employer and other interested parties an opportunity to be heard before issuing a determination letter with respect to the plan and related trust. If the Service ultimately concludes that a plan is no longer qualified, then the Service is to proceed in the usual manner by notice of deficiency. Of course, the Service while concluding that the plan remains qualified could conclude that there has been a violation of a fiduciary obligation, and the Service would then proceed by imposition of the excise tax.

While this new procedure is being made available to parties who desire to use it, there is no requirement that a party use this new procedure to determine the status of a plan. Further, there is no requirement, as a condition for qualification, that a request for a determination be made.

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[2] The present Service procedure provides that appeals from a district director are to be considered by the national office in Washington, D.C., and as a result, if a party wishes to make an oral presentation, he must incur the cost of travel. The Service has instituted a regional appeals procedure in connection with the status of an organization exempt by reason of section 501(c)(3) and it is hoped that the Service will institute a similar appeals procedure for employee benefit plan determinations.

Explanation of provisions

In general.—The bill provides that the United States Tax Court is to have jurisdiction to hear and enter judgments with respect to controversies as to the qualification of an employee plan which has been established by an employer. The plans for which the Tax Court may enter a declaratory judgment are pension, profit-sharing, and stock bonus plans (described in sec. 401(a)), annuity plans (described in sec. 403 (a)), and bond purchase plans (described in sec. 405(a)). A declaratory judgment issued by the Tax Court is to be treated as the final decision of the court and is to be appealable to the U.S. Court of Appeals.

The Tax Court is to have jurisdiction to declare whether a plan is, or is not, a qualified plan, but in this judgment is not to determine whether any proposed action is a prohibited transaction (sec. 4973). The Court is to base its determination upon the reasons provided by the Internal Revenue Service in its notice to the party making the request for a determination, or based upon any new matter which the Service may wish to introduce at the time of the trial. The Tax Court decision, however, is to be based upon a redetermination of the Service's determination and not by a general examination of the provisions of the plan or related trust. The judgment is to be binding upon the parties to the case based upon the facts as presented to the Court in the case for the year or years involved. This, of course, does not forclose future action if an examination of the operations of the plan indicates that the plan does not in operation meet the requirements for qualification.

The parties entitled to petition the Tax Court for a declaratory judgment under this provision in general are the trustee of a plan, a taxpayer seeking to take a deduction for contributions to a plan or trust, or an employee of the taxpayer.

Exhaustion of administrative remedies required.—For a petitioner to receive a declaratory judgment from the Tax Court under this provision, he must demonstrate to the court that he has exhausted all administrative remedies which are available to him within the Internal Revenue Service. Thus, in the case of an employer (or a plan trustee) he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Internal Revenue Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination by a district office to the national office of the Internal Revenue Service, or has requested or obtained through the district director technical advice of the national office. To exhaust his administrative remedies a party must satisfy all procedural requirements of the Service. For example, the Service may decline to make a determination if an employer fails to supply the Service with the necessary information on which to make a determination. In addition, the Service should decline to make a determination if it is not satisfied that the employer has taken reasonable steps to notify all employees who might have an interest in the action on request for a determination.

In addition to exhausting administrative remedies, an employer must have placed a plan into effect prior to the petition of the Tax Court for a declaratory judgment. However, a new plan is to be treated as being in effect even if it includes a provision that the funds con-

tributed to it by the employer and employee may be refunded in the event that the plan is not found to be a qualified plan by the Service or the Tax Court. In the event that the contributions are refunded, all deductions for contributions would be disallowed and all income derived by the trust would be includable in income by the person who receives the payment. In the case of a plan amendment or plan termination, the proposed action by the employer or plan trustee also may be put into effect on a conditional basis.

While the Service presently does not provide any procedure for employee objection to proposed determinations concerning the qualification of a plan, it is anticipated that the Service will adopt procedures similar to those procedures provided for employers making the request for the determination. These procedures would permit employees who have an interest in the requirements necessary for the plan to qualify to participate in the administrative determination of whether a plan is entitled to qualified status. An employee must exhaust these remedies before petitioning the Tax Court for a declaratory judgment. If there has been a failure to provide an employee with adequate notice of a request for a determination, then he need only exhaust those administrative remedies that are available to him at the time he receives adequate notice.

Tax Court Commissioners.—In order to provide the court with flexibility in carrying out this provision, the bill authorizes the Chief Judge of the Tax Court to assign the Commissioners of the Tax Court to hear and make determinations with respect to petitions for a declaratory judgment, subject to such conditions and review as the Court may provide.

Right to petition Tax Court.—The right to petition the Tax Court for a declaratory judgment is to arise only out of cases involving requests for a determination with respect to a new plan, an amendment to an existing qualified plan, or a termination of an existing qualified plan. The request for a determination must be communicated by the employer (or plan trustee) to the employees at the time that a request for a determination is made to the Service. This apprises the employees of their rights, or lack of rights, under the plan and permits them to participate in the proceedings with the Service and enter an objection to any proposed determination.

An employer (or a trustee of a plan) may bring an action for a declaratory judgment in connection with a pension, profit-sharing, stock bonus, annuity, or bond purchase plan if he has submitted to the Service a request for a determination as to the qualified status of a new plan or the continued qualified status of a plan that has been amended or the status of a plan which has been terminated. If the action is brought by the employer or trustee, any employee who had intervened in the proceedings before the Service is to be allowed to intervene in the Tax Court proceedings.

An employee may bring an action for a declaratory judgment if his employer or the trustee of his employer's plan obtained a determination from the Service that is adverse to the employee. A determination may be adverse to an employee, for example, if he is excluded from the group of employees covered by the plan or if his vesting or benefits are not as favorable as he claims they need to be in order to

satisfy the nondiscrimination provisions of the tax law. To bring the action an individual must have been an employee of the employer during the period for which he is questioning the qualification of the plan. In any suit by an employee for a declaratory judgment his employer or the trustee of the plan is to be allowed to intervene.

Time for bringing action.—In general, the petition to the Tax Court for a declaratory judgment must be filed within 90 days after the date on which the Commissioner sends by certified or registered mail his final determination in response to an employer or trustee's request for a determination. Generally, the event causing the period to begin to run is to be a notification by the national office of a refusal to hear an appeal from a district director's determination, or of a notice of a decision with respect to an appeal from a district director's determination. Alternatively, the event may be a notice by the district director of a response by the national office for technical advice. To give interested parties an additional period of time in which to make determinations or file documents, the bill provides that the period for filing a petition may be extended for such additional period as may be needed if agreed to by the Service and the party making the request for a determination.

Generally, the Commissioner is to have 270 days within which to make a final determination. As explained above, however, this period may be extended by consent for whatever period is agreed to by the Commissioner and the party making the request for a determination.

If the Service fails to make a final determination within the specified period of time (including any extensions of time), the employer or trustee may bring his action for a declaratory judgment within 90 days after the expiration of the 270-day period or such longer period for which an extension had been agreed.

Burden of proof.—The normal rules of burden of proof and evidence for the Tax Court are to be applicable in declaratory judgment cases. The burden of proof is on the petitioner with respect to any ground which was set forth in the determination in a manner which informs the petitioner of the reasons for the Service's action. The burden of proof is on the Service with respect to any reason which was not set forth by the Service as a reason for denial of qualification. If the case involves a request for a declaratory judgment where the Service did not make a determination, the burden of proof is to be on the Service for any ground on which it relies in the declaratory judgment proceeding. If an employee disagrees with the Service's determination that a plan is qualified, the burden of proof is on the employee to show that the plan is not qualified.

Effective date

The amendments providing for petitioning of the Tax Court to issue declaratory judgments is to take effect on January 1, 1975.

4. DETERMINATION OF EMPLOYEE RIGHTS

Present law

Under present law, retirement plan participants do not have any right under Federal law to access to an inexpensive forum for having their pension rights declared. In the case of those plans which do not

provide for some form of grievance or arbitration procedure, the plan participants generally only have an opportunity to obtain redress of their grievances in State or local courts.

General reasons for change

The committee believes that all workers and plan beneficiaries should have the opportunity to resolve any controversy over their retirement benefits under qualified plans in an inexpensive and expeditious manner. Hardships have been encountered in the past by workers who are unable to plan for their retirement because of the uncertainty of their benefits and by beneficiaries who have lost benefits to which they were entitled. Accordingly, the committee has decided to provide that controversies as to retirement benefits are to be heard by the Department of Labor.

The procedures provided by this section of the bill are provided as alternatives to existing procedures that may be available to plan participants or beneficiaries. Nor are these procedures intended to override the provision of any collective bargaining agreement or similar agreement which sets out procedures for employees in redressing their grievances.

Explanation of provisions

The bill provides a procedure whereby a plan participant or beneficiary may request the Secretary of Labor to hear and decide disputes as to the present or future entitlement of a plan participant or beneficiary to benefits under a plan which is (or was) qualified under the Internal Revenue Code. For this purpose, a qualified plan is a pension, profit-sharing, or stock bonus plan (described in sec. 401(a) of the code), an annuity plan (described in sec. 403(a) of the code), or a bond purchase plan (described in sec. 405(a) of the code).

To be a participant, an individual must be actively employed by the employer at any time during the calendar year. Further, the individual must be entitled to have amounts contributed to or under a qualified plan on his behalf by the employer (or to make contributions to the plan) and must not currently be receiving benefits under the qualified plan (that is, is not a retiree). A plan beneficiary generally is an individual who is receiving (or claims a right to receive) benefits under a qualified plan.

Upon the application of a plan participant or beneficiary for a determination of his retirement rights the Secretary of Labor is to notify the administrator of the plan under which the applicant is requesting that his rights be declared. The Secretary is to notify the plan administrator of the matters complained of and the relief requested by the applicant, and to hold a proceeding at such time and place and in such manner as to permit the plan participant or beneficiary to be present and to present his case to the Secretary.

The Secretary is to attempt to secure voluntary compliance with any decision he makes with respect to an applicant's retirement rights, but he has the power to issue an order directing the plan administrator to comply with the terms of any decision. In the case of a refusal to comply with a decision of the Secretary, the Secretary may petition any U.S. District Court within the jurisdiction of the proceedings to issue an order requiring compliance.

In any hearing conducted by the Secretary under this proceeding the Secretary is to have the authority to require attendance and to permit examination of witnesses and the production of books, papers, and documents (secs. 49 and 50 of the Federal Trade Commission Act). Under this provision the Secretary also is authorized to examine and copy any documentary evidence of any corporation which is a party to the proceedings and to have the power to require by subpoena the attendance and testimony of witnesses and the production of documentary evidence relating to any matter relative to the proceedings. Other procedures and practices common in administrative determinations of this type are also provided for. It is expected that the procedures adopted by the Secretary will be conducted with a minimum of formality and without requiring a printed record in all cases. It is believed if this procedure is followed, the hearings can be conducted in an expeditious and inexpensive manner.

Any decision made by the Secretary determining the pension benefits of an applicant may be appealed to any United States District Court within the jurisdiction of which the proceeding was held. The provisions of Chapter 7 of Title 5 of the United States Code (relating to judicial review) are to apply to any such appeal and on appeal the facts upon which the decision was based are subject to a trial de novo by the reviewing court.

Effective date

The provisions of this section are to take effect and apply to applications for determinations made on or after January 1, 1975.

I. Limitation on Contributions

(Secs. 702, 704, and 706 of the bill and secs. 72, 401, 404, 412, 414, 1379, and 6691 of the Code)

Present law

Under present law, different rules are provided for employer and employee contributions in the case of plans for self-employed individuals (H.R. 10 plans), plans of "regular" corporations, and plans of electing small business corporations (subchapter S).[1] These are described below.

H.R. 10 plans.—The amount of deductible contributions to an H.R. 10 plan on behalf of a self-employed person cannot exceed the lesser of 10 percent of his earned income[2] or $2,500 (sec. 404(e)). In addition, nondeductible contributions may be made in certain cases, but these contributions on behalf of owner-employees may not exceed the lesser of 10 percent of earned income or $2,500. Allowable voluntary contributions by employees of self-employed individuals must be at least proportionate to allowable voluntary contributions for self-employed (sec. 401(e)(1)(B)(ii)).

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[1] All the types of plans must, in addition to the rules described below, meet the general reasonable compensation tests (sec. 162). The statute does not specify limitations on the benefits which may be paid under a qualified pension plan. However, in Rev. Rul. 72-3, 1972-1 CB. 105, the Internal Revenue Service ruled that pension benefits from a qualifid pension plan are intended as a substitute for compensation, and that in general a plan which provides benefits in excess of an employee's compensation is therefore not qualified.

[2] "Earned income" is generally defined as being equivalent to "net earnings from self-employment"—the kind of income that may be subject to self-employment taxes in lieu of FICA taxes (secs. 401(c)(2) and 1402).

"Regular" corporate plans.—In the case of a "regular" corporate plan there are no limitations on how much may be contributed by the employer. There are, however, limitations on the amount of the contribution that is deductible. Different limitations apply to profit-sharing and stock bonus plans and to pension plans.

In the case of profit-sharing or stock bonus plans, the amount of the contribution that is allowable as a deduction is not to exceed in the aggregate 15 percent of compensation to employees covered under the plan. Contributions in excess of the 15-percent limitation may be carried over to future years. In addition, within certain limits, to the extent that an employer does not make the full 15-percent contribution in one year he may increase the amount of his deductible contribution in a future year.

In the case of pension plans, the amount of the contribution that is deductible is not to exceed 5 percent of the compensation to employees covered under the plan, plus the amount of the contribution in excess of 5 percent of compensation to the extent necessary to fund normal pension costs and remaining past service costs of all employees under the plan as a level amount or as a level percent of compensation. In the alternative, the taxpayer may compute the limit on his deductible contributions by limiting his deduction to his normal cost for the plan plus 10 percent of the past service cost of the plan (sec. 404(a)). In practice, these limitations have very little effect in limiting contributions to regular corporate pension plans.

Where an employer contributes to two or more retirement plans which are governed by different limits on deductions (pension, profit-sharing or stock bonus, or employee annuities), the total amount annually deductible under all the plans cannot be more than 25 percent of compensation otherwise earned by the plan beneficiaries. If any excess is contributed, it may be deducted in the following year; the maximum deduction in the following year (for carryover and current contributions together) is 30 percent of compensation. A carryover is available for additional excess contributions which are deductible in the succeeding taxable years in order of time.

Subchapter S plans.—The limitations on the deductibility of contributions to a subchapter S corporation plan are the same as those in "regular" corporate plans. However, a shareholder-employee (an employee who owns more than 5 percent of the outstanding stock of such a corporation) must include in his gross income the amount by which the deductible contributions paid on his behalf exceeds the lesser of 10 percent of his compensation or $2,500 (sec. 1379(b)).

Professional corporations.—Generally, lawyers, doctors, accountants and certain other professional groups in the past have been unable to carry on their professions through the form of corporations because of the personal nature of their responsibility or liability for the work performed for a client or patient. Consequently, their contributions to retirement plans were limited by the rules governing self-employed persons. In recent years, however, all States have adopted special incorporation laws which provide for what are generally known as "professional corporations." These have been used increasingly by groups of professional persons, primarily to obtain the more favorable tax treatment for pensions generally available to corporate

employees. The Treasury Department, in the so-called Kintner regulations, held that professional corporations were not taxable as corporations. A number of court cases, however, have overturned the regulations and the Service has now acquiesced and generally recognizes these professional corporations as corporations for income tax purposes.

General reasons for change

Many self-employed people, especially professionals, feel that they are discriminated against as compared with corporate executives and proprietary employees of corporations in regard to the tax treatment of retirement savings. This is because, at present, there is no comprehensive limit on the amounts the corporate employer can contribute on behalf of its executives and proprietary employees. Self-employed persons, on the other hand, are subject to the contribution limits described above.

In addition, many of the self-employed argue that, as a result of these contribution limits, it is difficult for them to provide adequately for their retirement, particularly as many professionals have a limited number of years of peak earnings, in which it is comparatively easy to set something aside. It is also argued that the $2,500 limit is no longer appropriate, since in the approximately 10 years since H.R. 10 was first enacted, there has been a substantial inflation factor in the economy. Furthermore, it is contended that the present law in the retirement plan area creates an artificial incentive for the incorporation of businesses which more traditionally, and perhaps more appropriately, have been conducted in unincorporated form. For all of these reasons, the committee believes that a substantial increase in deductible contributions for self-employed individuals is justified at the present time. Under the committee bill, the present limits would generally be increased to 15 percent of earned income, up to a maximum deduction of $7,500 per annum.

At the same time, it is clear to the committee that the formation of professional corporations, a practice which has proliferated enormously in recent years, has had the effect of circumventing the limitations which Congress intended to impose on deductible contributions by persons who are essentially, in most respects, self-employed. In many corporate plans a much larger percentage of the contributions and benefits go to "rank and file" employees than is the case with regard to most H.R. 10 plans. In such corporate plans, if large contributions are made for executives, then the antidiscrimination provisions of present law (sec. 401(a)(4)) require that proportionate contributions be made on behalf of rank and file employees. Not only does this "financial drag" effect tend to impose practical restrictions on the size of contributions made for the highest level employees, but it also means that, if large contributions are made for this group, then lower level employees will also benefit. Thus, it appears that many corporate plans are subject to practical limitations which do not apply in the case of self-employed plans. The absence of such practical limitations is the reason that it has been thought necessary to impose legal limitations upon self-employed plans.

However, it appears to the committee that the current method of limitations does not apply equally to all situations where "financial

drag" is very small or nonexistent. Also, the committee feels that the present system discriminates in favor of those who choose to incorporate, and against those who do business in the more traditional partnership form. Similarly, other small businesses in corporate form are treated differently for pension plan purposes depending whether or not they are under subchapter S, and without regard to whether most of the benefits under the retirement plan go to rank and file employees.

The committee bill would correct this situation by putting the regulation of retirement benefits on a realistic basis, applying limitations where they are appropriate, whereas the current system depends too greatly on the form of business operation. Thus, under the committee bill, limitations on contributions would be imposed not only on self-employed plans, as under present law, but also on proprietary employees holding a two percent or greater interest in an incorporated business, but only where all such persons, in the aggregate, have more than a 25-percent interest in benefits under the plan.

Explanation of provisions

The committee bill increases the maximum deductible contribution on behalf of self-employed persons to the lesser of $7,500, or 15 percent of earned income. (A similar, although not identical, rule is applied in the case of defined benefit pension plans.) However, no more than the first $100,000 of earned income may be taken into account in applying the percentage limits. The $100,000 ceiling on the earned income rate base means that a self-employed person with more than $100,000 income will have to contribute at a rate of a least 7½ percent on behalf of his employees if he wishes to take the full $7,500 deduction on his own behalf (in order to comply with the antidiscrimination requirements).[3] A self-employed person earning more than $100,000 who wishes to contribute $5,000 for himself will have to contribute at least 5 percent on behalf of his employees.

The committee bill also extends the application of these provisions to plans for the benefit of "proprietary employees." In general, a "proprietary employee" would be any individual owning either directly, or through attribution rules (those prescribed in sec. 1563(e)), at least 2 percent of the total combined voting stock of the corporation, or 2 percent of the total value of all shares of stock in the corporation. However, the provision does not apply unless all proprietary employees who are active participants, as a class, have more than 25 percent of the total account balances for active participants under a defined contribution plan (such as a money purchase plan), or in other cases have more than 25 percent of the present value of all accrued benefits under the plan (whether or not vested) for active plan participants.[4] The committee believes that this approach will place the treatment of corporate plans on a more realistic and equitable basis—where most of the benefits under the plan are for individuals who are not proprietary employees, the contribution ceiling will not apply, but

[3] The limitations on nondeductible contributions on behalf of owner-employees in a self-employed plan is not increased, however.

[4] In a case where a corporation has two or more plans, an individual will be a proprietary employee for purposes of all the plans, if the more than 25 percent test is met with respect to any of the plans.

where a substantial portion of the plan benefits are for proprietary employees, the ceiling will apply.

The new rules are also to apply in the case of subchapter S corporations. Under the committee bill, section 1379 is repealed. However, subchapter S corporations would remain subject to limitations under the same rules applicable to other corporations. Thus, if more than 25 percent of the benefits under the plan were for individuals who each held at least 2 percent of the stock in the corporation, these stockholders would be considered to be proprietary employees, and would be subject to the 15 percent—$7,500 limitation. But if less than 25 percent of the benefits were for these individuals, these limitations would not apply.

As is the case under present law with respect to an owner-employee, a proprietary employee (or a group of two or more proprietary employees) who controls more than one business would be required under the bill to group together all controlled business activities for the purpose of determining whether all employees of the proprietary employee are covered by a retirement plan on a nondiscriminatory basis, and also for the purpose of assuring that the limitations on contributions are not exceeded. As a result of this requirement, a proprietary employee could not make contributions under two or more retirement plans, which, when totaled together exceeded $7,500. This provision ensures that a proprietary employee may not exceed the limitations on deductible contributions by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his business and set up a retirement plan in one business where, for example, he is the only employee.

The bill also provides that—like an H.R. 10 owner-employee under present law—an individual who is a proprietary employee in a business (whether or not he controls the business), and is also a proprietary employee in another business which he controls, may not be covered under the plan of the first business unless he has established a plan for the employees of the business which he controls. The plan for the business which he controls must provide contributions and benefits for employees which are at least as favorable as the contributions and benefits provided for him under the plan of the first business.

The rules outlined above also apply in cases where an individual is an owner-employee in one firm and a proprietary employee in a second business.

Defined benefit plans—limitation on benefits.—The committee bill also contains a provision, which applies in the case of all defined benefit plans (including corporate plans without proprietary employees), generally limiting the annual benefits which can be paid out under these plans (as of age 65) to 100 percent of the participant's average compensation from the employer during his highest 3 consecutive years of earnings. A pension is essentially a substitute for earning power during the retirement years and the committee believes that no qualified pension plan should pay defined benefits which are higher than an employee's average earnings during his highest 3 years. It is the understanding of the committee that this provision is consistent with present law (Rev. Rul. 72-3, 1972-1 C.B. 105) and by this provision the committee only intends to clarify and make more explicit present law.

The plan could, however, provide for a cost of living adjustment over and above the 100 percent limit. However, benefits paid in the event of early retirement would have to be scaled down from the 100 percent of salary level on an actuarial basis. In general, in the case of any defined benefit pension plan which does not pay benefits in the form of a straight life annuity, commencing at age 65, or which provides ancillary benefits, the 100 percent limitation would have to be adjusted in accordance with regulations.[5] In the case of a contributory plan, upward adjustments in the benefit schedule would be permitted in accordance with regulations, to reflect the fact that part of the annuity had been purchased with the employee's own after-tax dollars.

In the case of an employee who is a participant in both a defined benefit pension plan and a money purchase pension plan, the maximum 100 percent of salary benefit under the defined benefit pension plan would be reduced under the committee bill by multiplying 100 percent of the participant's average compensation by a fraction, the numerator of which is the percentage of compensation contributed under the money purchase plan, and the denominator of which is 20. (Under another provision of the committee bill, 20 percent would be the maximum tax-excludable contribution under a money purchase plan.)

For example, if an employee had an average high-three-year salary of $20,000, and a 10 percent of salary contribution had been made on his behalf to a money purchase plan, his maximum yearly benefit under the defined benefit pension plan could not exceed $10,000 (10/20ths of $20,000). This would prevent the situation where an employee might seek to circumvent the limitations on benefits under a defined benefit plan, or on tax-excludable contributions under a money-purchase plan, by setting up two different types of plans for himself. (In cases where the rate of contributions to a money purchase plan fluctuated over the career of the employee, or were made for certain years when he was a participant under the defined benefit plan, but not for others, appropriate adjustments to this formula will be made in accordance with regulations.)

As a further adjustment, in the case of an employee who participates in a defined benefit plan for less than 10 years, the defined benefit otherwise allowable in accordance with the rules described above is to be reduced by multiplying the otherwise allowable benefit by a fraction, the numerator of which is the proprietary employee's years of active participation in the plan, and the denominator of which is 10. For example, if an individual who was an active participant for 3 years under the plan had an average high-three years salary of $50,000 (and no other adjustments were required) his maximum benefit could not exceed 3/10ths of $50,000, or $15,000 per annum.

This would prevent a situation where an individual might receive an extremely high pension, even though he had only a few years of active service under a plan.

Defined benefit plans for proprietary employee corporations.—At present, many small corporate plans are defined benefit plans, although

[5] The committee expects that the adjustment for ancillary benefits will be substantially equivalent to the adjustment now provided under present law for a plan which is integrated with social security.

most self-employed plans are defined contribution plans because of the limitations on contributions imposed on self-employed persons under present law. The committee was concerned that in extending the contribution limits to certain proprietory employee corporate plans, the committee bill might inadvertently take away, as a practical matter, the option of having defined benefit plans from these corporations. As a result, the committee bill contains a formula (which under the bill may also be used by self-employed individuals) which would allow proprietary employees, in effect, to translate the 15 percent—$7,500 limitations on contributions, to which they would otherwise be subject, into limitations on benefits which they could receive under a defined benefit plan. (Of course, all employees of all corporations, and all self-employed individuals, remain subject to the 100 percent of salary limitation, discussed above.)

Under the formula, the basic benefit for the employee (that is, a straight life annuity commencing at the later of age 65 or 5 years from the time the participant's current period of participation began, with no ancillary benefits) is not to exceed the amount of the employee's compensation which is covered under the plan (up to a maximum of $50,000) times the percentage shown on the following table.

Age at participation	*Percentage*
30 or less	6.5
35	5.4
40	4.4
45	3.6
50	3.0
55	2.5
60 or over	2.0

The percentages in early years are higher to reflect the fact that contributions made during these time periods earn interest for a longer period prior to retirement than contributions made in later years. The Secretary or his delegate is to have authority to prescribe regulations in cases of plans which provide something other than the "basic benefit." Also, the regulations are to specify percentages for individuals who become participants at ages other than those shown on the table. In addition, the Secretary or his delegate is given authority to prescribe new percentages, to be used in years beginning after December 31, 1977, based on changes in money rates and mortality tables occurring after 1973.

To illustrate how this formula would work, assume that a self-employed person enters a defined benefit plan at age 30, and participates in the plan for 5 years, with income covered under the plan of $20,000 per annum. At age 35, he leaves the plan, but at age 50, he again becomes a participant. For the first 5 years his covered income is $30,000 per year, then $40,000 for the next 5 years, and finally $50,000 for the last five years prior to his retirement.

The calculation would work as follows:

Age	Compensation per year	Rate	Benefit earned per year	Total benefit
30–35	$20,000	6.5	$1,300	$6,500
50–55	30,000	3.0	900	4,500
55–60	40,000	3.0	1,200	6,000
60–65	50,000	3.0	1,500	7,500
Total				24,500

Thus, the maximum benefit which could be paid to the individual under the plan in the form of a single life annuity commencing at age 65 with no ancillary benefits would be $24,500 per year.

The committee bill also provides that for purposes of the antidiscrimination rules, the maximum amount of compensation which is to be taken into account is to be $100,000. (This is the same ceiling provided in connection with contributions to a money purchase plan.) For example, if a self-employed person established a defined benefit plan for himself at age 50 (where a 3 percent rate would apply) and earned $100,000 per year, benefits under the plan for his employees could be earned at the rate of 1.5 percent of covered compensation, and the plan would not be considered to be discriminatory. In other words, the maximum benefit which could accrue per year for the self-employed person would be 3 percent of $50,000, or $1,500, which is equivalent to 1.5 percent on a $100,000 base. Thus, the self-employed person would be permitted to make contributions which would purchase a 1.5 percent benefit for his employees. However, even if the self-employed person's earnings were $200,000, benefits earned for the employees under the plan could not drop below the 1.5 percent rate.

Limitations on contributions to money purchase plans.—The committee bill also contains a provision which would limit tax excludable contributions under a money-purchase plan. Cases have been found where the stockholders of small corporations invest very substantial percentages of their income in what is, in effect, a deferred compensation arrangement. As discussed above, the Internal Revenue Service has ruled (Rev. Rul. 72-3, 1972-1 C.B. 105) that a pension is essentially a substitute for earning power during the retirement years and that, in general, a pension plan does not qualify in cases where the pension benefit is more than the employee's highest average salary. The committee agrees with this interpretation of present law, but the 100-percent-of-salary limitation is difficult to apply in the case of money purchase plans because the amount of the pension benefit which will ultimately be received cannot be determined with precision. Thus, the committee bill, as a corollary to the 100-percent-of-salary limitation for defined benefit plans, also contains a provision that tax excludable contributions to a money purchase or other defined contribution plan cannot exceed 20 percent of the employee's compensation. Any additional contributions on behalf of the employee must be included in income by him.[6]

To enforce these provisions, employers or pension plan custodians would be required to report to the Service, in accordance with regulations, whenever contributions in excess of the 20 percent limitation had been made, and a penalty ($10 a day up to a $5,000 maximum) would be imposed for each instance of unexcused failure to comply with these reporting requirements.

Any amount included in gross income under this provision would be considered as part of the employee's investment in the contract for purposes of computing the taxable amount of a distribution from the plan to the employee. However, these contributions would be considered to be made by the employer for purposes of qualification of the

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[6] The only exception would be in the situation where a contribution was made by the employer at a 20 percent rate (or less) for his employees, but the contribution happened to exceed 20 percent of the employee's actual compensation due, for instance, to a termination of employment.

plan. If the employee's rights under the plan should terminate before tax excludable payments under the plan equaled the amounts included in gross income under this provision, a tax deduction would be allowed equal to the unrecovered contributions.

Integration rules for plans benefiting proprietary employees.—Under present law, any H.R. 10 plan which benefits owner-employees is subject to certain additional rules with respect to integration. If more than one-third of the contributions under the plan are made on behalf of owner-employees, the plan is not permitted to integrate with social security. On the other hand, if less than one-third of the contributions are made for owner-employees, and the owner-employee treats the self-employment taxes which he pays as contributions on his own behalf under the plan, the plan may integrate by treating the employer's social security contributions on behalf of his employees as contributions made under the plan (sec. 401(d)(6)). By contrast, a qualified employer plan may integrate by treating social security benefits as benefits provided under the plan (within certain limits).

Under the committee bill, essentially these same provisions would be applied in the case of plans for proprietary employees. Otherwise, it was apparent to the committee that professionals and others would still have a substantial artificial tax incentive to incorporate rather than to do business in more traditional forms. In addition, it seemed reasonable that the same general considerations which led the committee to conclude that it was desirable to extend the limitations on contributions to certain corporate plans, also suggest that employees of those corporations should have the extra protection against erosion of their pensions through integration that the special rules afford.

Therefore, under the committee bill, it is provided, in general, that in any plan for the benefit of proprietary employees, the plan may not integrate if more than one-third of the account balances or accrued benefits under the plan are for the benefit of individuals each of whom holds 10 percent or more of the stock in the corporation. Other proprietary employee plans may integrate, but only on the same basis as an owner-employee plan could integrate (that is, by treating social security taxes paid for the employees as contributions paid on their behalf under the plan).

At the same time, the commitee recognizes that there are many small corporate plans, already in existence, which now use integration, and which might be seriously affected if the rules in this area were to be altered too abruptly.

The committee bill provides a transitional rule, under which any proprietary employee plan which was in existence on July 24, 1973, may continue to integrate (in plan years beginning before January 1, 1980) at the same level of integration (if any) as was in effect under the plan on July 24, 1973, but the level of integration may not increase. (For example, when the social security rate base rises, the plan must still continue to integrate at the old level.) However, any self-employed plan which elects to convert to a defined benefit basis (using the table and formula described above) and any new proprietary plan, created after July 24, 1973, which elects a defined benefit approach, may not integrate. Also, any proprietary plan in existence on July 24, 1973,

which shifts from a defined contribution plan to a defined plan may not integrate.

Other special rules for proprietary employee plans.—The committee bill also extends certain other provisions which apply to H.R. 10 plans under present law to plans for the benefit of proprietary employees as well. For example, payments under a qualified pension plan to a proprietary employee would have to begin by the time he attained age 70½, and the employee's account would have to be paid out at least ratably over the life of the employee or the lives of the employee and his spouse (sec. 401(a)(9)). Also, if a proprietary employee should die before his entire interest in the plan had been distributed to him, the plan would generally be required to distribute that interest, or purchase an annuity for his beneficiaries, within 5 years after his death (sec. 401(d)(7)).

Also, excess contributions on behalf of any proprietary employee would have to be prohibited by the plan (although, as under present law, nondeductible employee contributions could be made by a proprietary employee, up to $2,500 per year, in plans where such contributions may be made by employees who are not proprietors) (secs. 401(d)(5)(A) and (B), and 401(e)(1)). Any excess contributions which were made inadvertently would have to be repaid by the plan to the corporation within 6 months after mailing of notice of the overcontribution by the Internal Revenue Service (secs. 401(d)(8)(A) and 401(e)(2)(C)).

Also, death benefits paid by a qualified plan to a proprietary employee would not qualify for the $5,000 death benefit exclusion for purposes of the Federal income tax (sec. 101). Proprietary employees (and individuals who had been proprietary employees at any time within 5 years prior to the distribution) would be treated the same as self-employed persons for purposes of the rules with respect to the income tax treatment of lump-sum distributions (sec. 72(n)).

In addition, if a proprietary employee borrows money, pledging his interest in the pension plan as security, the portion pledged as security shall be treated as a distribution under the pension plan to the employee (sec. 72(m)(4)). The purpose of this rule is to prevent the employee from engaging in an arbitrage type of transaction, in which he makes a tax deductible contribution to the pension, which also earns tax-free interest, then gets the money out of the plan, in effect, by means of a loan secured by his portion of the plan assets, and also receives a tax deduction for the amount of interest paid on the loan (subject to certain limitations on excess investment interest (sec. 163(d)).

Time for making contributions.—Under present law, contributions to a self-employed plan must be made by the end of the taxable year in order to be deductible for that year. Often this can create difficulties for the self-employed person, who may not have at hand all the information necessary for him to determine how much he is permitted to contribute on his own behalf. In order to meet this problem, the committee bill provides that tax deductible contributions to self-employed plans (and all other qualified plans) may be made at any time up to the point when the Federal income tax return (corporate or individual, as the case may be) for that year is due (including any exten-

sion). This rule should provide the additional time necessary for the individuals involved to make the required calculations and determine the amount of the maximum deductible contribution which is permitted for the taxable year in question.

Custodial Accounts.—Under present law, a custodial account may be treated as a qualified trust, but only if the custodian is a bank, and the investments are made solely in the stock of regulated investment companies, or solely in annuity, endowment, or life insurance contracts (and certain other conditions are met) (sec. 401(f)). The committee believes that present law is too restrictive in this respect and the committee bill would allow the custodian of the account to be someone other than a bank, provided, however, that the custodian would have to establish, to the satisfaction of the Internal Revenue Service, that it would manage the assets of the account in a manner consistent with the intention of the tax law. (For example, it would have to be shown that no premature distribution prior to age 59½ would be made to owner-employees.) Also, a formal custodial account would no longer be necessary under the bill. Any similar arrangement having appropriate safeguards could be used if approved by the Secretary.

Also, the committee bill would provide that someone other than the trustee or custodian, including the employer, can have authority to control the investments of the plan account, either by directing the investment policy of the plan, or by exercising a veto power.

Generally, the requirement of the bill would be satisfied in a situation, where, for example, a regulated investment company or other investment advisor might make investment decisions with respect to the assets of the account, but an independent third party, which might be a bank or some other responsible institution, would administer the plan, and handle distributions. The committee is desirous of affording extra flexibility in this area, and reducing the cost of pension plan administration, but it also wishes to preserve the safeguard of a plan administrator which is independent with respect to the employer.

Withdrawal of voluntary contributions by owner-employees.—Under present law, amounts received from a retirement plan before retirement are tax free to all participants other than owner-employees to the extent of all nondeductible contributions made to the plan by the participants. Thus, all participants other than owner-employees may, if the plan permits it, withdraw their voluntary contributions prior to retirement. The committee bill would extend this same treatment to owner-employees.

Effective date

Generally, these provisions would take effect in plan years beginning after December 31, 1973. However, in the case of proprietary employee plans in existence on July 24, 1973, that will be made subject under the bill to certain rules and limitations which, under present law, apply only in the case of owner-employee plans, the committee believes that a transitional period is necessary to allow time for plan amendments. Thus, proprietary plans in existence on July 24, 1973, will generally be made subject to the contribution limits for plan years beginning after December 31, 1974. Extension of H.R. 10 owner-employee plan restrictions to proprietary employee plans in

existence on July 24, 1973, will also generally take effect in plan years beginning after December 31, 1974. In addition, proprietary employee plans which were integrated on July 24, 1973 may continue as integrated plans, but may not increase the level of integration.

The repeal of the special subchapter S limitation (sec. 1379) is effective for plan years beginning after December 31, 1973, and subchapter S corporations will then become subject to corporate rules (including the rules on proprietary employee plans) in this area.

The treatment of proprietary employees as self-employed persons for purposes of the death benefit income tax exclusion (sec. 101) and the rules on lump-sum distributions (sec. 72(n)) will apply to taxable years beginning after December 31, 1973.

The amended rules, with respect to custodial accounts apply to plan years beginning after December 31, 1973.

Revenue effect

By increasing the maximum amount that self-employed persons will be allowed to deduct as contributions under H.R. 10 plans to 15 percent of earned income up to $7,500 a year, an increased revenue loss is estimated that will amount to $175 million annually. The provision in the bill that allows individuals who are not covered presently by pension plans to deduct up to $1,000 a year as contributions to personal retirement plans will reduce revenues by an estimated $270 million a year. A revenue gain of $125 million is estimated to be the result of the provision that applies to certain proprietary employees of corporations the same limitations on deductible pension contributions that apply to self-employed individuals under H.R. 10 plans. The net result of these three provisions that are designed to equalize tax treatment under pension plans is a revenue loss of $320 million. These estimates assume 1973 levels of income and employment.

J. Employee Savings for Retirement

(Secs. 701 and 706 of the bill and secs. 72, 219, 408, 409, and 4960 of the Code)

Present law

Generally, an employee is not allowed a deduction for amounts which he contributes from his own funds to a retirement plan. There is no provision for an employee to establish his own retirement plan with tax-free dollars. Also, while an employer's qualified plan may allow employees to contribute their own funds to the plan,[1] no deduction is allowed for these contributions (except to the extent that tax excludable contributions made in connection with salary reduction plans, described below, may be viewed as employee contributions). However, the income earned on employee contributions to an employer's qualified plan is not taxed until it is distributed.[2]

In the case of a salary reduction plan, however, in the past employees have been permitted to exclude from income amounts contributed by

[1] Generally, if the plan allows it, employees may make voluntary contributions to a qualified retirement plan of up to 10 percent of compensation. I.R.S. Publication 778, p. 14 (Feb. 1972)

[2] At one time, Congress took the position that a contribution to an H.R. 10 plan on behalf of a self-employed person was made half by the employer and half by the self-employed person; no deduction was allowed for half of the contribution (presumably, the half "contributed by" the self-employed person). This limitation (see 404(a)(10)) was repealed for taxable years after December 31, 1967.

their employers to a pension or profit-sharing plan, even where the source of these amounts is the employees' agreement to take salary reductions or forego salary increases. If the plan met certain nondiscrimination requirements, the Internal Revenue Service in the past had taken the position in rulings that, under certain circumstances, the amount of the salary reduction would be treated as an employer contribution to a qualified pension plan, not taxable to the employee (until benefits were received from the plan). The maximum amount that could be so treated was 6 percent of compensation.[3]

On December 6, 1972, however, the Service issued proposed regulations (37 Fed. Reg. No. 235, p. 25938) which would change this result in the case of qualified pension plans by providing that amounts contributed by an employer to such plans in return for a reduction in the employee's total compensation, or in lieu of an increase in such compensation, will be considered to have been contributed by the employee and consequently will be taxable income to the employee.[4] Public hearings have been held on these proposed regulations but regulations in final form have not yet been issued.

General reasons for change

While in the case of many millions of employees provision is made for their retirement out of tax-free dollars by their participation in qualified retirement plans, many other employees do not have the opportunity to participate in qualified plans. Often plans are not available because an employer is not willing to incur the cost of contributing to a retirement plan. This may be so even though the employees would be willing to contribute their own funds for this purpose. The employees not covered under a qualified plan who, as a result, are not able to set anything aside for their retirement out of after-tax dollars, are further disadvantaged by the fact that in their case earnings on their retirement savings are subject to tax, and grow more slowly than the tax sheltered earnings on contributions to a qualified plan.

The committee bill deals with this problem by making available a special deduction for amounts set aside for retirement by employees who are not covered under a qualified plan (including an H.R. 10 plan), a government plan, or a tax exempt organization annuity plan (sec. 403(b)). Individuals in this status, in computing their income tax, will be permitted to deduct up to $1,000 a year for contributions to an individual retirement account. The earnings on this amount will also be tax free. As in the case of H.R. 10 plans, the amounts set aside plus the earnings become taxable to the individual generally after he has

[3] In the case of employees of tax-exempt charitable, educational, religious, etc., organizations and employees of public educational institutions, a specific statutory provision provides for employer contributions of up to 20 percent of compensation, times years of service, reduced by amounts previously contributed by the employer for annuity contracts on a tax excluded basis to the employee (sec. 403(b)). The regulations under the statute allow the employer contributions to be made under these salary reduction plans. Antidiscrimination provisions that apply generally to qualified plans do not apply to those tax sheltered annuities. The committee bill does not affect the tax treatment of these contributions.

[4] The proposed regulations would not affect the tax treatment of contributions to certain qualified profit-sharing plans, where the contributed amounts are distributable only after a period of deferment, presumably because the Federal tax treatment of this type of plan has been established by a long-standing series of revenue rulings. (Rev. Rul. 56-407, 1956-2 C.B. 284; Rev. Rul. 63-180, 1963-2 C.B. 189; Rev. Rul. 68-89, 1968-1 C.B. 402.)

reached retirement age, when he receives benefits from the account. In addition, as a way of gradually converting retirement accounts of this type into qualified retirement plans, the bill provides that employers can (but are not required to) provide part or all of the $1,000 retirement savings for employees.

Explanation of provisions

In general.—Under the committee bill, any individual who was not covered during a year as an active participant in a qualified retirement plan, or a government plan (whether or not qualified), or a section 403(b) annuity plan,[5] is to be permitted a deduction of up to $1,000 a year from earned income for contributions to a personal retirement account. In order to provide the widest possible scope for the provision, the committee bill provides that the deduction in this case is to be from gross income, and as a result can be taken even by those taxpayers who do not itemize the rest of their deductions. This is designed to assure every employee, or self-employed person, the opportunity to set aside at least some retirement savings on a tax sheltered basis. Earnings on these contributions would also be tax free (until actually distributed to the employee as benefits from the account).

In the case of a married couple, each spouse may establish his or her separate retirement savings account and the $1,000 limitation is to be applied separately to the earned income of each spouse. For example, a married woman with only a limited amount of earned income from part-time employment would be enabled, under the committee bill, to set this aside for her own retirement. (For this purpose, earned income is to be attributed to the person earning the income without regard to any State community property laws.) This provision permits an individual to set something aside for his or her own retirement based on his or her own earned income.

Under the bill, the employee can establish his own retirement savings account, or the retirement savings can be made through the medium of contributions by an employer (either in the form of additional compensation provided by the employer or a salary reduction plan) if there is no qualified, government or exempt organization plan which covers the employees in question. In other words, if the employer does not have a qualified plan, or if he has such a plan but it does not cover certain employees, the employer can establish a retirement savings account of up to $1,000 for each of these employees. Any employees not covered under the employer plan (including those excluded from participation due to length of service requirements, or because of age) can be covered under an employer-sponsored retirement account, or alternatively, these individuals can establish their own individual retirement accounts. The committee believes, however, that it is important to preserve the employer-sponsored retirement account as an option, because it may be easier administratively for the employer to set up individual retirement accounts for his employees than for each employee to have to set up his own account. In addition such an employer-sponsored plan is likely to grow into a qualified pension or profit-sharing plan.

[5] If contributions were made on behalf of an individual under a plan during the taxable year, he would generally be considered an active participant for that year.

Where individual retirement accounts are set up by the employer, the aggregate tax excludable contributions and tax deductible contributions by the employee (which are to be accounted for separately in the records of the account) are not to exceed $1,000 per year.[6] Of course, all benefits under the salary reduction plan are to be immediately vested, since the contributions, in effect, either represent compensation to the employee or come from his own funds.

It is the intention of the committee that where an employer has both a qualified plan and employer-sponsored retirement accounts, that the qualified plan must meet the nondiscrimination standards without regard to the individual retirement accounts.

Since the deduction for contributions to individual retirement accounts is to be available to the self-employed as well as employees, the committee bill will also benefit people such as jockeys, who in years of low earnings are limited in what they can contribute to an H.R. 10 plan by the percentage-of-income limitation (15 percent under the bill). However, since there is no such limitation on contributions for personal retirement savings, an individual could, if he chose, contribute all of his earned income to a qualified retirement account, up to the $1,000 ceiling. Moreover, a self-employed person, such as a jockey, might, if he chose, participate in an H.R. 10 plan in certain years, and make contributions to an individual retirement account in other years so long as he does not actively participate in both types of plans in the same year.

Requirements for an individual retirement account.—An individual who wishes to establish an individual retirement account (instead of participating in an employer-sponsored retirement account) would have to maintain, under the provisions of a written governing instrument, a separate accounting of his contributions, the earnings on them, and the distributions made either to the individual involved or to his beneficiaries.[7] The balance in the account could, for example, be invested in insurance annuity contracts, in a common trust fund managed by a bank, in a savings account with a savings and loan institution or a credit union, or in stock of a mutual fund. However, in any case, the funds must be held by a bank or other person who establishes to the satisfaction of the Service that the manner in which it will hold the balance in the account is consistent with the intention of the new provision. The funds might be held in a trust, a custodial account, or any similar arrangement approved by the Secretary of the Treasury.

The bill also contains a number of other provisions designed to ensure that the accounts will be used for retirement savings, many of which are similar to requirements which are already in the law with respect to H.R. 10 plans.

One of these requirements relates to excess contributions. The written governing instrument is to provide that no contributions in excess of

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[6] Any amount deductible or excludable under these provisions is not to be considered to be part of the employee's investment in the contract for purposes of computing the taxable part of the distribution, since all of the contributions would be made, in effect, with tax-free dollars. If contributions in excess of these limits are made, the employer is not to receive a deduction for the excess contribution, and all excess would have to be repaid to the employer.

[7] However, in the case of a married individual in a community property State, the committee bill would allow the establishment of an individual retirement account, even though contributions to the account were treated as community property under the State law.

the deductible limit can be made to the plan. Any excess contributions inadvertently made would have to be refunded to the individual with interest within 6 months after notice of the excess contribution was sent by the Internal Revenue Service. If the excess contributions were not repaid, the account would be disqualified for that year and all succeeding taxable years. In this case, the individual would also be required to take into income the assets of the account (valued as of the first day of the taxable year in which the account became disqualified), reduced by any contributions in the account for the current year (for which deductions are denied).

In addition, if it is found that the excess contributions are made willfully, the taxpayer's interest in all individual retirement accounts is to be distributed to him and he is not to be permitted to establish another retirement account for a period of five years (in the same way that owner-employees are subject to similar penalties for excess contributions to H.R. 10 plans).

An example of an excess contribution which would not be willful might occur where the employee made a $1,000 contribution to a retirement account believing at that time he would be eligible to receive the deduction for this amount. Later in the year, however, the employee might become ineligible because he changed jobs and became a participant in a government or qualified pension plan. Under these circumstances, the employee would receive no deduction for the contribution to the qualified retirement account, and the proper procedure, in order to preserve the qualified status of the account, would be to request repayment of the excess contribution.

Generally, an individual would only be permitted to receive a deduction for contributions to one individual retirement account in any one taxable year. However, the bill provides an exception to cover the situation where the employee entered or left employment during the year with an employer who contributed to his qualified retirement account. For example, under these circumstances, an employee would be permitted to contribute $200 to an account which he established, and then, upon entering his new employment, the employee and employer together could contribute up to $800 on a tax-free basis to an account established by the employer.

In addition to the rules on excess contributions, the written instrument is also required to provide that no distributions can be made to the individual prior to age 59½, except in the event of death or disability. On the other hand, under the bill, the plan is required to begin distributions when the individual attains the age of 70½, and distributions then have to be made at least on a ratable basis over the life expectancy of the individual, or the individual and his spouse. After age 70½, an excise tax of 10 percent a year is imposed on any amounts in the individual's account in excess of the amounts to be ratably distributed. Also, under the committee bill, no tax deductible contributions could be made to the account after the individual attains the age of 70½. By these provisions the committee hopes to encourage the use of the proceeds of these accounts for retirement purposes.

If the individual establishing the account should die before his entire interest in the account has been distributed to him, the governing instrument is generally to require that the undistributed assets be

distributed, or applied to the purchase of an annuity for his beneficiaries, within 5 years after his death. However, this rule does not apply if distributions began prior to his death, and the account was to be completely distributed over a period not exceeding the life expectancy of the individual and his spouse (measured as of the time when distributions from the account began).

In addition, if the assets of the account are invested in an insurance contract, the governing instrument must provide that any refunds of premiums are to be held by the insurance company and applied toward the payment of future premiums or the purchase of additional benefits within the current taxable year or the next succeeding year.

Premature distributions.—Premature distributions frustrate the intention of saving for retirement, and the committee bill, to prevent this from happening, imposes a penalty tax. If a premature distribution from the account is made before the individual attains the age of 59½, the distribution is subjected to a penalty tax of 30 percent.[8] This is in addition to any other income taxes payable on this distribution, and would not be offset by any tax credits (other than the refundable credits for overwithholding, overpayment of tax, and the gasoline tax credit). Also, this tax would not be treated as reducing the individual's tax liability under the minimum tax provisions (sec. 56).

The penalty tax is not to apply in the event of death or disability. However, the committee expects that the Internal Revenue Service will require that the custodian must receive proof of disability before making distributions under the disability provision. Generally it is intended that the proof be the same as where the individual applies for disability payments under social security.

The penalty tax also is not applied in the case of a refund of excess contributions which were not willful.[9]

Taxation of beneficiaries.—Generally, the proceeds of an individual retirement account are to be taxable to the individual when distributed. Since the contributions to the account will be made with tax free dollars, the employee's basis in the account will be zero.

The amounts distributed to the individual are not to be eligible for capital gains treatment, and the special averaging rules applicable to lump sum distributions (under sec. 72) are not to be available. This should encourage the individual to take down the amounts ratably over the period of his retirement. However, the individual would be permitted to use the general averaging rules (sec. 1301).

If any individual borrows money, pledging his interest in the retirement account as security, the portion pledged as security is to be treated as a distribution from the retirement account to the individual. This treatment also is consistent with the committee's intention to encourage retirement savings, since in this case if the employee had already pledged his retirement account as security for a loan, he has no funds left for retirement. For the same reasons, any contribution to an individual retirement account, or any income of the account, applied to the purchase of life insurance protection under any retirement

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[8] The distribution would not, however, be subject to the penalty provided under section 72(m)(5) for premature distributions to owner-employees.

[9] For example, some qualified and government plans permit an employee to elect to participate if he makes employee contributions. In some instances, the employee with some years of service already to his credit may join the plan retroactively, by means of makeup contributions. If an employee should join a qualified plan on this retroactive basis, his individual retirement accounts for those retroactive years would no longer be qualified. Thus, he would have to take the previously deducted contributions into income for that year, but no penalty tax would be payable.

income, endowment, or other life insurance contract also will constitute income to the individual.

For purposes of the estate and gift taxes the amounts in individual retirement accounts are not to be excluded from tax (secs. 2039(c) and 2517). This too is consistent with the committee's intent that the funds be spent during the individual's period of retirement.

Rollovers.—To permit flexibility with respect to the investment of an individual retirement account, the bill provides that money or property may be distributed from an individual retirement account, without payment of tax, provided this same money or property is reinvested by the individual within 60 days in another qualifying individual retirement account. The transfer may be desired because the individual desires to shift his investments, for example, from, or to, an annuity contract, a mutual fund, a savings account or perhaps to a Government bond (described below). To prevent too much shifting of investments under this provision, the committee bill provides that this rollover can only be used once every three years. Also, before releasing the account, the committee anticipates that the custodian will be required by the Internal Revenue Service to receive a declaration of intention from the individual as to the proposed reinvestment (except in the case of an individual who was entitled to receive a distribution because of his retirement at age 59½, or because of disability). The custodian is also to be required to notify the Service that a distribution of assets from the account had been made.

Qualified retirement bonds.—In addition to the various types of investment described above in which an individual retirement account can be placed, the bill also provides that these amounts may be invested annually in a retirement bond, to be issued by the government. The bonds are to be issued under the Second Liberty Bond Act and provide for the accumulation of interest until the time of redemption. In conformity with the general provisions for individual retirement accounts, the bill provides that the bonds generally can only be cashed after the individual has reached the age of 59½ years, or if he becomes disabled. If he dies, the bonds could be redeemed by his estate.

There would be one further exception to cover the case of an individual who purchased the bonds, believing that he would be eligible for the deduction for that year, only to discover later that he was not eligible. For example, an individual might purchase the bond early in the year, and later become a participant under a qualified retirement plan sponsored by his employer. To meet this situation, the committee bill provides that the bond may be redeemed at any time within 12 months of its purchase without penalty (and without payment of interest).[10] This provision could also be used by individuals who purchased the bond, but discovered within a year that they needed the money for other purposes. In this case the Internal Revenue Service would be notified that the bond had been redeemed and, therefore, would be on notice that no deduction should be allowed because of its purchase.

Consistent with the general rules for individual retirement accounts, the bill provides that the bonds are to cease to bear interest when the

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[10] If the bond was not cashed within the 12 month grace period, the individual would still not receive the deduction, in those cases where he was not eligible for it. However, when he cashed in the bond at retirement age, the proceeds of the bond would constitute income to him (since his basis in the bond would be zero under the committee bill).

individual reaches age 70½. In addition, during that year the individual is also required to take any of these bonds he is still holding into income, even if he does not cash them in. It is anticipated that these rules will be set forth on the face or back of the bonds.

Also, for similar reasons, the committee bill provides that bonds are to cease to bear interest not later than five years after the death of the individual in whose name the bonds have been issued.

The bonds are to be issued in the name of the individual who purchases them for his retirement and are not to be transferrable, under any circumstances, except to his executor in the event of his death (or to a trustee for his benefit in the event he became incompetent to manage his own affairs). For example, the bonds could not be pledged for the payment of debts, and could not be assigned to a trustee in bankruptcy. Also, the bonds could not be awarded to the individual's spouse as the result of a divorce settlement.

When the bonds are redeemed, the full proceeds of the bonds, including any interest earned on them, is to be treated as ordinary income to the individual, whose basis in the bonds would be zero.[11] However, if the individual chose to do so, he could treat this income under the general averaging provisions of the tax law (sec. 1301 et seq.).

Other rules.—To safeguard the individual retirement accounts, the committee bill imposes certain additional rules with respect to fiduciary standards and reporting. Under these provisions, the qualified retirement account is to be treated as an owner-employee plan for purposes of the rules with respect to the excise tax on prohibited transactions (sec. 551 of the bill and sec. 4973 of the code) and also for purposes of the provisions relating to returns of information by exempt organizations (sec. 6033) and fiduciary returns required to be filed in connection with certain trusts, annuity and bond purchase plans (sec. 6047). In addition, the rules with respect to unrelated business income (sec. 511) also are to apply to these accounts.

A special rule is also provided in the case of divorce settlements. Under present law, if an asset of an individual is transferred pursuant to a divorce settlement, the individual is deemed to realize gain on the difference between his basis in the asset and its fair market value at the time of the transfer (if the asset has appreciated). The committee believes that this is not a desirable result with respect to individual retirement accounts. As a result, under the committee bill, if an individual retirement account should be transferred to the individual's spouse pursuant to a divorce decree, or settlement agreement, this transfer is not to be taxable under the bill. Thereafter, the account would be maintained for the benefit of the spouse, and only the spouse could make further contributions to the account.

Six percent salary reduction plans.—The committee bill also clarifies the law with respect to the tax treatment of 6 percent salary reduction plans. As discussed above, until recently, the Internal Revenue Service had taken the position that amounts contributed to a qualified retirement plan on a salary-reduction basis could, under certain conditions, be considered as tax excludable employer contributions to the plan.

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[11] A limited exception to this rule is provided in the case of an individual who redeems bonds after age 59½, and reinvests the proceeds within 60 days in another qualified retirement account. This form of "rollover" from one type of qualified retirement account to another is permitted under the committee bill on a tax-free basis in order to provide flexibility of investment. Prior to age 59½, there could be a rollover from an individual retirement account to the purchase of bonds, but not vice-versa, because the bonds could not be cashed.

Under the committee bill, this treatment is continued with respect to contributions to a qualified pension or profit-sharing plan made prior to January 1, 1974. Thereafter, as is already true under present law, in the case of employee contributions under the Federal Civil Service Plan, or similar government plans, contributions which are really employee contributions (whether required to be made or made at the individual option of the employee in return for a reduction in his basic or regular compensation, or in lieu of an increase in such compensation) are to be treated as such and will no longer be excludable from income by the employee. The only modification in this rule is that where an individual is not covered by a qualified plan, a government plan, or a sec. 403(b) annuity plan, employer contributions of up to $1,000 per annum can be made to an individual retirement savings account under a salary reduction arrangement. Income earned on amounts contributed under a salary reduction plan prior to 1974 would for the future remain tax exempt as also would the earnings on these amounts.

Section 403(b) annuity plans.—Under present law, the proceeds of a section 403(b) annuity plan, for the benefit of teachers or employees of tax-exempt organizations, may be invested only in insurance contracts. The committee believes that it would be desirable to provide more flexibility in this area and, accordingly, the committee bill provides that the assets of these accounts may also be invested in mutual funds, under appropriate custodial restrictions.

Retirement income credit.—A conforming amendment provides that amounts distributed from an individual retirement account, or the proceeds of qualified retirement bonds, are to be treated as retirement income for purposes of the retirement income credit. As a result, this form of retirement income will form part of the base for determining the credit, in the same manner as other forms of taxable retirement income do under present law.

Net operating loss provisions.—The bill provides that any individual retirement account contributions by individuals which are deductible are to be treated as personal expenses and not as trade or business expenses of the individual for purposes of the net operating loss provisions. As a result, contributions to a qualified retirement account may not be used to create or increase a net operating loss. This is consistent with the treatment afforded contributions under H.R. 10 plans.

Effective date

These provisions will apply with respect to taxable years beginning after December 31, 1973.

Revenue effect

It is estimated that these provisions (at 1973 levels of income) will result in a revenue loss of $170 million in 1974, rising to $270 million.

K. Lump-Sum Distributions

(Sec. 703 of the bill and secs. 72, 402, and 403 of the Code)

Present law

Retirement benefits generally are taxed as ordinary income under the annuity rules (sec. 72) when the amounts are distributed, to the extent they do not represent a recovery of the amounts contrib-

uted by the employee. However, an exception to this general rule under the law in effect before the Tax Reform Act of 1969 provided that if an employee's total accrued benefits were distributed or paid in a lump-sum distribution from a qualified plan within one taxable year on account of death or other separation from service (or death after separation from service), the taxable portion of the payment was treated as a long-term capital gain, rather than as ordinary income.

The capital gains treatment accorded these lump-sum distributions allowed employees to receive substantial amounts of deferred compensation at more favorable tax rates than other compensation received currently. The more significant benefits under this treatment apparently accrued to taxpayers with adjusted gross incomes in excess of $50,000, particularly in view of the fact that a number of lump-sum distributions of over $800,000 have been made.

To correct this problem, the Tax Reform Act of 1969 provided that part of a lump-sum distribution received from a qualified employee's trust within one taxable year on account of death or other separation from the service (or death after separation from service) is to be given ordinary income treatment, instead of the capital gains treatment it had been given under prior law. The ordinary income treatment applies to the taxable portion of the distribution (i.e., the total distribution less the employee's contribution) which exceeds the sum of the benefits accrued during plan years beginning before 1970, and the portion of the benefits accrued thereafter which does not consist of employer contributions (sec. 402(a)(5) and 403(a)(2)(c)).

The 1969 Act provided a special limitation in the form of a seven-year "forward" averaging formula which applies to the portion of the lump-sum distribution treated as ordinary income. An employee (or beneficiary) is eligible for the special 7-year forward averaging provision if the distribution is made on account of death or other separation from service (or death after separation from service)[1] and, in the case of receipt by an employee, if he has been a participant in the plan for 5 or more taxable years before the taxable year in which the distribution is made.

Reasons for change

The Treasury has had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the precise breakdown between ordinary income and capital gain in a lump-sum distribution. It has also had great difficulty in formulating regulations to carry out the 1969 Act provisions for determining the amount of tax imposed on account of the "ordinary income" element of post-1969 lump-sum distributions. Recently, the Treasury withdrew its earlier proposed regulations on the second point and substituted new ones which, in general, would produce lower tax liabilities than those determined under the earlier set of proposed regulations. The new regulations would produce lower tax liabilities than under current long-term capital gain rates in many cases, and this could mean that they would result in revenue losses, rather than revenue gains, in comparison to the law which would have applied in the absence of any special action with respect to this provision in the Tax Reform Act of 1969.

[1] Self-employed taxpayers, on the other hand, continue to be eligible for their special 5-year forward averaging only on lump-sum distributions received on account of death, disability as defined in sec. 72(m)(7) of the Code, or if received after age 59½ and, in the case of receipt by an employee, after at least 5 years of participation.

More important, the new proposed regulations appear to share with the old proposed regulations the problem of excessive complexity. It is frequently maintained that lump-sum distributees are unable to compute their taxes, and that accountants and tax lawyers have been refusing to attempt the computations.

To eliminate undue complexity but maintain the revenue at least as high as that which would result under the proposed regulations under the 1969 Act provision, the committee chose to introduce a new and simplified method of computing the tax due on lump-sum distributions. The substance of the 1969 change in the tax treatment would be preserved, however. Under the bill, all pre–1974 portions of lump-sum distributions would be taxed as capital gain, rather than as ordinary income. The effect of the January 1, 1974, cutoff date under this bill is to provide long-term capital gains treatment for that portion of future distributions that relates to years after 1969 and before 1974; under the 1969 Act, portions of the distributions allocable to those years would have been taxed as ordinary income.

Under the simplified computational rules, ordinary income portions of lump-sum distributions from qualified plans are to continue to benefit from special "forward" averaging. The portion of the distribution representing pre-1974 value is to receive capital gains treatment, as stated above. The portion of the distribution attributable to post-1973 value in excess of the employee contributions is to be subject to tax as though it were ordinary income of the taxpayer, but his only income, and with 15-year averaging.

This ordinary income treatment for the post-1973 value of the lump-sum distribution is computed completely separately from the taxpayer's other income. This separate computation is used because it was found that taxpayers were, in effect, being treated quite differently depending upon the presence or absence of other income in the year of distribution—something which they sometimes had in their power to control. The 15-year averaging is provided in order to give roughly the equivalent of what the tax would be were the individual to live 15 years after retirement and receive his interest in the plan over that period. In this case, a tax is computed on $\frac{1}{15}$th of the distribution computed as if the taxpayer had no other income or deductions. After the tax is computed, the result is multiplied by 15, and this amount is then added to the employee's tax liability on his other income. His tax liability on this other income takes into account not only his tax on wages, salary, or investment income, etc., but also the capital gains tax on the portion of the lump-sum distribution attributable to pre-1974 value. The tax liability on this other income does not in any way, however, take into account the portion of the lump sum distribution treated as ordinary income.

In making the ordinary income computation on the post-1973 value, a special minimum distribution allowance is provided to insure that the tax on relatively small lump-sum distributions will generally be not more than it would be under present law. This allowance is phased out for lump-sum distributions over $20,000.

A major problem with the rule arrived at under the 1969 Act was the difficulty in determining the value of the distribution attributable to years before 1970 for which capital gains treatment was continued by that Act. To meet that problem, the committee bill provides that where a lump-sum distribution relates to active participation

which began before 1974 and ended after that time, the distribution is to be apportioned between the pre-1974 participation (eligible for capital gains treatment) and post-1973 participation (treated as ordinary income under a separate 15-year averaging computation) on the basis of the amount of time in which the employee was an active participant in each period. This method will significantly simplify the computation previously required.

Table 1 presents a comparison showing the average effective tax rates applicable for taxpayers in various situations and with various amounts of lump-sum distributions, with the methods of computing post-1973 taxable value as capital gain, under present law (with the proposed regulations), and under the committee bill.

TABLE 1.—COMPARISON OF INCOME TAX TREATMENT OF LUMP SUM DISTRIBUTIONS UNDER THE COMMITTEE BILL WITH CAPITAL GAINS TREATMENT AND WITH THE TREATMENT PROVIDED IN 1969 (AS SHOWN BY PROPOSED REGULATIONS)

Assumed adjusted gross income, other than lump sum [1] distribution	Assumed lump sum distribution [2]	Average effective income tax rates (percent)		
		Capital gains treatment (1973 law) [3]	1969 treatment as shown by proposed regulations [4]	Rates which apply under Finance Committee bill when all but employee contributions are ordinary income
$5,000	$2,500	7.4	5.1	7.0
	5,000	7.7	5.3	7.0
	10,000	7.4	5.6	7.0
	50,000	8.5	10.6	15.4
	60,000	8.7	11.3	16.6
	100,000	10.6	13.2	19.1
$10,000	5,000	8.1	5.7	7.0
	10,000	9.2	5.9	7.0
	20,000	9.5	8.9	7.1
	50,000	10.4	12.0	15.4
	100,000	12.2	15.4	19.1
	200,000	15.8	19.5	22.6
$25,000	12,500	15.6	11.5	7.0
	25,000	15.7	13.9	9.3
	50,000	16.7	16.1	15.4
	125,000	18.8	20.0	20.1
	250,000	22.3	23.2	24.3
	500,000	25.6	27.2	32.9
$50,000	25,000	24.6	19.6	9.3
	50,000	24.8	21.0	15.4
	100,000	25.5	22.2	19.1
	250,000	27.0	25.2	24.3
	500,000	29.1	28.4	32.9
	1,000,000	31.2	32.5	46.0
$100,000	50,000	25.0	30.1	15.4
	100,000	28.2	31.4	19.1
	200,000	30.7	33.8	22.6
	500,000	32.0	37.0	32.9
	1,000,000	33.8	38.8	46.0
	2,000,000	35.1	43.9	57.3

[1] Income other than lump sum distributions consists of income taxed at ordinary rates and which is not subject to either the maximum tax on earned income or the minimum tax on items of tax preference. To avoid problems of maximum tax on earned income, ordinary income in excess of $50,000 is considered as coming from sources other than earnings. Taxable income is computed from AGI by deducting the larger of the standard deduction or itemized deductions equivalent to 15 percent of AGI and from personal exemptions of $750 each. Taxpayer is considered to be married and filing a joint return. No additional itemized deductions are considered to accrue to the taxpayer due to the receipt of lump sum distribution.

[2] Net of taxpayer's basis.

[3] 50 percent inclusion of capital gains in AGI. Taxpayer is eligible for either alternative tax of 25 percent on 1st $50,000 of capital gains or normal 5 year income averaging. Four prior year base period income is assumed to be the same as taxable income excluding distribution for the current year, except for $5,000 AGI class which is assumed to have a base of $1,462.50 and the $10,000 AGI class which is assumed to have a base of $5,850.

[4] 70 percent of distribution assumed to be capital gains; 30 percent ordinary income.

Explanation of provisions

Under the simplified computation of the tax on lump-sum distributions, the post–1973 portion of a distribution is to be taxed as ordinary income (but with 15-year "forward" averaging), thus maintaining the recognition in the Tax Reform Act of 1969 that the taxable portions of these distributions are basically deferred compensation, and generally should be taxed as is other compensation; that is as ordinary income. Fifteen-year averaging is provided to recognize the fact that the distribution represents compensation which generally is received spread out over the taxpayer's life beginning with the time he retires. The fifteen-year averaging insofar as the size of the tax is concerned achieves this result. It is believed that it would be unfair to use the high tax rate that would be applicable if the distribution were treated as received wholly in one year. As a result of the averaging, the distribution would be taxed roughly as if it were received in 15 equal parts in 15 years. The decision to tax this income separately from all other income (to the extent it is not treated as pre-1974 income eligible for capital gains treatment) was made on the basis that most distributees will have little or no other taxable income in the years following their retirement.

The portion of the distribution attributable to pre-1974 service is to be taxed as capital gain and taxed along with any other income the taxpayer may receive. For this income, the committee believed it was appropriate to preserve the pre-1969 treatment (at current capital gains rates) to the fullest extent possible. The portion which constitutes a return of employee contributions continues to be nontaxable as a return of basis.

Under the computation, the capital gain portion is included in the amount of the taxable distribution prior to the deduction of the minimum distribution allowance and the application of the 15-year averaging rule. After a total tax is determined under the 15-year averaging rule, the tax on the ordinary income element is the portion of that total tax determined according to that portion of the plan participant's total time in the plan that was spent after 1973. The capital gain is added to the taxpayer's other income and the combined amount (minus regular deductions, exclusions, etc.) is taxed under usual rules. (See the examples at the end of this *Explanation of provisions* section.)

A further simplification from prior law in the computation is the determination of the amounts to be attributed to pre-1974 employment (capital gain taxation) and to post-1973 employment (15-year averaging with ordinary income taxation). That attribution is to be made on the basis of the amount of time in which the distributee was an active participant in each period. Thus, if a distributee was an active participant from January 1, 1971, through December 31, 1980, three-tenths of the taxable portion of his distribution would be taxed as capital gain while seven-tenths would be taxed as ordinary income and averaged over 15 years.

In order to treat all distributees equally, all computations of the tax on the 15-year averaging ordinary income portion are to be made on

the basis of the tax schedule for unmarried individuals.[2] In addition, community property laws are to be ignored for these purposes. Thus, a distributee in a community property State is to compute his tax on the basis that the entire amount of the distribution is his income.

The committee recognized that excessive computational problems would arise if separate computations were made where a plan participant had accrued some of the value of his lump-sum distribution over the years as a rank-and-file employee, while accruing another portion as a self-employed individual or as a proprietary employee.[3]

To avoid undue complexity in these cases the committee bill provides that the five-year averaging available for self-employed persons and proprietary employees is to be used for the entire distribution if the number of years spent by that person while he participated as a self-employed person or proprietary employee exceeds 50 percent of the total time he was a participant in the plan. If not, the 15-year averaging rule is to apply.

In the 15-year averaging computation, a minimum distribution allowance is to be allowed to reduce the amount of the distribution subject to tax. In this computation, the amount of the taxable distribution (the total distribution less the distributee's basis) is to be reduced by the minimum distribution allowance before the tax is computed. The minimum distribution allowance is one-half of the first $20,000 of the distribution. This allowance is to be phased out at the rate of $1 for every $5 by which the distribution exceeds $20,000. Thus, the entire allowance would be eliminated for distributions of $70,000 or more.

It was recognized that a tax avoidance possibility would exist if a taxpayer were able to apply separate 15-year averaging computations to distributions received in different tax years. For that reason, although it is believed that few will have to use the provision, the bill provides for a 5-year "lookback", under which distributions made during the previous 5 years are included in the 15-year averaging computation for the purpose of determining the tax on the second distribution. When the total tax is determined, the amount of the tax liability on the earlier distribution or distributions is subtracted, and the remainder is the tax on the second distribution.

All distributions made within the previous 5 years to the same distributee, whether or not with respect to the same plan and whether or not with respect to the same participant, are to be subject to this 5-year lookback.[4]

Earlier distributions (or purchases of annuities) for the spouse of the distributee are not to be included under the lookback rule. Each spouse is to have his or her distributions taxed under a separate computation.

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[2] Distributees, in computing the tax on their other income (including the capital gain element of the distribution) may use any appropriate tax schedule. They are not restricted to the schedule for unmarried individuals. They may also use, when appropriate, the regular five-year averaging method for the tax on their other income (including the capital gains portion of the distribution). The regular five-year averaging rule is provided under present law for cases in which taxable income in any taxable year increases markedly from taxable income in prior years.

[3] In general terms, a proprietary employee is an employee with a two percent ownership interest in a business having a plan in which the accrued benefits of such proprietary employees have an aggregate total exceeding 25 percent of the accrued benefits from employer contributions.

[4] A lump-sum distribution is made a reportable event, under the bill, in the provisions for plan termination insurance (As a result, under appropriate circumstances, the plan might be terminated.) For purposes of providing a time limit to the lookback rule, the five years is determined from the time the distribution is reported to the insurance corporation.

The computation is to take into account any annuity purchased for the plan participant in the year of distribution or in the previous five years. For purposes of the computation, the amount included with the taxable portion of the distribution is the cash surrender value of the annuity. The value of the annuity is to be added to the value of the other property distributed and a tax is calculated on the sum. From that is to be subtracted the tax calculated on the value of the annuity alone (using the minimum distribution allowance applicable to the total). The remainder is to be used in calculating the tax on the taxable (nonannuity) portion of the distribution. No changes are made with respect to the treatment of distributions of employer securities, as such.

Examples of tax computations involving lump-sum distributions.—The tax computations involved in lump-sum distributions can be shown by the following two examples, the first involving a distribution in 1975 and the second a distribution in 1976 which also involves the lookback provision.

First example.—On December 31, 1975, A (who was not self-employed or a proprietary employee) retires and receives a lump-sum distribution of $50,000 from a qualified plan. A has been participating in the plan since January 1, 1966. The plan is noncontributory. A is married; both A and his wife are over 65. Their only other income is A's salary of $15,000 and his salary from a second job ($5,000). Their itemized deductions are $3,000. Their avearge base period income for the preceding four years (1971 through 1974) is $14,000.

The tax on the portion of the distribution which is not treated as a long-term capital gain is computed as follows:

Net distribution		$50,000
Less: minimum distribution allowance: 50 percent of first $20,000	10,000	
Reduced by: 20 percent of net distribution in excess of $20,000	6,000	
		4,000
Distribution less allowance		46,000

The tax on 1/15th of the distribution less allowance computed from the tax rate schedule for single taxpayers is $512.67.

Multiply this amount by 15: $7,690.05.

Then, multiply by the fraction,

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}} = \frac{2}{10} = 0.2$$

which yields $1,538.01.

Thus, the tax on the ordinary income portion of the distribution is $1,538.01.

The amount of the distribution taxed as a long-term capital gain is the amount of the net distribution multiplied by the fraction,

$$\frac{\text{Years of participation before 1974}}{\text{Total years of participation}} = \frac{8}{10} = 0.8$$

Net distribution	50,000
Capital gains element	40,000

The capital gains element is taxed along with other income (exclusive of the ordinary income element) in the normal way. The tax on the taxable income of $34,000 ($15,000 salary from first job, plus $5,000 from second job, plus $40,000 capital gains element of lump-sum distribution, less $20,000 capital gains exclusion, less $3,000 itemized deductions, less four times $750 personal exemptions) is calculated using the tax rate schedule for married taxpayers filing joint returns. In this case the alternative tax on capital gains is not available, but the regular five-year income averaging provisions are.

Ordinary tax	$9,500.00
Tax—Using regular income averaging	[1] 8,348.00

[1] As indicated above, average base period income is $14,000.

Selecting the tax computation method which yields the smallest amount of tax, A uses the regular 5-year income averaging method and has a tax of $8,348.00.

Finally A combines the tax on the capital gains portion of the distribution and his salary, with the tax on the ordinary income portion of the distribution:

Tax on salary and capital gains portion of distribution	$8,348.00
Tax on ordinary income portion of distribution	1,538.01
Total 1975 income tax	9,886.01

Second example.—On December 31, 1976, A retires from his second job and receives from that employer a nontransferable annuity contract, the cash value of which is $6,000, and a lump sum distribution of $4,000 financed solely by the employer. A had participated in the plan since January 1, 1967. Mr. and Mrs. A's only other income is A's salary of $5,000 and interest of $3,000 on the prior lump sum distribution of $50,000. They have itemized deductions of $2,100. Mr. and Mrs. A's 1976 tax is computed as follows:

First, compute the tax on the portion of the distribution which is not treated as a long-term capital gain and which is taxed separately.

Step 1:

1976 cash distribution		$4,000
1976 annuity contract		6,000
Prior year distribution		50,000
		60,000
Less: Minimum distribution allowance: 50 percent of first $20,000	$10,000	
Reduced by: 20 percent of net distribution in excess of $20,000	$8,000	
		2,000
		58,000

Fifteen times the tax on one-fifteenth of $58,000 (from the rate schedule for single taxpayers) is $9,970.05.

Step 2:

1976 annuity	$6,000
Minimum distribution allowance from step No. 1	2,000
	4,000

Fifteen times the tax on one-fifteenth of $4,000 is $559.95.

Step 3:

$9,970.05 − $559.95 = $9,410.10

Step 4:

Determine ordinary income and capital gains elements of A's distribution and his prior year distribution. The ordinary income element of A's latest distribution is determined by multiplying $4,000 by:

$$\frac{\text{Years of participation in plan after 1973}}{\text{Total years of participation}} = \frac{3}{10} = 0.3$$

Thus, A's ordinary income element is $1,200. $10,000 of Mr. A's prior distribution of $50,000 was ordinary income.

Thus, the tax on the ordinary income element is the fraction of the tax from Step 3 which the ordinary income elements of the 1976 and prior year distributions bear to the entire distributions.

$$\frac{(\$1{,}200+\$10{,}000)}{(\$4{,}000+\$50{,}000)} \times \$9{,}410.10 = \$1{,}951.72$$

Step 5:

The tax on the ordinary income element of A's 1975 distribution from their 1975 income tax return was $1,538.01. Subtracting that from the tax calculated in Step 4 yields the tax on the ordinary income element of A's latest distribution:

$1,951.72 − $1,538.01 = $413.71

Second, compute the tax on all other income, including the capital gains portion of the distribution.

Step 6:

In Step 4, the ordinary income element of the distribution was calculated as $1,200. Therefore, the long-term capital gains element is:

$4,000.00 − $1,200.00 = $2,800.00

Step 7:

The capital gains element is taxed along with other income in the ordinary manner.

Capital gains element	$2,800
Less: 50% of net long-term capital gain	1,400
	1,400
Salary	5,000
Interest	3,000
Adjusted gross income	9,400
Less: Itemized deductions	2,100
Less: Personal exemptions (4 x $750)	3,000
Taxable income	4,300

The tax on $4,300 from the rate schedule for married taxpayers filing joint returns is $677.00. The A's income does not make them eligible for either the regular five year income averaging or the alternative tax on capital gains.

Third, combine the taxes computed above.

Step 8:

Tax on capital gains portion of distribution and on other income	$677.00
Tax on ordinary income portion of distribution	413.71
Total 1976 income tax	1,090.71

Effective date

The effective date of the lump-sum distribution provisions of the bill is January 1, 1974.

This early date was chosen to eliminate at the earliest practical date the problems and confusion that result from attempting to compute tax on lump-sum distributions under current law. As previously stated, current law provides that the pre-1970 value of lump-sum distributions (and a portion of the post-1969 value) is to receive the capital gain treatment.

Revenue effect

The revised tax treatment of lump-sum distributions from qualified plans is expected to result in relatively small increases in revenue over the next few years since the bulk of the lump-sum distributions in these years will be attributable to pre-1974 years. However, after a transition period, this provision is expected to result in annual revenue gains amounting to $35 million a year based on 1973 levels of income.

L. Miscellaneous Provisions

1. *Right to elect a survivor annuity (sec. 261 of the bill and sec. 401 of the Code).*

Under present law, there is no requirement that a qualified retirement plan must offer the option of a survivor annuity. This can result in a hardship where an individual primarily dependent on his pension as a source of retirement income is unable to make adequate provision for his spouse's retirement years, should he predecease her. To correct this situation, the committee provision requires that a joint and survivor annuity be offered as an option with respect to any benefit under a qualified retirement plan which is payable as an annuity. If the option is exercised, and a survivor annuity is elected, the participant's own annuity may be reduced, so that the value of the joint and survivor annuity and the value of the annuity the participant would have been entitled to receive had the option not been exercised are actuarially equivalent.

This provision generally applies to plan years beginning after the date of enactment. However, in the case of a plan in existence on the date of enactment, the provision applies to plan years beginning after December 31, 1975.

2. *5 percent deduction limitation (sec. 706(d) of the bill and sec. 404 (a)(1) of the Code).*

Contributions to a pension plan are deductible under three alternative provisions, the "5 percent" method which allows deductions to be taken for contributions not in excess of 5 percent of the annual compensation of the covered employees (sec. 404(a)(1)(A) of the code), the "level cost" method (sec. 404(a)(1)(B) of the code), and the "normal cost" method (sec. 404(a)(1)(C) of the code).

Unlike the "level cost" method and the "normal cost" method, the 5-percent limitation on contributions is often unrelated to the funding needs of the pension plan, for it frequently is not determined by the level of benefits provided by the plan. Consequently, the 5-percent method has allowed employers to contribute and deduct more than is reasonably needed to fund a pension plan.

The bill repeals the 5-percent deduction limitation (sec. 404(a)(1)(A) of the code). Thus, deductible contributions under a qualified pension plan are to be limited under either the "level cost" or the "normal cost" methods.

3. *Retroactive remedial changes to qualified plans (sec. 706(h) of the bill and sec. 401 of the Code).*

Employers may now retroactively cure defects in employee benefit plans (which do not meet the requirements for tax qualification) by making remedial amendments by the 15th day of the third month after the end of the taxable year of the employer in which a plan is newly established. Retroactive remedial changes however may not be made with respect to plan amendments.

The time allowed for remedial changes may be too short for a plan to be cured to qualify as of the year in which it is established. This occurs because many plans are established at the end of the year and thus only 2½ months are available to cure a plan. Additionally, plan amendments (which may be as significant as newly established plans) may not be retroactively cured. As a result of these limitations, plans may not be qualified, to the detriment of employers and employees.

The committee bill provides that retroactive remedial amendments may be adopted to cure a plan regardless of whether failure occurs on establishing a new plan or because of an amendment of an existing plan. The bill also extends the time to adopt a retroactive remedial amendment to the time (including extensions) for filing the employer's return for the taxable year for which the plan or amendment was put into effect, or to a later time designated by the Service. It is expected that the regulations will provide for extension for reasonable cause, such as the filing of a bona fide request for a determination by the Service that a plan or plan amendment is qualified.

4. *Reporting and publication of returns (sec. 706(i) of the bill and secs. 6040, 6103, and 6104 of the Code).*

In order that many of the new rules governing qualified plans may be enforced, new reporting and publication requirements are needed.

The bill restates present law by requiring employers (or plan administrators) who establish or maintain deferred compensation plans

to file annual information returns. In addition, the bill extends this requirement to individuals who establish individual retirement accounts (described in section 408 of the Code, as added by the bill) and individual bond purchase plans (described in section 409 of the Code, as added by the bill). Also, to enable the Internal Revenue Service to enforce the limits on contributions to individual retirement accounts, the bill requires additional information from persons who pay wages to individuals covered under qualified plans.

The bill makes certain information returns open to inspection by proper officers of the Pension Benefit Guaranty Corporation, in order that the Corporation can properly administer the insurance program. In addition, the bill opens to public inspection applications for a determination that a plan is qualified and that the trust under the plan is exempt, except for plans where the employer has less than 26 employees; annual returns with respect to qualified plans are also open to public inspection. These rules enable plan participants and beneficiaries to easily obtain the full information needed to enforce their plan rights, pursuant to the new rules established in the bill. With respect to plans of smaller employers, this information will be available only to participants and beneficiaries from the employer and the Service; this limitation is established because of the more confidential nature of small business.

The bill establishes a penalty for failure to file annual returns (under sec. 6040 and sec. 6047 of the code); the penalty will be $10 for each day that a return is late, up to a maximum penalty of $5,000 for any one failure to file. However, this penalty will not be owed if failure to file is shown to be due to reasonable cause.

V. EFFECT ON THE REVENUES OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of this bill. The committee estimates that the bill will on balance reduce direct tax revenues by $237 million a year over the long run. This figure includes an estimated $48 million of annual receipts from two new taxes imposed by the bill (the audit fee tax and the tax to finance plan termination insurance). However, deductions taken by employers for their payment of these two new taxes will offset these receipts by $23.4 million a year.

In addition, because it increases employer contributions to qualified plans and hence tax deductions, the minimum vesting standard adopted by the bill involves an estimated annual long-run revenue loss, which could range from $130 million to $265 million, but which is probably closer to $130 million. The minimum funding standards imposed by the bill also result in a modest reduction in revenue as a result of larger tax deductions for contributions to qualified plans.

The administration of the more comprehensive requirements for qualified plans adopted by the bill will add an estimated $13 million a year over the next five years to the present cost of administration of the provisions relating to such plans by the Internal Revenue Service. This additional cost of administration is financed out of the proceeds of the audit fee tax provided by the bill.

The Treasury Department agrees with this statement. Part III of this report contains a more detailed statement of the revenue effect of the bill.

VI. VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with section 133 of the Legislative Reorganization Act, as amended, the following statement is made relative to the vote of the committee on reporting the bill. This bill was ordered favorably reported by the committee without a roll call vote and without objection.

VII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

VIII. ADDITIONAL VIEWS OF MR. HARTKE

Today over 34 million working men and women are subject to great inequities in the private pension system. These inequities cause the intolerable situation in which only one out of ten employees enrolled in pension plans will ever receive benefits. It is fortunate that the Senate Finance Committee has reported out a bill on the private pension system. It is unfortunate that their proposal falls short of a viable and comprehensive reform. The committee is taking steps in the right direction at a time when large strides are necessary.

Over the past 9 years, I have introduced a number of proposals aimed at providing a degree of security for the millions of workers enrolled in pension plans. Beginning with termination insurance legislation and now with the inclusive Federal Pension Plans Protection Act (S. 1858), which I introduced this year. I have been motivated by the conviction that every working man and woman in this country deserves the dignity and security of adequate means of support for his or her retirement years. I am greatly distressed that so many people still consider pensions a form of insurance in which most must lose so that some may gain. The committee proposal seems based on this concept. In rejecting this notion, I maintain that a pension should not be a game of chance.

Some may be satisfied with the committee's minimal proposals on vesting, funding, portability and termination insurance. I am not content. The committee solutions aid only a few, leaving millions who need adequate and secure pension coverage wanting. Let me specifically explain my points of difference with the committee.

I. Administration and Enforcement

A. THE COMMITTEE PROPOSAL

Principle responsibility would be placed in the Treasury Department. The Secretaries of Labor, Treasury and Commerce would be the trustees of the termination insurance program and the voluntary central portability program, and the Secretary of Treasury would be the managing trustee.

B. OBJECTIONS

While I agree that the Treasury Department should be responsible for enforcement of the provisions of the bill, I believe that the Labor Department should be the principle agency for administration. Rather than playing political games over questions of committee jurisdiction, our principle concern should be safeguarding the rights of workers. I do not believe that the principal administration of this bill should be given to an agency whose primary interest is tax collection.

C. THE HARTKE APPROACH

Under my proposal, the Secretary of Labor would administer the vesting standards and termination insurance program. The Treasury Department would administer funding standards and would be responsible for the enforcement of the bill. The Labor Department is charged historically with the protection of workers' rights and collects and analyzes annual information on assets, costs, and actuarial liabilities under the Pension and Welfare Plans Disclosure Act.

II. PARTICIPATION

A. THE COMMITTEE'S PROPOSAL

A qualified pension plan would require, as a condition of eligibility, service of no more than 1 year, or attainment of age 30, whichever occurs later.

B. OBJECTIONS

Most workers begin their jobs in their late teen years or early twenties. A fair and equitable reform should not exclude these early years of service. Age 30 is too late a date for participation because it delays the acquisition of vesting rights.

In many cases the committee's proposal is only slightly more progressive than the administration's vesting standards—the so-called "rule of 50," i.e. a worker gains 50 percent vesting when his age and years of participation equal 50, and 10 percent additional each year thereafter. (See table below under vesting.) Under the committee proposal a worker who started at age 20 would have to work 15 years until age 35 before he attained his full vested rights. The committee proposal would make attainment of full vested rights difficult or impossible for millions of part-time and part-year workers. Examples of these groups of workers excluded by the committee bill are given below under vesting.

C. THE HARTKE APPROACH

Pension benefits should not be considered an exclusive privilege of the fortunate few; rather they should be made a right for all. My reasonable approach provides for a more quickly attainable eligibility; participation would commence after a period of service no longer than 2 years or age 25, whichever occurs later.

III. VESTING

A. THE COMMITTEE'S PROPOSAL

A qualified plan must provide at least 25 percent vesting after 5 years participation, 5 percent additional vesting for each of the next 5 years, and 10 percent each year for the next 5 years thereafter. This formula would provide for at least 25 percent vesting after 5 years participation, 50 percent after 10 years and 100 percent after 15 years.

B. OBJECTIONS

Progressive vesting rights are the heart of pension reform. Weak vesting clauses make for ineffectual and superficial pension legislation. The committee's proposal gives the illusion of reform without the substance. The vesting provisions are extremely weak and inadequate. Such a scheme would discriminate against women, seasonal workers, and workers in mobile or faltering industries. A recent Senate Labor Subcommittee study found that, for plans requiring 10 years participation or less for vesting, 78 percent of those separated did not qualify for benefits. Under these same conditions, the committee proposal would provide 50 percent vesting after 10 years participation for only 22 percent of those who separate. I do not consider such an approach acceptable.

Achieving vested rights for women is also difficult under the committee's proposal. Most women work at a job for shorter periods than men, and often work part-time or part-year. The committee has made no provision for part-time or part-year work. While men in manufacturing have a median of 14.3 years of service, women in their later years, have only 8.3 years of service. And in retailing, women over 45 had an average of 4.9 years. As a result, a woman would achieve only 40 percent of her vested rights. This is not a decent retirement benefit.

A moderately good benefit will give $5 a month for each year of credited service. A normal retirement for a woman would be 8 years of credited service or $40 a month. But the committee's proposal would provide only 40 percent of this or $16 a month—less than $4 a week. And that benefit is subject to erosion by inflation between the time it vests and the time it becomes payable.

Aerospace is an example of a faltering industry in which many plants have shut down and many more will shut down in the future. A recent study found that 80 percent of the employees in this industry had completed fewer than 10 years of service. At the very best, the committee's proposal would provide 50 percent vesting for these workers—too minimal a standard.

With no provision for part-year work, it will be virtually impossible for the seasonal worker to attain vested rights. Many cumulative years of service will add up to nothing in retirement.

The committee vesting proposal would provide for little or no benefits for the majority of workers in this country. It ignores the overwhelming evidence which demonstrates that the weaker the vesting requirements, the less likely it is that the participant will ever receive his needed pension benefits.

C. THE HARTKE APPROACH

I propose that 100 percent vesting be achieved after only 5 years of service. These more progressive rules on vesting will open the way for more frequent job changes, increases in work satisfaction, a more mobile and a more effective labor force. We owe this to the working

men and women of this country. In order to demonstrate graphically the superiority of the Hartke approach, I submit the following table:

VESTING TABLE

Age	Percent vested committee proposal	Percent vested administration proposal	Percent vested Hartke proposal
20	0	0	0
25	0	0	100
30	50	0	100
35	100	0	100
40	100	50	100
45	100	100	100

The table shows what would happen to a worker beginning his job at age 20. Under the committee proposal, this worker would not qualify for participation until the age of 30. After 10 years of work he would be only 50 percent vested. This worker would be 35 before he was fully vested under the committee bill, 45 under the Administration's bill; *but* only *25* under the Hartke proposal.

IV. Funding

A. THE COMMITTEE'S PROPOSAL

The committee agreed to a minimum funding standard which requires the payment of current or normal pension costs and the level payment, or amortization, over a 30 year period of unfunded accrued liabilities, without regard to whether such past service liabilities are vested or unvested. A plan amendment resulting in a 5 percent increase in unfunded past service cost existing at the time of the amendment is to be regarded as a "substantial" increase in unfunded past service costs which may be treated as a new plan and funded over 30 years.

B. OBJECTIONS

Inadequate funding is the primary reason that thousands of workers yearly lose their benefits when a plan terminates. In 1964, when the Studebaker plant in South Bend, Indiana, shut down, over 8,500 employees lost their pensions because there was not enough money to fund them. *The Committee's bill would not have prevented this tragedy.* Studebaker had a 30 year funding schedule. Tragedies like the Studebaker case occur every year and in all parts of the country. Only strong funding requirements will prevent them from occurring.

C. THE HARTKE APPROACH

My proposal would require past service liabilities to be funded over a 25 year period, and substantial increases in liabilities due to amendments would also be funded over 25 years.

V. Termination Insurance

A. THE COMMITTEE'S PROPOSAL

Vested rights of participants would be insured up to a maximum of 50 percent of the average monthly wage over the past 5 years and not to exceed $750 a month. For the first 3 years, the termination insurance would be financed by a 50 cents per capita payment for each participant in the pension plan. After such time, premiums would be set at a level based on cost experience.

B. OBJECTIONS

On the average, 20,000 workers a year are affected by pension failures. The participants hit hardest by these closeouts are those between the ages of 40 and 60. This group is usually paid little or nothing in pension benefits for many years of service.

I am gratified that the Committee's proposal would establish an insurance program to protect these thousands of workers, but I am disappointed that the proposal would provide such inadequate benefits. Fifty percent of expected benefits is simply not an adequate means of support for the average worker. When a worker enrolls in a pension plan he has the right to expect adequate benefits regardless of whether the plan folds, whether his department is phased out, whether his company goes out of business or merges with a larger unit.

C. THE HARTKE APPROACH

My plan would insure vested benefits to a maximum of 80 percent of the highest average wage over a 5 year period or $500 a month, whichever is less. The insurance premium rate would be no higher than 0.5 percent of unfunded liabilities.

VI. Portability

A. THE COMMITTEE'S PROPOSAL

A voluntary central portability fund would be established as a private corporation under the trusteeship of the Secretaries of Labor, Commerce and Treasury, with the Secretary of Treasury being the managing trustee. If the employer and employee both agree, the departing employee could transfer his vested benefits to the fund.

B. OBJECTIONS

Voluntary portability will do very little for the employee. There is little reason to expect that an employer would give away dollars to a departing employee which he could give to a retiring employee who remains with his company. The trusteeship of the fund by three Secretaries causes needless confusion and duplication of effort. It is

much simpler and more reasonable that the Secretary of Labor alone be the managing trustee of the fund.

C. THE HARTKE APPROACH

I will propose the establishment of a compulsory portability fund into which an employee's vested benefits would automatically be transferred. The employer would have a maximum of 5 years to pay these vested benefits into the portability fund.

The private sector should be given an initial opportunity of at least 18 months to develop plans for the organization of a portability fund. If they fail to act, the Secretary of Labor would establish the plans for portability funds. I strongly believe that these efforts should be made to keep pension monies within the private sector.

The central portability fund should also have the option of offering basic plans of pension coverage to companies that do not have any. Such plans would be limited to employers with 300 employees or less. This service would be particularly beneficial to smaller companies who cannot afford the high costs of establishing and operating pension programs. We must make a strong effort to expand the private pension industry to cover the millions of Americans not presently enrolled.

VII. Conclusion

These are among the changes to the committee's proposal which I propose to bring real reform to the private pension system in this Nation. I emphasize that we should not accept any illusions of reform but rather we should have the courage to help the 34 million working men and women who are enrolled in pension plans. When the Senate begins debate on pension reform, I intend to initiate a full discussion of the issues which I have raised in this statement.

VANCE HARTKE.

IX. SUPPLEMENTAL VIEWS OF MR. CURTIS

This legislation is important to our private pension programs in the United States. It carries many provisions which I advocate and endorse. I am especially interested in the provisions which make it possible for an individual not covered by a company pension or an H.R. 10 pension to set aside for his own retirement and have the tax advantages that other plans have. This is a matter that I have worked for for many years.

In general, I would have preferred to have had the enactment of my own bill, S. 1631, which was supported by the Administration. The provisions of that bill are more acceptable in several respects including the issue of professional corporations.

CARL T. CURTIS.